

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-58665; File No. SR-ISE-2008-21)

September 26, 2008

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of Proposed Rule Change as Modified by Amendment No. 1 Relating to an Exchange Member's Conduct of Doing Business with the Public

I. Introduction

On March 27, 2008, the International Securities Exchange, LLC ("ISE" or the "Exchange"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> filed with the Securities and Exchange Commission (the "Commission") the proposed rule change relating to the Exchange's rules governing doing business with the public. On July 9, 2008, the Commission issued a release noticing the proposed rule change, which was published for comment in the Federal Register on July 16, 2008.<sup>3</sup> The comment period expired on August 6, 2008. The Commission did not receive any comment letters in response to the proposed rule change. On May 13, 2008, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>4</sup> This order provides notice of the proposed rule change, as modified by Amendment No. 1, and approves the proposed rule change as amended on an accelerated basis.

II. Description

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 58129 (July 9, 2008), 73 FR 40895 (July 16, 2008) ("Initial Notice").

<sup>4</sup> The Initial Notice did not provide notice of Amendment No. 1. Amendment No. 1 made minor changes to the initial filing consisting of adding clarifying text and fixing typographical and similar errors.

The Exchange proposes to amend certain Exchange rules that govern an Exchange member's conduct of doing business with the public. Specifically, the proposed rule change would require members to integrate the responsibility for supervision of their public customer options business into their overall supervisory and compliance programs. In addition, the proposal would require members to strengthen their supervisory procedures and internal controls as related to their public customer options business.

A. Integration of Options Supervision

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B and C below, of the most significant aspects of such statements.

The purpose of the proposed rule change is to create a supervisory structure for options that is similar to that required by New York Stock Exchange, Inc. ("NYSE") Rule 342 and National Association of Securities Dealers, Inc. ("NASD") Rule 3010. The proposed rule change would also conform ISE rules to those of the Chicago Board Options Exchange ("CBOE") which has recently eliminated the requirement that members qualified to do a public customer business in options must designate a single person to act as a Senior Registered Options Principal ("SROP") for the member and that each such member designate a specific individual as a Compliance Registered Options

Principal (“CROP”).<sup>5</sup> Instead, the rule requires members to integrate the SROP and CROP functions into their overall supervisory and compliance programs.

The SROP concept was first introduced during the early years of development of the listed options market. Previously, members were required to designate one or more persons qualified as Registered Options Principals (“ROPs”) to have supervisory responsibilities with respect to the firms’ options business. As the number of ROPs at larger firms began to increase, an additional requirement was imposed that firms designate one of their ROPs as the SROP. This was intended to eliminate confusion as to where the compliance and supervisory responsibilities lay by centralizing in a single supervisory officer overall responsibility for the supervision of a firm’s options activities.<sup>6</sup> Subsequently, following the recommendation of the Commission, the options exchanges required firms to designate a CROP to be responsible for each firm’s overall compliance program with respect to its options activities.<sup>7</sup> The CROP could be the same person designated as a SROP.

Since the SROP and CROP requirements were first imposed, the supervisory function with respect to options activities of most securities firms has been integrated into the matrix of supervisory and compliance functions in respect of the firms’ other securities activities. This not only reflects the maturity of the options market, but also recognizes the ways in which the uses of options themselves have become more integrated with other securities in the implementation of particular strategies. By

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<sup>5</sup> See Securities and Exchange Act Release No. 56492 (September 21, 2007), 72 FR 54952 (September 27, 2007) (SR-CBOE-2007-106).

<sup>6</sup> Securities and Exchange Commission, 96th Cong., 1st Sess., Report of the Special Study of the Options Markets (Comm. Print 1978) 316 fn. 11.

<sup>7</sup> Id. at p. 335.

permitting supervision of a firm's options activities to be handled in the same manner as the supervision of its securities and futures activities, the proposed rule change would ensure that supervisory responsibility over each segment of a firm's business is assigned to the best qualified persons in the firm, thereby enhancing the overall quality of supervision and compliance.

The proposed rule change would allow firms the flexibility to assign such supervisory and compliance responsibilities, which formerly resided with the SROP and/or CROP, to more than one individual. For example, the proposed rule change would permit a member firm to designate certain ROPs to be responsible for a variety of supervisory compliance functions such as approving acceptance of discretionary accounts,<sup>8</sup> approval of communications to customers,<sup>9</sup> and exceptions to a member firm's suitability standards for trading uncovered short options.<sup>10</sup> A firm would be likely to do this in instances where the firm believes it advantageous to do so to enhance its supervisory or compliance structure. Typically, a firm may also wish to divide these functions on the basis of geographic region or functional considerations. Rule 601 would be amended to clarify the qualification requirements of individuals designated as ROPs.<sup>11</sup> Rule 602 would be amended to specify the registration requirements of individuals who accept orders from non-broker-dealer customers.<sup>12</sup>

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<sup>8</sup> See Proposed Rule 611.

<sup>9</sup> See Proposed Rule 601(e).

<sup>10</sup> See Proposed Rule 608(f)(3).

<sup>11</sup> See Proposed Rules 601(d) and 601(e).

<sup>12</sup> See Proposed Rule 602(d).

The proposed rule change would call for options discretionary accounts, the acceptance of which must be approved by a ROP qualified individual (other than the ROP who accepted the account), to be supervised in the same manner as the supervision of other securities accounts that are handled on a discretionary basis. The proposed rule change would eliminate the requirement that discretionary options orders be approved on the day of entry by a ROP (with one exception as discussed below). This requirement predates the Special Study and is not consistent with the use of supervisory tools in computerized format or exception reports generated after the close of a trading day. No similar requirement exists for supervision of other securities accounts that are handled on a discretionary basis.<sup>13</sup> Discretionary orders would be reviewed in accordance with a firm's written supervisory procedures. The Exchange believes the proposed rule change would ensure that supervisory responsibilities are assigned to specific ROP-qualified individuals, thereby enhancing the quality of supervision.

Exchange Rule 611 would be revised by adding the requirement that any member that does not utilize computerized surveillance tools for the frequent and appropriate review of discretionary account activity must establish and implement procedures to require ROP-qualified individuals who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered. The Exchange believes that any firm that does not utilize computerized surveillance tools to monitor discretionary account activity should continue to be required to perform the daily manual review of discretionary orders.

Under the proposed rule change, firms would continue to be required to designate ROP-qualified individuals to provide frequent appropriate supervisory review of options

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<sup>13</sup> See, e.g., NYSE Rule 408.

discretionary accounts. This review includes the requirement that these ROP-qualified individuals review the accounts in order to determine whether the ROP accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the proposed strategies or transactions. This requirement provides an additional level of supervisory audit over options discretionary accounts that does not exist for other securities discretionary accounts.

In addition, Proposed Rule 609(g) would require that each member submit to the Exchange a written report by April 1 of each year that details the member's supervision and compliance effort, including its options compliance program, during the preceding year and reports on the adequacy of the member's ongoing compliance processes and procedures.<sup>14</sup>

Proposed Rule 609(h) would require that each member submit, by April 1 of each year, a copy of the Rule 609(g) annual report to one or more of its control persons or, if the member has no control person, to the audit committee of its board of directors or its equivalent committee or group.<sup>15</sup> Further, the proposed rule would provide that a member that specifically includes its options compliance program in a report that complies with substantially similar NYSE and NASD rules would be deemed to have satisfied the requirements of Rules 609(g) and 609(h).

Members would be required to designate a single general partner or executive officer to assume overall authority and responsibility for internal supervision, control of the organization and compliance with securities laws and regulations.<sup>16</sup> Members would

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<sup>14</sup> See Proposed Rule 609(g), which is modeled after NYSE Rule 342.20.

<sup>15</sup> See Proposed Rule 609(h), which is modeled after NYSE Rule 354.

<sup>16</sup> See Proposed Rule 609(a).

also be required to designate specific qualified individuals as having supervisory or compliance responsibilities over each aspect of the firm's options activities and to set forth the names and titles of these individuals in their written supervisory procedures.<sup>17</sup>

B. Supervisory Procedures and Internal Controls.

The Exchange is also proposing to amend certain rules to strengthen members' supervisory procedures and internal controls relating to a member's public customer options business. The proposed rule changes discussed below are modeled after NYSE and NASD rules approved by the Commission in 2004.<sup>18</sup> The Exchange believes its proposal to strengthen member supervisory procedures and internal controls is appropriate and consistent with the proposal discussed above to integrate the responsibility for supervision of a member firm's public customer options business into its overall supervisory and compliance program.

The Exchange is proposing to revise Rule 609(a) to require members to develop and implement written policies and procedures reasonably designed to supervise sales managers and other supervisory personnel who service customer options accounts.<sup>19</sup> This requirement would apply to branch office managers, sales managers, regional/district sales managers, or any person performing a similar supervisory function. Such policies and procedures are expected to encompass all options sales-related activities. Proposed Rule 609(a)(3)(i) would require that supervisory reviews of producing sales managers be conducted by a qualified ROP who is either senior to, or

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<sup>17</sup> See Proposed Rule 609(i).

<sup>18</sup> See Securities Exchange Act Release Nos. 49882 (June 17, 2004), 69 FR 35108 (June 23, 2004) (SR-NYSE-2002-36) (approval order), 49883 (June 17, 2004), 69 FR 35092 (June 23, 2004) (SR-NASD-2002-162).

<sup>19</sup> Proposed Rule 609(a) is modeled after NYSE Rule 342.19.

otherwise “independent of,” the producing manager under review. This provision is intended to ensure that all options sales activity of a producing manager is monitored for compliance with applicable regulatory requirements by persons who do not have a personal interest in such activity.

Proposed Rule 609(a)(3)(ii) would provide an exception for firms so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the review. In this case, the review would be conducted by a qualified ROP to the extent practicable. Under proposed Rule 609(a)(3)(iii), a member relying on the limited size and resources exception must document the factors used to determine that compliance with each of the “senior” or “otherwise independent” standards of proposed Rule 609(a)(3)(i) is not possible, and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of proposed Rule 609(a)(3)(i) to the extent practicable.<sup>20</sup>

Proposed Rule 609(c)(1) would require members to develop and maintain adequate controls over each of their business activities. The proposed rule would further require that such controls include the establishment of procedures to independently verify and test the supervisory systems and procedures for those business activities. A member would be required to include in the annual report, prepared pursuant to proposed Rule 609(g), a review of the member’s efforts in this regard, including a summary of the tests conducted and significant exceptions identified. The Exchange believes proposed Rule

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<sup>20</sup> Proposed Rule 609(a)(3)(iv) would provide that a member organization that complies with the NYSE or NASD rules that are substantially similar to the requirements in Rules 609(a)(3)(i), (a)(3)(ii) and (a)(3)(iii) will be deemed to have met such requirements.



609(c)(1) would enhance the overall quality of each member organization's supervision and compliance function.<sup>21</sup>

Proposed Rule 609(d) would establish requirements for branch office inspections similar to the requirements of NYSE Rule 342.24. Specifically Rule 609(d) would require a member to inspect, at least annually, each supervisory branch office and inspect each non-supervisory branch office at least once every three years.<sup>22</sup> The proposed rule would further require persons who conduct a firm's annual branch office inspection to be independent of the direct supervision or control of the branch office (i.e., not the branch office manager, or any person who directly or indirectly reports to such manager, or any person to whom such manager directly reports). The Exchange believes that requiring branch office inspections to be conducted by someone who has no significant financial interest in the success of a branch office should lead to more objective and vigorous inspections.

Under proposed Rule 609(e), any firm seeking an exemption, pursuant to Rule 609(d)(1)(ii), from the annual branch office inspection requirement would be required to submit to the Exchange written policies and procedures for systematic risk-based surveillance of its branch offices, as defined in Rule 609(e). Proposed Rule 609(f) would require the annual branch office inspection programs to include, at a minimum, testing and verification of specified internal controls.<sup>23</sup> Proposed Rule 609(d)(3) would provide

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<sup>21</sup> Proposed Rule 609(c)(i) is modeled after NYSE Rule 342.23. Paragraph (c)(ii) of proposed Rule 609 would provide that a member organization that complies with NYSE or NASD rules that are substantially similar to the requirements in paragraph (c)(i) of proposed Rule 609 will be deemed to have met such requirements.

<sup>22</sup> Proposed Rules 609(d)(1)(i) and (ii) would provide members with two exceptions from the annual supervisory branch office inspection requirement.

<sup>23</sup> Proposed Rules 609(e) and (f) are modeled after NYSE Rules 342.25 and 342.26.

that a member that complies with the requirements of NASD or the NYSE that are substantially similar to the requirements of Rules 609(d), (e) and (f) would be deemed to have met such requirements. The Exchange is also proposing to amend Rule 609 to define “branch office” in a way that is substantially similar to the definition of branch office in NYSE Rule 342.10.

Proposed Rule 609(g)(4) would require a firm to designate a Chief Compliance Officer (CCO). Proposed Rule 609(g)(5) would require each firm’s Chief Executive Officer (CEO), or equivalent, to certify annually that the member organization has in place processes to: (1) establish and maintain policies and procedures reasonably designed to achieve compliance with applicable Exchange rules and federal securities laws and regulations, (2) modify such policies and procedures as business, regulatory, and legislative changes and events dictate, and (3) test the effectiveness of such policies and procedures on a regular basis, the timing of which is reasonable designed to ensure continuing compliance with Exchange rules and federal securities laws and regulations.

Proposed Rule 609(g)(5) would also require the CEO to attest (1) that the CEO has conducted one or more meetings with the CCO in the preceding 12 months to discuss the compliance processes in proposed Rule 609(g)(5)(i), (2) that the CEO has consulted with the CCO and other officers to the extent necessary to attest to the statements in the certification, and (3) that the compliance processes are evidenced in a report, reviewed by the CEO, CCO and such other officers as the member firm deems necessary to make the certification, that is provided to the member firm’s board of directors and audit committee (if such committee exists).<sup>24</sup>

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<sup>24</sup> Proposed Rule 609(g)(5) is modeled after NASD Rule 3013 and NYSE Rule 342.30(e).

Under proposed Rule 609(b)(2), a member, upon a customer's written instructions, may hold mail for a customer who will not be at his or her usual address for no longer than two months if the customer is on vacation or traveling, or three months if the customer is going abroad. This provision would help ensure that members that hold mail for customers who are away from their usual addresses do so only pursuant to the customer's written instructions and for a specified, relatively short period of time.<sup>25</sup>

Proposed Rule 609(b)(3) would require that, before a customer options order is executed, the account name or designation must be placed upon the memorandum for each transaction. In addition, only a qualified ROP would be permitted to approve any changes in account names or designations. The ROP would be required to document the essential facts relied upon in approving the changes and maintain the record in an easily accessible place. A member would be required to preserve any documentation that provides for an account designation change for a period of not less than three years, with the documentation preserved for the first two years in an easily accessible place, as the term "easily accessible place" is used in Rule 17a-4 of the Act. The Exchange believes the proposed rule would help to protect account name and designation information from possible fraudulent activity.<sup>26</sup>

Proposed Rule 611(d) would allow a member to exercise time and price discretion on orders for the purchase or sale of a definite number of options contracts in a specified security. The Exchange proposes to limit the duration of this discretionary authority to the day it is granted, absent written authorization to the contrary. In addition, the proposed rule would require any exercise of time and price discretion to be reflected on

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<sup>25</sup> Proposed Rule 609(b)(2) is modeled after NASD Rule 3110(i).

<sup>26</sup> Proposed Rule 609(b)(3) is modeled after NASD Rule 3110(j).

the customer order ticket. The proposed one-day limitation would not apply to time and price discretion exercised for orders effected with or for an institutional account (as defined in the Rule) pursuant to valid Good-Till-Cancelled instructions issued on a “not held” basis. The Exchange believes that investors would receive greater protection by clarifying the time such discretionary orders remain pending.<sup>27</sup>

The Exchange believes the proposed rule changes recognize that options have become more integrated with other securities in the implementation of particular strategies, and thus should not continue to be regulated as though they are a new and experimental product. The Exchange further asserts that the supervisory and compliance structure in place for non-options products at most firms is not materially different from the structure in place for options. The proposed rule change would also conform ISE rules to those of the CBOE. Accordingly, the Exchange submits that the proposed rule changes are appropriate and would not materially alter the supervisory operations of member firms.

### III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder.<sup>28</sup> In particular, the Commission finds the proposal to be consistent with the objectives of Section 6(b)(5) of the Act,<sup>29</sup> in that it is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, and in general, to

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<sup>27</sup> Proposed Rule 611(d) is modeled after NASD Rule 2510(d)(1).

<sup>28</sup> In approving this rule change, as amended, the Commission notes that it has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>29</sup> 15 U.S.C. 78f(b)(5).

protect investors and the public interest. The Commission believes the proposed rule change would integrate the supervision and compliance functions relating to member organizations' public customer options activities into the overall supervisory structure of a member organization, thereby eliminating any uncertainty over where supervisory responsibility lies. In addition, the proposed rule change would foster the strengthening of members' and member organizations' internal controls and supervisory systems.

The Commission also finds good cause for approving the proposed rule change, as modified by Amendment No.1, prior to the thirtieth day after the date of publication of notice of filing of the amendment in the Federal Register.<sup>30</sup> The Commission believes that Amendment No. 1 should reduce ambiguity by providing clarifying changes and fixing typographical and similar errors. Amendment No. 1 does not contain any major modifications that would alter the scope of the proposed rule change as published in the Federal Register. The Commission believes that approving the proposed rule change, as modified by Amendment No. 1, will simplify compliance, and is consistent with the public interest and the investor protection goals of the Act. Finally, the Commission finds that it is in the public interest to approve the proposed rule change as modified as soon as possible to expedite its implementation. Accordingly, the Commission believes good cause exists, consistent with Section 19(b)(2) of the Act<sup>31</sup> to approve the proposed rule, as modified by Amendment No. 1 on an accelerated basis.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1, including whether Amendment No. 1 is consistent with the Act. Comments may be submitted by any of the following methods:

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<sup>30</sup> See supra footnotes 3 and 4.

<sup>31</sup> 15 U.S.C. 78s(b)(2).

Electronic comments:

- Use the Commission's Internet comment form <http://www.sec.gov/rules/sro.shtml>); or
- Send an E-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. SR-ISE-2008-21 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-ISE-2008-21. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commissions Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the ISE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available

publicly. All submissions should refer to File Number SR-ISE-2008-21 and should be submitted by [insert date 21 days from the date of publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>32</sup> that the proposed rule change (SR-ISE-2008-21), as amended by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>33</sup>

Florence E. Harmon  
Acting Secretary

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<sup>32</sup> 15 U.S.C. 78s(b)(2).

<sup>33</sup> 17 CFR 200.30-3(a)(12).