

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54340; File No. SR-ISE-2006-40)

August 21, 2006

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to the Establishment of the Second Market

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 5, 2006, the International Securities Exchange, Inc. (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the ISE. On August 16, 2006, ISE filed Amendment No. 1 to the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The ISE is proposing to adopt Second Market rules for the listing and trading of low-volume options classes. The text of the proposed rule change, as amended, is available on the ISE’s Web site (<http://www.iseoptions.com>), at the principal office of the ISE, and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the ISE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaces and supersedes the original filing in its entirety.

rule change. The text of these statements may be examined at the places specified in Item IV below. The ISE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The ISE currently trades options on approximately 900 equity securities that qualify for options trading pursuant to the listing standards contained in ISE Rule 502. The listing standards for underlying securities are uniform across all of the options exchanges, and there are many additional underlying equity securities that qualify for options trading under these standards which the ISE does not currently list for trading, but are traded on one or more of the other options exchanges. In general, the Exchange has chosen not to list and trade these options classes based on the low average daily trading volume ("ADV") they have on the other options exchanges. The purpose of this proposal is to adopt rules for the listing and trading of these low-volume options classes that qualify for listing under ISE Rule 502 in a "Second Market." Establishing the Second Market would allow the Exchange to provide an opportunity for additional members to provide liquidity as market makers, and to apply a modified fee structure to this segment of the options market.

Under the proposal, the Exchange would initially list eligible equity options classes (excluding options on exchange traded funds) that trade on another options exchange and that have an ADV below 500 contracts over a six-month period in the Second Market and those with an ADV of over 1500 contracts in the existing market (the "First Market"). The proposed rules allow the Exchange to list such options classes with an ADV between 500 and 1500 contracts initially in either market, which is necessary to take into account other factors to ensure that

options classes are placed in the appropriate market (e.g., whether the volume trend over the six-month period is up or down, or whether the underlying security is going to be or has been part of a corporate action). Starting one year after the Second Market initiates trading,⁴ the Exchange would review the market in which options classes are listed every three months, and options classes would be moved from the First to the Second Market when their ADV in the prior six-month period falls below 300 contracts,⁵ and moved from the Second to the First Market when their ADV in the prior six-month period exceeds 750 contracts.

Under the proposal, all members approved to operate ISE market maker memberships would be eligible to be Competitive Market Makers in the Second Market. In addition, members that are only approved as Electronic Access Members may also register as Competitive Market Makers in the Second Market,⁶ but would pay a \$0.10 transaction surcharge over those market makers that own or lease ISE market maker memberships. The Exchange believes that providing greater access to make markets in the Second Market would help it attract additional liquidity for

⁴ Initially, the Exchange intends to add options classes to the Second Market over several months. The Exchange believes it is important to provide participants in the Second Market a period of continuity in Second Market products before moving options between the First Market and Second Market. Therefore, if for example, the Exchange were to initiate trading in September 2006, it would not conduct the first review to move options classes from the First Market to the Second Market, and vice versa, until September 2007. The first review would look at the industry ADV of each options class over the previous 6 months. Three months later, the Exchange would again review the industry ADV of each options class over the previous 6 months, and repeat this same review every three months thereafter.

⁵ Such options classes would remain in the Second Market for at least twelve (12) months before being returned to the First Market.

⁶ Under proposed ISE Rule 902, members that are only Electronic Access Members that want to become Competitive Market Makers in the Second Market would be required to complete the same market maker application and meet the same standards that are applied to Competitive Market Makers under the Exchange's existing rules. Members that are only Electronic Access Members are not eligible to be Primary Market Makers in the Second Market.

these low-volume options classes from firms that do not currently participate on the ISE as market makers, while assuring that such market makers do not have an inappropriate cost advantage over market makers that have purchased or leased ISE market maker memberships. Only Primary Market Makers in the First Market may be Primary Market Makers in the Second Market. All market makers would pay the same \$2,000 monthly access fee for the right to quote in the Second Market.

Market making requirements in the Second Market would be mostly the same as those currently applied in the First Market. As in the First Market, a Primary Market Maker would be appointed for each class traded in the Second Market (“SMPMMs”). SMPMMs would have all of the same obligations in their appointed options as Primary Market Makers in the First Market, including, among other things, entering continuous quotations in all of the series of all of the options classes to which they are appointed and satisfying requirements related to the Plan for Creating and Operating an Intermarket Option Linkage. Competitive Market Makers in the Second Market (“SMCMMs”) would be considered “appointed” to all of the options classes listed in the Second Market and, among other things, must continuously quote all of the series of any options class in which they choose to make markets.⁷ An SMCMM would be able to choose

⁷ In the First Market, Competitive Market Makers are appointed to a group of options, but are only required to enter continuous quotes in a minimum number of those appointed options pursuant to ISE Rule 804(e)(2). Similarly in the Second Market, SMCMMs would be considered appointed to all of the Second Market options, but would not be required to enter continuous quotations in a minimum number of Second Market options classes. Therefore, in both the First and the Second Markets, there may be options classes to which a Competitive Market Maker is appointed for which it is not making markets. Other ISE rules regarding obligations and requirements related to market maker quotations in appointed options, such as ISE Rule 803(b), currently are (and would be) applicable only when a Competitive Market Maker is quoting in an appointed option and do not create an obligation for Competitive Market Makers to continuously quote all appointed options classes. Other than the minimum quotation requirement for Competitive Market Makers in the First Market, the rules applicable to Competitive Market Makers in the First Market and the Second Market for options classes in which

whether to make markets in one or more Second Market options classes on a daily basis. SMCMMs would be permitted to quote in all of the options classes listed in the Second Market, but would not be required to quote a minimum number of Second Market options. Accordingly, SMCMMs would be able to choose to make markets in as many or as few options classes as they wish. Finally, SMPMMs and SMCMMs would be permitted to execute a limited percentage of their volume in Second Market options in which they are not currently making markets.⁸

The Exchange proposes several changes to its fee schedule for the Second Market as follows: (1) members would be charged an execution fee of \$.05 per contract for public customer orders; (2) a \$.10 per contract surcharge would be applied to transactions executed by market makers that do not own or lease an ISE market maker membership (i.e., Electronic Access Members that make markets in the Second Market); (3) Second Market options would be excluded from the payment for order flow fee; (4) market makers would be charged a \$2,000 per month access fee (there would be no additional access fee for Electronic Access Members to send orders to the Second Market); and (5) firms that are only market makers in the Second

they are appointed would be the same. Because SMCMMs would be appointed to all options classes in the Second Market, the rules applicable to Competitive Market Makers in the First Market in options classes to which they are not appointed would not apply to SMCMMs (i.e., ISE Rule 805(b)).

⁸ As explained in note 7 above, ISE Rule 805(b) regarding options classes in which a Competitive Market Maker in the First Market is not appointed would not apply to SMCMMs. The Rule permits such Competitive Market Makers to enter orders in options classes to which they are not appointed, limited to 25% of their total volume. Since SMCMMs would be considered appointed to all of the options classes in the Second Market, the Exchange proposes to adopt a parallel rule to ISE Rule 805(b) for SMCMMs that allows them to enter orders in options classes in which they are not currently making markets (as opposed to in which they are not appointed), limited to 25% of their total volume. The proposed rule specifies that SMCMMs may only enter orders in options classes that they are not quoting when the SMCMMs are making markets in at least one options class. If a SMCMM chooses not to make markets in any Second Market options classes on a particular day, it would not be permitted to enter any orders in Second Market options.

Market (i.e., Electronic Access Members that make markets in the Second Market) would be charged the same \$5,000 annual regulatory fee paid by Competitive Market Makers in the First Market.

2. Statutory Basis

The Exchange believes that the basis under the Act for this proposed rule change is the requirement under Section 6(b)(4)⁹ that an exchange have an equitable allocation of reasonable dues, fees and other charges among its members and other persons using its facilities, and the requirement under Section 6(b)(5)¹⁰ that an exchange have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, the proposal is designed to attract liquidity in low-volume options classes by providing for open access to market makers.

B. Self-Regulatory Organization's Statement on Burden on Competition

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any written comments from members or other interested parties.

⁹ 15 U.S.C. 78f(b)(4).

¹⁰ 15 U.S.C. 78f(b)(5).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

- (a) by order approve such proposed rule change, as amended, or
- (b) institute proceedings to determine whether the proposed rule change, as amended,

should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the amended proposed rule change is consistent with the Act.

Comments may be submitted by any of the following methods:

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. Please include File No. SR-ISE-2006-40 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-ISE-2006-40. 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 Commission's 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. 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-2006-40 and should be submitted on or before [insert date 21 days from the date of publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹¹

Nancy M. Morris
Secretary

¹¹ 17 CFR 200.30-3(a)(12).