

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54580; File No. SR-ISE-2006-40)

October 6, 2006

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

I. Introduction

On July 5, 2006, the International Securities Exchange, LLC (f/k/a the International Securities Exchange, Inc.) (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposal to establish a “Second Market” for the listing and trading of low-volume option classes. On August 16, 2006, ISE filed Amendment No. 1 to the proposed rule change.³ The proposed rule change, as amended, was published for comment in the Federal Register on August 29, 2006.⁴ The Commission received no comments regarding the proposal. This order approves the proposed rule change, as amended.

II. Description of the Proposal

The ISE proposes to adopt rules for the listing and trading of low-volume option classes that qualify for listing under existing Exchange standards in a “Second Market.” Historically, the Exchange has elected to refrain from trading many option classes that qualify for trading on the ISE, but are characterized by low average daily trading volumes (“ADVs”) on the other option exchanges.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced and superseded the original filing in its entirety.

⁴ See Securities Exchange Act Release No. 54340 (August 21, 2006), 71 FR 51240.

A. Listing in the Second Market

Under the proposal, the Exchange would be able to list in the Second Market equity option classes (excluding options on exchange traded funds) that trade on other option exchange(s) that are characterized by an ADV below 500 contracts over the previous six-month period. The proposed rules would allow the Exchange to list equity option classes with an ADV of over 1,500 contracts only in the existing market (the “First Market”), and would trade such classes pursuant to existing ISE rules. The Exchange would be able to list option classes with an ADV between 500 and 1,500 contracts initially in either market. Starting one year after the Exchange initiates trading in the Second Market, the Exchange would review the market in which option classes are listed every three months, and option classes would be moved from the First to the Second Market when their ADV in the prior six-month period falls below 300 contracts, and moved from the Second to the First Market when their ADV in the prior six-month period exceeds 750 contracts.

B. Participation as Market Makers in the Second Market

Under the proposal, all members approved to operate ISE market maker memberships would be eligible to be Competitive Market Makers in the Second Market (“SMCMMs”). In addition, members that are only approved as Electronic Access Members (“EAMs”) may also register as SMCMMs.⁵ Only Primary Market Makers in the First Market may be Primary Market Makers in the Second Market (“SMPMMs”).

⁵ Under the proposed rules, members that are only EAMs that want to become SMCMMs 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 EAMs are not eligible to be SMPMMs.

As in the First Market, a primary market maker would be appointed for each class traded in the Second Market. SMPMMs would be subject to all the same obligations in their appointed options as Primary Market Makers in the First Market, including, among other things, entering continuous quotations in each series of every option class to which they are appointed and satisfying requirements related to the Plan for Creating and Operating an Intermarket Option Linkage. Similar to Primary Market Makers in the First Market, SMPMMs would be permitted to execute no more than 10% of their volume in Second Market option classes to which they are not assigned.

For purposes of existing Exchange rules relating to market maker obligations, SMCMMs will be considered “appointed” to all option classes listed in the Second Market and will be able to choose whether to make markets in any option class listed in the Second Market on a daily basis. Unlike Competitive Market Makers in the First Market, SMCMMs would not be required to enter continuous quotations in a minimum number or percentage of assigned option classes. An SMCMM will be required to continuously quote all of the series of any options class in which it chooses to make a market. If an SMCMM chooses to make markets in one or more options classes in the Second Market, it must participate in the opening rotation and make markets and enter into any resulting transactions on a continuous basis in all series of the options class until the close of trading that day. SMCMMs may not initiate quoting in an options class intraday. In addition, an SMCMM would undertake all the obligations that a Competitive Market Maker in the First Market assumes in appointed option classes for any option class(es) in which the SMCMM elects to make a market on a given day. SMCMMs will

be permitted to execute no more than 25% of their volume in Second Market option classes in which they are not contemporaneously making markets.

C. Proposed Fees in the Second Market

The Exchange proposes several changes to its fee schedule to accommodate introduction of 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., EAMs that make markets in the Second Market); (3) market makers would be excluded from the \$0.65 per contract payment for order flow fee for Second Market options; (4) all market makers in the Second Market would be charged a \$2,000 per month access fee (there would be no additional access fee for EAMs to send orders to the Second Market); and (5) firms that are only market makers in the Second Market (i.e., EAMs 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.

III. Discussion

After careful consideration, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁶ and, in particular, the requirements of Section 6 of the Act.⁷ Specifically, the Commission finds that the

⁶ In approving this proposed rule change, as amended, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁷ 15 U.S.C. 78f.

proposed rule change is consistent with Section 6(b)(5) of the Act,⁸ which requires, among other things, that the rules of a national securities exchange be 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 of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission believes that the ISE proposed market maker obligations for SMPMMs and SMCMMs are consistent with the Act. Market Makers are accorded certain benefits under the securities laws and ISE rules. The Commission believes the obligations of Market Makers in the Second Market justify these benefits.

The Commission also believes that the proposal is consistent with Section 6(b)(4) of the Act,⁹ which requires that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among the Exchange's members and issuers and other persons using its facilities. The Exchange currently assesses no execution fee for public customer order, but proposes to assess a \$0.05 per contract execution fee for public customer orders executed in the Second Market. The Commission believes that this assessment is reasonable. The proposed rule change also appears to be reasonably designed to avoid duplicative charges to market makers already assessed certain fees, such as transaction and regulatory fees. The surcharge for Second Market transactions and the market maker regulatory fee will apply only to SMCMMs that are not also Market Makers in the First Market.

⁸ 15 U.S.C. 78f(b)(5).

⁹ 15 U.S.C. 78f(b)(4).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁰ that the proposed rule change (File No. SR-ISE-2006-40), as amended, is hereby approved.

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

Nancy M. Morris
Secretary

¹⁰ 15 U.S.C. 78s(b)(2).

¹¹ 17 CFR 200.30-3(a)(12).