

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49602; File No. SR-ISE-2003-26)

April 22, 2004

Self-Regulatory Organizations; International Securities Exchange, Inc.; Order Granting Approval to a Proposed Rule Change by the International Securities Exchange, Inc. to Amend its Rules Governing Limits on the Entry of Orders of Less Than Ten Contracts and Revising the Quotation Size Requirements for Market Makers

On October 14, 2003, 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 proposed rule change to repeal the limits on the entry of orders and revise the quotation requirements of market makers. On January 13, 2004, the ISE filed Amendment No. 1 to the proposed rule change.³ On January 30, 2004, the ISE filed Amendment No. 2 to the proposed rule change.⁴ On March 8, 2004, the ISE filed Amendment No. 3 to the proposed rule change.⁵ The proposed rule change, as amended, was published for comment in the Federal Register on March 17, 2004.⁶ The Commission received no comment letters on the proposal. This order approves the proposed rule change, as amended.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy J. Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated January 12, 2004 (“Amendment No. 1”).

⁴ See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated January 29, 2004. (“Amendment No. 2”).

⁵ See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated March 5, 2004. (“Amendment No. 3”).

⁶ See Securities Exchange Act Release No. 49393 (March 10, 2004), 69 FR 12724.

The proposed rule change revises the ISE's restrictions on the entry of orders of less than 10 contracts, along with related market maker quotation requirements. Specifically, the proposed rule change removes the prohibition on Electronic Access Members ("EAMs") submitting orders for non-customers that cause the ISE's best bid and offer ("BBO") to be for less than 10 contracts, and removes the prohibition on EAMs entering multiple orders for the same trading interest if one or more orders are for less than 10 contracts. Further, the proposed rule change repeals the obligation of the Primary Market Maker ("PMM") either to "trade out" customer orders of less than 10 contracts or "derive" additional size to maintain a 10-contract displayed size. PMMs must continue, however, to "derive" size by buying or selling the number of contracts needed to maintain a firm quote for at least 10 contracts to incoming orders from the Options Market Linkage. Finally, the proposed rule change repeals the requirement that market makers refresh their quotations if there is an execution that results in the size of the ISE's BBO falling below 10 contracts. The proposed rule change, however, retains the obligation that market makers initially enter quotations for a size of at least 10 contracts, which the ISE believes is a necessary obligation for market makers to provide reasonable liquidity to the market place.

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 exchange⁷ and, in particular, the requirements of Section 6 of the Act⁸ and the rules and regulations thereunder. Specifically, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁹ which, among other things, requires that the ISE's

⁷ In approving this proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78f.

⁹ 15 U.S.C. 78f(b)(5).

rules be designed 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 proposed rule change, as amended, should provide greater transparency to investors and the marketplace and should better reflect the true state of liquidity in the marketplace. Specifically, as proposed, the actual size of customer limit orders representing the ISE's BBO will be disseminated rather than an artificial minimum size. In addition, the Commission notes that this aspect of the proposal is similar to rules on other options exchanges.¹⁰ In addition, the proposal will permit non-customer orders of less than 10 contracts that improve the ISE BBO to be disseminated.

Finally, the Commission notes that market makers will be permitted to maintain a quote that represents the ISE's BBO for a size less than 10 contracts when executions have decremented their initial quote to less than 10 contracts. However, because market makers will be required to initially enter a quote for at least 10 contracts, the Commission believes that market makers would still be obligated to add liquidity to the market.¹¹

¹⁰ See Securities Exchange Act Release Nos. 46325 (August 8, 2002), 67 FR 53376 (August 15, 2002) (SR-Phlx-2002-15); 46029 (June 4, 2002), 67 FR 40362 (June 12, 2002) (SR-PCX-2002-30); 45067 (November 16, 2001), 66 FR 58766 (November 23, 2001) (SR-CBOE-2001-56); 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003) (SR-CBOE-2002-05); and 48957 (December 18, 2003), 68 FR 79254 (December 30, 2003) (SR-AMEX-2003-24)

¹¹ The Commission notes that ISE market makers must maintain a continuous quote for the options in which they make a market. See ISE Rules 803(b) and 804(e).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹² that the proposed rule change (File No. SR-ISE-2003-26) is hereby approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland
Deputy Secretary

¹² 15 U.S.C. 78s(b)(2).

¹³ 17 CFR 200.30-3(a)(12).