

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54603; File No. SR-ISE-2006-62)

October 16, 2006

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Proposed Rule Change to Implement a Pilot Program to Quote and to Trade Certain Options in Pennies

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 11, 2006, the International Securities Exchange, LLC (the "Exchange" or the "ISE") 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 substantially prepared by the ISE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The ISE is proposing to implement a pilot program to quote and to trade certain options in pennies. The text of the proposed rule change is available on the ISE's Web site at www.iseoptions.com, at the Exchange's Office of the Secretary, and at the Commission's Public Reference Room.³

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 Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Exhibit 5 to the proposed rule change contains a proposed Regulatory Information Circular that also is part of the text of the proposed rule change.

received on the proposed 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 proposed rule change will implement a pilot program (the "Pilot") for the quoting and trading of specified options contracts in \$.01 increments. In a letter dated June 7, 2006, Chairman Cox of the Commission encouraged the six options exchanges to commence the Pilot. ISE proposes the following rule changes and related actions to implement the Pilot:

- To amend ISE Rule 710, regarding trading increments, to specify that the Exchange: (i) will participate in the Pilot; and (ii) will identify the specific options to be included in the Pilot, as well as the increments for the quoting and trading of such options, in circulars that the Exchange will file with the Commission as proposed rule changes and will distribute to its members.
- To issue the proposed regulatory information circular attached as Exhibit 5 to the proposed rule change, identifying the initial Pilot options. These options are the NASDAQ 100 Trust, for which all series will be quoted and traded in pennies, and 12 other options, for which series trading at less than \$3.00 will be quoted and traded in penny increments, and series trading at \$3.00 or more will be quoted and traded in nickel increments.

- To amend ISE Rule 716, which currently permits trades in the Exchange's Block, Facilitation and Solicitation Mechanisms to be effected at "split prices," which are the mid-points of the current standard trading increments. The Exchange proposes that options trading in penny increments not be eligible for such split pricing.
- To codify certain ISE "quote mitigation" actions. In proposing the Pilot, Chairman Cox noted that the Pilot "is almost certain to increase demands on all market participants' systems" and that "it is essential that any exchange proposal also include a workable strategy for quote mitigation." The Exchange believes that it currently has an effective quote mitigation strategy in place. Specifically:
 - API Fees: The ISE has implemented a fee program that requires market makers to purchase more APIs as the market maker generates more quotes, providing economic incentives on market makers to limit the number of quotations they disseminate.⁴
 - Monitoring: The ISE submits that it actively monitors the quotation activity of its market makers. When the Exchange detects that a market maker is disseminating significantly more quotes than an average market maker, the Exchange contacts that market maker and alerts it to such activity. Often such monitoring reveals that the market maker may have internal system issues or has incorrectly-set system parameters that were not immediately apparent to it. The Exchange believes that, even without

⁴ See Securities Exchange Act Release No. 53522 (March 20, 2006), 71 FR 14975 (March 24, 2006) (SR-ISE-2006-09).

uncovering problems, alerting a market maker to possible excessive quoting usually leads the market maker to take steps to reduce the number of its quotes.

- Holdback Timer: The ISE has the systemic ability to limit the dissemination of quotations and other changes to the ISE best bid and offer according to prescribed time criteria (a "holdback timer"). For example, if there is a change in the price of a security underlying an option, multiple market makers likely will adjust the price or size of their quotes. Rather than disseminating each individual change, the holdback timer permits the Exchange to wait until all market makers have adjusted their quotes and then to disseminate a new quotation. This helps prevent the "flickering" of quotations. The ISE proposes to codify the holdback timer in this rule filing. As proposed in ISE Rule 804, the ISE will utilize a holdback timer that delays quotation updates for no longer than one second.

- Delisting: The ISE has committed to the Commission that it will delist options with average daily volume ("ADV") of less than 20 contracts.⁵ However, it has been the ISE's policy to be much more aggressive in delisting relatively inactive options, thereby eliminating the quotation traffic attendant to such listings. Currently, it is the ISE's policy to delist

⁵ See Securities Exchange Act Release No. 47483 (March 11, 2003), 68 FR 13352 (March 19, 2003) (SR-ISE-2003-04).

options with ADV of less than 50, even with the advent of the Exchange's new "Second Market,"⁶ which provides liquidity for less-active options.

- To submit certain reports. The Commission staff has asked the options exchanges to prepare reports regarding the first three months' experience under the Pilot and to submit such reports by the end of the fourth month of the Pilot. The reports will compare quotation and trading activity in the three months prior to the Pilot (October 26, 2006 through January 25, 2007), to the first three months of the Pilot (January 26, 2007 through April 25, 2007). The ISE will submit the following reports to the Commission pursuant to this timetable:
 - Quality of Markets: This report will focus on quotation spread and size of quotations, as well as a number of other factors, including average daily volume.
 - Capacity: This report will focus on the number of quotations in the Pilot options and the effect on the ISE's system's capacity.
 - Linkage: This report will focus on trade-throughs, Satisfaction orders the ISE sends and receives, the number of Linkage Orders that "time out" without a response and the flickering of quotations.

2. Statutory Basis

The Exchange believes that its proposed rule change is consistent with Section

⁶ See Securities Exchange Act Release No. 54340 (August 21, 2006), 71 FR 51240 (August 29, 2006) (SR-ISE-2006-40).

6(b) of the Act,⁷ in general, and furthers the objectives of Section 6(b)(5) of the Act,⁸ in particular, in that the proposed rule change is 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. In particular, the proposed rule change will permit the pilot quoting and trading of certain options in pennies to help determine whether such quoting and trading increments benefit investors.

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

The Exchange does not believe that the proposed rule change will 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

Written comments on the proposed rule change were neither solicited nor received.

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; or

⁷ 15 U.S.C. 78f(b).

⁸ 15 U.S.C. 78f(b)(5).

- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the 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-2006-62 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-ISE-2006-62. 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-2006-62 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.⁹

Nancy M. Morris
Secretary

⁹ 17 CFR 200.30-3(a)(12).