

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49754; File No. SR-ISE-2003-22)

May 21, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the International Securities Exchange, Inc., Relating to Permanent Approval of the Pilot Program for Quotation Spreads

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 September 24, 2003, the International Securities Exchange, Inc. (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the ISE.³ On May 20, 2004, the ISE filed Amendment No. 1 to the proposed rule change. 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

On March 19, 2003, the Commission approved an ISE proposal to establish a pilot program permitting the allowable quotation spread for options on up to 50 equity securities to be \$5, regardless of the price of the bid (“Pilot Program”).⁴ The Pilot Program was extended several times, most recently until June 29, 2004, and expanded to include all equity options

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated May 19, 2004 and accompanying Form 19b-4 (“Amendment No. 1”).

⁴ See Securities Exchange Act Release No. 47532, 68 FR 14728 (March 26, 2003) (order approving File No. SR-ISE-2001-15) (“Pilot Program Approval Order”).

trading on the ISE.⁵ The ISE proposes to make the Pilot Program permanent and to expand the Pilot Program to include index options as well as equity options. The text of the proposed rule change appears below. Additions are italicized; deletions are bracketed.

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Rule 803. Obligations of Market Makers

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(b) Appointment. With respect to each options class to which a market maker is appointed under Rule 802, the market maker has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular options contract, or a temporary distortion of the price relationships between options contracts of the same class. Without limiting the foregoing, a market maker is expected to perform the following activities in the course of maintaining a fair and orderly market:

* * * * *

(4) To price options contracts fairly by, among other things, bidding and offering so as to create differences of no more than \$5 between the bid and offer following the opening rotation in an equity or index options contract. Prior to the opening rotation, spread differentials shall be no more than 1/4 of \$1 between the bid and offer for each options contract for which the

⁵ See Securities Exchange Act Release Nos. 48514 (September 22, 2003), 68 FR 55685 (September 26, 2003) (notice of filing and immediate effectiveness of File No. SR-ISE-2003-21) (extending the Pilot Program through January 31, 2004); 49149 (January 29, 2004), 69 FR 05627 (notice of filing and immediate effectiveness of File No. SR-ISE-2004-02) (extending the Pilot Program through March 31, 2004); and 49509 (March 31, 2004), 69 FR 18411 (April 7, 2004) (notice of filing and immediate effectiveness of File No. SR-ISE-2004-10) (extending the Pilot Program through June 29, 2004, and expanding the Pilot Program to include all equity options listed on the ISE) (“Pilot Expansion Notice”).

bid is less than \$2, no more than 3/8 of \$1 where the bid is at least \$2 but does not exceed \$5, no more than 1/2 of \$1 where the bid is more than \$5 but does not exceed \$10, no more than 3/4 of \$1 where the bid is more than \$10 but does not exceed \$20, and no more than \$1 where the bid is \$20 or greater, provided that the Exchange may establish differences other than the above for one or more options series. The bid/offer differentials stated above shall not apply to in-the-money options series where the underlying securities market is wider than the differentials set forth above. For these series, the bid/ask differential may be as wide as the quotation on the primary market of the underlying security.

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Supplementary Material to Rule 803

[.01 Pursuant to paragraph (b)(4) of Rule 803, during a pilot period expiring on June 29, 2004, all options classes may be quoted with a difference not to exceed \$5 between the bid and offer regardless of the price of the bid.]

[.02] .01 A Primary Market Maker must act with due diligence in handling orders of Public Customers and must accord priority to such orders addressed pursuant to paragraph (c) of this Rule over the Primary Market Maker's principal orders.

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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 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's rules contain maximum quotation spread requirements that vary from \$.25 to \$1.00, depending on the price of the option. On March 19, 2003, the Commission approved a proposal to establish a six-month Pilot Program in which the allowable quotation spread for options on up to 50 underlying equity securities would be \$5, regardless of the price of the bid.⁶ The Pilot Program has been extended several times, most recently until June 29, 2004, and has been expanded to include all equity options listed on the ISE.⁷

As required by the Pilot Program Approval Order, the ISE submitted to the Commission a report detailing the ISE's experience with the Pilot Program, which provided data regarding the 50 options initially included in the Pilot Program ("Initial Pilot Report"). The ISE will provide the Commission with an updated Pilot Program report that covers all of the equity options classes in the expanded Pilot Program by June 15, 2004.

The ISE believes that the Pilot Program has been successful. The ISE notes that its Initial Pilot Report provides all of the information the Commission requested in the Pilot Program Approval Order. The Initial Pilot Report lists the Pilot Program options, details the quotation spreads in these options during the initial six-month Pilot Program period, and discusses the ISE's overall experience during the Pilot Program, as well as any problems the ISE experienced during the Pilot Program. According to the ISE, the Initial Pilot Report indicates that quotation spreads in the 50 equity options initially included in the Pilot Program were virtually unchanged when compared to pre-Pilot Program trading. When compared to non-Pilot Program options, the

⁶ See Pilot Program Approval Order, supra note 4.

⁷ See Pilot Expansion Notice, supra note 5.

ISE notes that the options included in the Pilot Program actually had relatively narrower spreads during the Pilot Program compared to the pre-Pilot Program period.

The purpose of the proposal is to make the Pilot Program permanent and to apply the relaxed spread requirements to all ISE-listed equity and index options. The one adjustment that the ISE is proposing to the structure of the Pilot Program is to apply the Pilot Program's relaxed spread requirements only after the opening in an option to assure fair and orderly markets at the opening. The ISE states that during the operation of the Pilot Program the ISE observed some indications that the relaxed spread requirements were having a negative effect on the quality of the ISE's market opening. Accordingly, the ISE issued a Regulatory Information Circular ("RIC") informing market makers that, for the Pilot Program options, they should quote pursuant to the traditional spread requirements for the opening.⁸ Consistent with this position, the relaxed quotation requirements in the proposal would become operative immediately following the opening rotation.

2. Statutory Basis

The ISE believes that the proposed rule change is consistent with the requirement under Section 6(b)(5) of the Act 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.

⁸ See ISE RIC 2003-08, "Bid/Ask Spreads--\$5 Maximum Pilot Program Policy Change."

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

The ISE believes that 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 ISE has not solicited, and does not intend to solicit, comments on the proposed rule change. The ISE has not received any unsolicited written comments from members or other interested parties.

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
- (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, as amended, 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 Number SR-ISE-2003-22 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-ISE-2003-22. 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, 450 Fifth Street, NW, 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-2003-22 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁹

Margaret H. McFarland
Deputy Secretary

⁹ 17 CFR 200.30-3(a)(12).