

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49931; File No. SR-ISE-2004-24)

June 28, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the International Securities Exchange, Inc. Relating to the Interaction of Market Maker Quotations

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 June 21, 2004, 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 and II below, which Items have been prepared by the Exchange. This order approves the proposal on an accelerated basis and publishes notice of the proposed rule change to solicit comments from interested persons.

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

The Exchange proposes to codify in its rules a one-second “timer” that it employs before the quotations of ISE market makers interact. Below is the text of the proposed rule change.

Proposed new language is italicized; proposed deletions are in [brackets].

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Rule 804. Market Maker Quotations

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(d) Firm Quotes. (1) Market maker bids and offers are firm for orders and Exchange market maker quotations both under this Rule and Rule 11Ac1-1 under the Exchange Act (“Rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

11Ac1-1”) for the number of contracts specified according to the requirements of paragraph (b) above. Market maker bids and offers are not firm under this Rule and Rule 11Ac1-1 if:

- (i) a system malfunction or other circumstance impairs the Exchange’s ability to disseminate or update market quotes in a timely and accurate manner;
- (ii) the level of trading activities or the existence of unusual market conditions is such that the Exchange is incapable of collecting, processing, and making available to quotation vendors the data for the option in a manner that accurately reflects the current state of the market on the Exchange, and as a result, the market in the option is declared to be “fast” pursuant to Rule 704;
- (iii) during trading rotations; or
- (iv) any of the circumstances provided in paragraph (c)(3) of Rule 11Ac1-1 exist.

(2) Notwithstanding Paragraph (1) above, if a market maker's bid (offer) can trade with the offer (bid) of another market maker, no execution shall occur between such quotations for a period of no more than one second. During this period, the System will update quotations that may be received; provided however, that during this period all quotations shall otherwise remain firm and the System will automatically execute all incoming orders against such quotations.

(3) [(2)] Within thirty seconds of receipt of an order to buy or sell an option in an amount greater than the Order Execution Size, or within thirty seconds of another Exchange market maker entering a quotation at a price executable against the market

maker's quotation, that portion of the order equal to the Order Execution Size, or the Quotation Execution Size, as the case may be, will be executed and the bid or offer price will be revised.

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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 Exchange 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 III below. The Exchange 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 proposes to codify in its rules a one-second “timer” that it employs before the quotations of ISE market makers interact. The ISE treats orders and quotations differently, with ISE Rule 804(a) stating that only market makers may enter quotations on the ISE. Market makers use quotations to input and update prices on multiple series of options at the same time. Quotations generally are based on pricing models that rely on various factors, including the price and volatility of the underlying security. As these variables change, a market maker’s pricing model automatically updates quotations for some or all of an option’s series. In contrast, an

order is an interest to buy a stated number of contracts of one specific options series. All ISE members, including ISE market makers, can enter orders.³

When stock prices change, ISE market makers update quotations in multiple series at the same time. The ISE represents that it promptly processes such quotation changes when it receives them. However, there is invariably a lag between the time the stock price first changes and the time by which the ISE can process all the corresponding option quotation changes. During this short period, the ISE may update one market maker's bid price to be the same as another market maker's asked price, resulting in a temporary market "lock." In addition, quotations may also "cross" each other. The ISE believes that if it were to permit executions at such prices, they would not properly reflect the true nature of the market. Rather, they would result in executions against quotations that simply were in the processing queue awaiting updating. According to the ISE, without there being some protection against this happening, the ISE would execute multiple market-maker-to-market-maker trades, subjecting market makers to multiple execution and clearing fees, with no real economic justification behind the trades. In addition, in the ISE's view, to avoid such executions and the attendant costs, market makers would widen their quotations or limit their size, to the detriment of customers and other market participants.

In order to address this concern, the ISE has established a one-second "timer" pursuant to which locked or crossed market maker quotations would not trade against each other. During this brief period, market maker quotations would remain firm for all orders the ISE may receive. That is, all orders would be executed at the "locked" or "crossed" price up to the full size of the

³ ISE Rule 717 imposes various limitations on orders that Electronic Access Members may

quotations, effectively resulting in a “zero spread” (or, for crossed markets, a “negative spread”) during this time period. This includes orders from customers, broker-dealers and even other market makers. The only exclusion is for executions against other market maker quotes.

The ISE believes that, the timer allows (1) market makers to update their quotations and (2) the ISE to process these updates, without effecting multiple executions during the update process. If a market maker has not entered a new quotation price during this brief period, trades would occur in all locked or crossed series up to the full size of the quotations upon the expiration of the time. In the ISE’s view, this brief timer allows market prices to reach true pricing equilibrium without the execution of trades lacking economic substance.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act⁴ in general, and furthers the objectives of Section 6(b)(5)⁵ in particular, in that it is 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. In particular, the Exchange believes that the proposed rule change will enhance the pricing efficiency on the ISE.

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enter on the ISE, while ISE Rule 805 governs market maker orders.

⁴ 15 U.S.C. 78f(b).

⁵ 15 U.S.C. 78f(b)(5).

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

The Exchange does not believe that the proposed rule change will result in any burden on competition.

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

No written comments were solicited or received with respect to the proposed rule change.

III. 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 Number SR-ISE-2004-24 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-2004-24. 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 Section, 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-2004-24 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁶ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act, which requires that the rules of an 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.⁷

The Commission notes that the ISE believes that, without the proposed one-second "timer" function, pricing inefficiencies would result on the Exchange and ISE market makers

⁶ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

would widen their quotations or limit size to avoid multiple executions against other market makers. The Commission also notes that the ISE would continue to require its market makers to be firm for their quotations for the same size to customers and broker-dealer orders, including orders for the account of other ISE market makers. Further, if a market maker does not revise its quotation during the one-second period, trades would execute against the quotations of other ISE market makers. Based on the foregoing, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,⁸ for approving the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register.

To implement this proposal, the ISE would require a limited exemption from Rule 11Ac1-1 under the Act (the “Quote Rule”)⁹ to permit the Exchange to relieve an ISE market maker from its obligation under the Quote Rule to trade with matching quotations from another ISE market maker.¹⁰ In connection with the approval of this proposal, the Commission granted ISE’s request for a limited exemption from the Quote Rule. Specifically, the Commission granted ISE market makers an exemption from their obligations under paragraph (c)(2) of the Quote Rule with respect to trades with matching ISE market maker quotations for no more than one second, provided that the quotations are locked or crossed for no more than one second, and that such ISE market maker is firm to all other customer and broker-dealer orders, including

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⁷ 15 U.S.C. 78f(b)(5).

⁸ 15 U.S.C. 78s(b)(2).

⁹ 17 CFR 240.11Ac1-1.

¹⁰ The ISE submitted a separate letter requesting a limited exemption from the Quote Rule. See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Annette Nazareth, Director, Division of Market Regulation (“Division”), Commission, dated June 14, 2004.

orders for the accounts of other ISE market makers.¹¹

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹² that the proposed rule change (SR-ISE-2004-24), is hereby approved on an accelerated basis.

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

Margaret H. McFarland
Deputy Secretary

¹¹ See letter from Robert Colby, Deputy Director, Division, Commission, to Michael Simon, Senior Vice President and General Counsel, ISE, dated June 24, 2004.

¹² 15 U.S.C. 78s(b)(2).

¹³ 17 CFR 200.30-3(a)(12).