

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50813; File No. SR-ISE-2004-31)

December 7, 2004

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to System-Assisted Quotation Services

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 30, 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, II, and III below, which Items have been prepared by the Exchange. On November 16, 2004, the ISE filed Amendment No. 1 to the proposed rule change.³ 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

The ISE proposes to codify in its rules descriptions of certain functionality it provides to market makers to assist them in meeting their quotation obligations. The text of the proposed rule change, as amended, is below. Proposed new language is in italics.

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Rule 804. Market Maker Quotations

(a) – (f) No change.

(g) Automated Quotation Adjustments. A market maker may establish parameters by which the Exchange will automatically restate:

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³ Amendment No. 1 replaced and superseded the original filing in its entirety.

- (1) the prices of a market maker's quotations in all series of an options class, at prices specified by the market maker, if the market maker trades, in the aggregate, a specified number of contracts (established by the market maker), within an Exchange-established time frame, in that class;
- (2) the price of a market maker's quotations in an options series if the number of contracts that the market maker is willing to buy or sell at a specified price is exhausted; and
- (3) the size of a market maker's quotation in an options series to 10 contracts if, as a result of an execution in that series, the market maker's quotation is decremented below that size and the Exchange's best bid (offer) would be less than 10 contracts.

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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 had received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV 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 purpose of this rule change is to codify in the ISE's rules certain services the ISE offers market makers to help them manage their quotations. By way of background, ISE Rules 803 and 804 require market makers to maintain continuous and firm quotations. To comply with

this requirement, each ISE market maker employs its own sophisticated proprietary quotation and risk management systems to determine the prices and sizes at which its quotes. The ISE system itself also contains several voluntary tools that market makers can use to assist them in meeting their quotation obligations. ISE market makers are not required to use the ISE-provided functionality and can program their own systems to perform the same functions if they prefer.

The three tools the ISE offers are:

- "Speed bump" functionality. A market maker's risk in an options class is not limited to the risk in a single series of that class. Rather, a market maker faces exposure in all series of a class, requiring that the market maker off-set or otherwise hedge its overall position in a class. The speed bump functionality helps a market maker limit this overall exposure and risk. Specifically, the functionality permits a market maker to establish parameters in the central system to move its quotations in all series of an option to an inferior price when the market maker trades a specified number of contracts in that class as a whole within a fixed time period. That time period currently is a rolling 30 seconds.⁴ Market Makers can specify a number of contracts ("the exposure limit") by class. For example, if a market maker establishes an exposure limit of 1,000 contracts in XYZ options, the system will move the market maker's quotations in all series of XYZ options to an inferior price following one or more transactions that result in the aggregate execution of 1,000 contracts in XYZ options, regardless of the series in which those trades occur. By limiting its exposure across series, a market maker is better able to quote aggressively in an option, knowing that the speed bump will automatically move all its quotations in a class when its exposure limit is hit.

⁴ If the ISE were to change this time period it would do so in a notice to market makers.

- "Tick-worse" functionality. Among other things, ISE Rules 803 and 804 require: (1) Primary Market Makers to provide continuous quotations in all their assigned options; and (2) Competitive Market Makers generally to provide continuous quotations in 60 percent of their assigned options. If the size of a market maker's quotation in a series is exhausted, ISE rules effectively require the market maker to immediately establish a new quotation, either at the same or different price. ISE provides market makers with "tick-worse" functionality that allows market makers to pre-define the prices and sizes at which the system will automatically move their quotation following an execution that exhausts the size of their existing quotation. Having this functionality in the central exchange system – rather than having market makers themselves send refreshed quotations when they receive a report of an execution exhausting their quotations – helps market makers maintain continuous quotations when their displayed quotations are exhausted.
- "Step-up" functionality. Until recently, ISE Rule 804(b) required that all of the ISE's disseminated quotations be for at least 10 contracts. To achieve compliance with that requirement, the rule prohibited market makers from initially entering a quotation of less than 10 contracts. Furthermore, if a market maker's quotation fell below 10 contracts due to executions at the quotation price, and the disseminated ISE quotation would be less than 10 contracts, ISE Rule 804(b) also required market makers to reestablish their quotation for at least 10 contracts (at the same price or a different price). In order to help market makers meet these obligations, the ISE developed the "step-up" functionality permitting a market maker to refresh its quotation to 10 contracts when an execution decrements the quotation below that size (if the best disseminated quotation on the Exchange would be less than 10

contracts). The Commission recently approved amendments to ISE Rule 804 eliminating the requirement that the ISE disseminate quotations of at least 10 contracts.⁵ Under ISE Rule 804(b), while market makers still must initially establish quotations of at least 10 contracts, they do not need to reestablish 10-contract quotes if their quotation is decremented due to executions at the quotation price. Although there is no current regulatory need for the step-up functionality, certain market makers continue to use it to maintain 10 contract quotations, and the ISE continues to offer it as a voluntary tool.

2. Statutory Basis

The Exchange believes the basis under the Act for this proposed rule change is the requirement under Section 6(b)(5)⁶ 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 foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, 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. In particular, the rule change will codify the ability of ISE members to use ISE-provided functionality to maintain competitive and liquid quotations.

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

The Exchange 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.

⁵ See Securities Exchange Act Release No. 49602 (April 22, 2004), 69 FR 23841 (April 30, 2004) (SR-ISE-2003-26).

⁶ 15 U.S.C. 78f(b)(5).

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

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange 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 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-2004-31 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-2004-31. 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 publicly available. All submissions

should refer to File Number SR-ISE-2004-31 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.⁷

Jill M. Peterson
Assistant Secretary

⁷ 17 CFR 200.30-3(a)(12).