

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51295; File No. SR-ISE-2005-14)

March 2, 2005

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto Relating to Position Limits and Exercise Limits

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 February 25, 2005, 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 ISE. On March 1, 2005 the ISE filed Amendment No. 1 to the proposed rule change.³ The Exchange has filed the proposal as a “non-controversial” rule change pursuant to Section 19(b)(3)(A) of the Act⁴ and Rule 19b-4(f)(6) thereunder,⁵ which renders it effective upon filing with the Commission. 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 amend ISE Rules 412, 413, and 414 to increase the standard position and exercise limits for equity options contracts and options on the Nasdaq-100 Index Tracking Stock (“QQQQ”). The text of the proposed rule change is available on the ISE’s Web site

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 made certain technical changes to Exhibit 5 to the filing.

⁴ 15 U.S.C. 78s(b)(3)(A).

⁵ 17 CFR 240.19b-4(f)(6).

(<http://www.iseoptions.com>), at the ISE's Office of the Secretary, and at the Commission's Public Reference Room.

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 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 Exchange is proposing several change to ISE Rule 412 (Position Limits), ISE Rule 413 (Exemptions from Position Limits), and ISE Rule 414 (Exercise Limits). ISE Rule 412 subjects equity options to one of five different position limits depending on the trading volume and outstanding shares of the underlying security. ISE Rule 413 establishes certain qualified hedging transactions and positions that are exempt from established options position limits as prescribed under ISE Rule 412. ISE Rule 414 establishes exercise limits for the corresponding options at the same levels as the corresponding security's position limits. On February 23, 2005, the Commission granted accelerated approval of a rule change proposed by the Chicago Board Options Exchange, Inc. ("CBOE") relating to position and exercise limits.⁶

⁶ See Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010 (March 1, 2005) (SR-CBOE-2003-30).

Standard Position and Exercise Limits

The Exchange is proposing to adopt a pilot program for a period of six months during which the standard position and exercise limits for options on the QQQQ and for equity option classes traded on the Exchange would be increased to the following levels:

Current Equity Option Contract Limit	Proposed Equity Option Contract Limit
13,500 contracts	25,000 contracts
22,500 contracts	50,000 contracts
31,500 contracts	75,000 contracts
60,000 contracts	200,000 contracts
75,000 contracts	250,000 contracts
Current QQQQ Option Contract Limit	Proposed QQQQ Option Contract Limit
300,000 contracts	900,000 contracts

The ISE's standard position limits have been in effect since the Exchange commenced trading in May 2000. These standard position limits are the same as the position limits at the other options exchanges at that time, which were last increased on December 31, 1998.⁷ Since that time, there has been a steady increase in the number of accounts that, (a) approach the position limit; (b) exceed the position limit; and (c) are granted an exemption to the standard limit. Several members have petitioned the options exchanges to either eliminate position limits, or in lieu of total elimination, increase the current levels and expand the available hedge exemptions. A review of available data indicates that the majority of accounts that maintain sizable positions are in those classes subject to the 60,000 and 75,000 tier limits. There also has

⁷ See Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842 (January 12, 1999) (SR-CBOE-98-25).

been an increase in the number of accounts that maintain sizeable positions in the lower three tiers. In addition, overall volume in the options market has continually increased over the past five years. The Exchange believes that the increase in options volume and lack of evidence of market manipulation occurrences during that same period justifies the proposed increase in the position and exercise limits.

The Exchange also proposes the adoption of a new equity hedge exemption to the existing exemptions currently provided under ISE Rule 413. Specifically, proposed ISE Rule 413(a)(5) would allow for a “reverse collar” hedge exemption where a long call position is accompanied by a short put position where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call short put can be in-the-money at the time the position is established. The Exchange believes this is consistent with existing ISE Rule 413(a)(4), which provides for an exemption for a “collar”, and ISE Rules 413(a)(2) and 413(a)(3), which provide for a hedge exemption for reverse conversion and conversions, respectively.

Manipulation

The ISE believes that position and exercise limits, at their current levels, no longer serve their stated purpose. The Commission has previously stated that:

Since the inception of standardized options trading, the options exchanges have had rules imposing limits on the aggregate number of options contracts that a member or customer could hold or exercise. These rules are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate or disrupt the underlying market so as to benefit the options

position. In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market. In addition such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.⁸

The Exchange believes that the existing surveillance procedures and reporting requirements at the ISE, other options exchanges, and at the several clearing firms are capable of properly identifying unusual and/or illegal trading activity. In addition, routine oversight inspections of ISE's regulatory programs by the Commission have not uncovered any material inconsistencies or shortcomings in the manner in which the Exchange's market surveillance is conducted. These procedures utilize daily monitoring of market movements via automated surveillance techniques to identify unusual activity in both options and in underlying stocks.

Furthermore, large stock holdings must be disclosed to the Commission by way of Schedules 13D or 13G.⁹ Options positions are part of any reportable positions and, thus, cannot be legally hidden. In addition, ISE Rule 415, which requires members to file reports with the Exchange for any customer who held aggregate long or short positions of 200 or more option contracts of any single class for the previous day, will remain unchanged and will continue to serve as an important part of the Exchange's surveillance efforts.

The Exchange believes that restrictive equity position limits prevent large customers, such as mutual funds and pension funds, from using options to gain meaningful exposure to individual stocks. This can result in lost liquidity in both the options market and the stock market. In addition, the Exchange has found that restrictive limits and narrow hedge exemption

⁸ See Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998) (SR-CBOE-97-11).

⁹ 17 CFR 240.13d-1.

relief restrict members from adequately facilitating customer order flow and offsetting the risks of such facilitations in the listed options market. The fact that position limits are calculated on gross rather than a delta basis also is an impediment.

Financial Requirements

The Exchange believes that the current financial requirements imposed by the Exchange and by the Commission adequately address concerns that a member or its customer may try to maintain an inordinately large unhedged position in an equity option. Current margin and risk-based haircut methodologies serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large position held by itself or by its customer. It also should be noted that the Exchange has the authority under ISE Rule 1204 to impose higher margin requirements upon a member when the Exchange determines that higher requirements are warranted. Also, the Commission's net capital rule, Rule 15c3-1 under the Act,¹⁰ imposes a capital charge on members to the extent of any margin deficiency resulting from the higher margin requirement.

Finally, equity position limits have been gradually expanded from 1,000 contracts in 1973 to the current level of 75,000 contracts for the largest and most active stocks. To date, the Exchange believes that there have been no adverse affects on the market as a result of these past increases in the limits for equity option contracts.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act¹¹ in general, and furthers the objective of Section 6(b)(5) of the Act¹² in particular, in that it is

¹⁰ 17 CFR 240.15c3-1.

¹¹ 15 U.S.C. 78f(b).

¹² 15 U.S.C. 78f(b)(5).

designed to promote just and equitable principles of trade and to protect investors and the public interest.

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

The proposed rule change does not impose any burden on competition.

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

The proposed rule change has been designated by the ISE as a “non-controversial” rule change pursuant to Section 19(b)(3)(A) of the Act¹³ and subparagraph (f)(6) of Rule 19b-4 thereunder.¹⁴

The foregoing rule change: (1) does not significantly affect the protection of investors or the public interest, (2) does not impose any significant burden on competition, and (3) by its terms does not become operative for 30 days after the date of this filing, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest. Consequently, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁵ and Rule 19b-4(f)(6) thereunder.¹⁶

Pursuant to Rule 19b-4(f)(6)(iii), a proposed “non-controversial” rule change does not become operative for 30 days after the date of filing, or such shorter time as the Commission

¹³ 15 U.S.C. 78s(b)(3)(A).

¹⁴ 17 CFR 240.19b-4(f)(6).

¹⁵ 15 U.S.C. 78s(b)(3)(A).

¹⁶ 17 CFR 240.19b-4(f)(6).

may designate, if consistent with the protection of investors and the public interest, and the ISE gave the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.¹⁷

The ISE has requested that the Commission waive the five-day pre-filing notice requirement and the 30-day operative delay. The Commission has determined that it is consistent with the protection of investors and the public interest to waive the five-day pre-filing notice requirement and the 30-day operative delay.¹⁸ Waiving the pre-filing requirement and accelerating the operative date will allow the ISE to immediately conform its position and exercise limits and its equity hedge exemption strategies to those of the CBOE, which were recently approved by the Commission.¹⁹

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Act.²⁰

¹⁷ 17 CFR 240.19b-4(f)(6)(iii).

¹⁸ For the purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f). See Securities Exchange Act Release No. 51244 (February 23, 2005).

¹⁹ See Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010 (March 1, 2005) (SR-CBOE-2003-30).

²⁰ For purpose of calculating the 60-day period within which the Commission may summarily abrogate the proposed rule change under Section 19(b)(3)(C) of the Act, the Commission considers that period to commence on March 1, 2005, the date that the ISE filed Amendment No. 1.

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 No. SR-ISE-2005-14 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 No. SR-ISE-2005-14. 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 will also 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 No. SR-ISE-2005-14 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.²¹

Margaret H. McFarland
Deputy Secretary

²¹ 17 CFR 200.30-3(a)(12).