

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51666; File No. SR-ISE-2003-07)

May 9, 2005

Self-Regulatory Organizations; International Securities Exchange, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 thereto and Order Granting Accelerated Approval of Amendment Nos. 2, 3, 4, and 5 thereto Relating to the Pricing of Block and Facilitation Trades

I. Introduction

On February 25, 2003, the International Securities Exchange, Inc. (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to provide for the entry and execution of block and facilitation trades at the midpoint between the standard trading increments. On December 18, 2003, the ISE amended the proposed rule change. The proposed rule change, as amended by Amendment No. 1, was published for comment in the Federal Register on January 20, 2004.<sup>3</sup>

The Commission received two comment letters in response to the proposed rule change, which were submitted by the Boston Stock Exchange and its wholly-owned subsidiary, Boston Options Exchange Regulation (collectively, “BSE”),<sup>4</sup> and the Chicago

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 49056 (January 12, 2004), 69 FR 2798.

<sup>4</sup> See Letter from Glenn Verdi, Chief Regulatory Officer, Boston Options Exchange Regulation, to Jonathan G. Katz, Secretary, Commission, dated February 26, 2004 (“BSE Letter”).

Board Options Exchange, Incorporated (“CBOE”).<sup>5</sup> The ISE submitted a letter in response to the BSE Letter on March 4, 2004.<sup>6</sup> Also, on March 4, 2004, the ISE filed Amendment No. 2 to the proposed rule change.<sup>7</sup> On March 24, 2004, the ISE filed Amendment No. 3 to the proposed rule change.<sup>8</sup> On April 18, 2005, the ISE filed Amendment No. 4 to the proposed rule change.<sup>9</sup> On May 4, 2005, the ISE filed Amendment No. 5 to the proposed rule change.<sup>10</sup> This order approves the proposed rule

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<sup>5</sup> See E-mail from Steve Youhn, CBOE, to Elizabeth King, Associate Director, Division of Market Regulation (“Division”), Commission, and Ira Brandriss, Assistant Director, Division, Commission, dated April 26, 2005 (“CBOE Letter”).

<sup>6</sup> See Letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Jonathan G. Katz, Secretary, Commission, dated March 4, 2004.

<sup>7</sup> In Amendment No. 2, the ISE revised the text of the proposed rule change to remove language relating to the ISE’s Solicited Order Mechanism. This language, however, was reinserted in Amendment No. 4 because the Commission had approved the ISE’s Solicited Order Mechanism. See Securities Exchange Act Release No. 49943 (June 30, 2004), 69 FR 41317 (July 8, 2004) (SR-ISE-2001-22).

<sup>8</sup> In Amendment No. 3, the ISE revised the text of the proposed rule change to delete the phrase “Public Customer” from Rule 716(d). The ISE stated that the purpose of this change is to allow Electronic Access Members (“EAMs”) to use ISE’s facilitation mechanism to facilitate broker-dealer orders as well as Public Customer orders.

<sup>9</sup> In Amendment No. 4, the ISE added Paragraph .07 to Supplementary Material to ISE Rule 716 to state that orders of 50 to 499 contracts executed through the Block Order and Facilitation Mechanisms will not be executed at prices inferior to the national best bid or offer at the time of execution. Amendment No. 4 also reinstated language removed in Amendment No. 2 that proposes to permit Orders and Responses to be entered into the Solicited Order Mechanism at Split Prices. In addition, Amendment No. 4 expands the group of participants who may enter Responses in to the ISE’s Solicited Order Mechanism to all ISE members.

<sup>10</sup> In Amendment No. 5, the ISE explained that Amendment No. 4 reinstated references to the Solicited Order Mechanism removed by Amendment No. 2 to reflect the Commission’s approval of the Solicited Order Mechanism. See Exchange Act Release No. 49943, supra note 7. Amendment No. 5 also

change, as amended, grants accelerated approval to Amendment Nos. 2, 3, 4, and 5 and solicits comments from interested persons on Amendment Nos. 2, 3, 4, and 5.

## II. Description of the Proposed Rule Change

The proposed rule change would permit the ISE to execute and report block, facilitation, and solicited order trades through its Block Order, Facilitation, and Solicited Order Mechanisms at prices that are at the midpoint between the standard \$.05 and \$.10 trading increments (“Split Prices”), i.e., in \$.025 increments for options with a standard minimum trading increment of \$.05 (e.g., \$1.025, \$1.05, \$1.075, etc.) and in \$.05 increments for options with a standard minimum trading increment of \$.10 (e.g., \$4.05, \$4.10, \$4.15, etc.). The proposal would permit members to enter both public customer and broker-dealer orders into the Block Order, Facilitation, and Solicited Order Mechanisms at Split Prices. As is the case under the ISE’s current rules, upon the entry of an order into the Block Order, Facilitation, and Solicited Order Mechanisms, a broadcast message is sent. The proposed rule change, however, would expand the members who receive such broadcast messages to include all members, not just market makers appointed to an options class and other members with proprietary orders at the inside bid or offer for a particular series. In addition, the proposal would permit members to enter “Responses”<sup>11</sup> to a broadcast message at Split Prices. Finally, while the ISE’s current rules only permit members to indicate whether they want to participate in the

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explained that Amendment No. 4 revised the Solicited Order Mechanism to expand to all ISE members the group of participants who receive broadcast messages and who may enter Responses and to permit orders to be entered and executed at Split Prices.

<sup>11</sup> A “Response” is an electronic message that is sent by a member in response to a broadcast message.

facilitation of an order at the facilitation price or a price no better than the ISE's best bid or offer, the proposed rule change would permit members to enter Responses that improve the ISE's best bid or offer. The proposed rule change also would bar executions of orders of between 50 and 499 contracts through the Block Order and Facilitation Mechanisms at prices inferior to the national best bid or offer at the time of execution. Orders executed at a Split Price would be reported to the Options Price Reporting Authority ("OPRA") and cleared by The Options Clearing Corporation ("OCC") at the Split Price.

### III. Discussion

After careful consideration of the proposed rule change, the BSE Letter, the CBOE Letter, and the ISE's response to the BSE Letter, 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.<sup>12</sup> In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>13</sup> which requires, among other things, that the Exchange's rules 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.

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<sup>12</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

A. Participation in Block Order, Facilitation, and Solicited Order Mechanisms

Currently ISE Rule 716 provides that only market makers appointed to an options class and other members with proprietary orders at the inside bid or offer for a particular series (“Crowd Participants”) receive notifications of orders entered into the Block Order, Facilitation, and Solicited Order Mechanisms, and only Crowd Participants may enter Responses to such orders. The proposal would expand the universe of market participants who would receive notification of an order entered into the Block Order, Facilitation, or Solicited Order Mechanism to all ISE members. The proposal also would expand the universe of market participants who could enter Responses into the Block Order, Facilitation, or Solicited Order Mechanism to all market participants, other than Responses for the account of an options market maker from another options exchange.<sup>14</sup>

The BSE Letter commented that the proposal is unclear as to how the ISE defines an “options market maker from another options exchange.” Further, the BSE Letter contends that if the ISE is referring to the unit that acts as a market maker on another options exchange, the proposal is unfairly discriminatory against BOX market makers. The CBOE Letter similarly contends that this aspect of the proposal is discriminatory. In its response, the ISE clarified that the “account of an options market maker on another exchange” is the options market maker account of a member at OCC. Thus, the limitation in Supplementary Material .03 does not restrict members from entering Responses with respect to any other firm proprietary accounts.

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<sup>14</sup> See Paragraph .03 to Supplementary Material to ISE Rule 716.

The Commission believes that the ISE's proposal to expand those ISE members who can enter Responses into the Block Order, Facilitation, and Solicited Order Mechanisms will improve the opportunities for orders executed in those Mechanisms to receive price improvement. The Commission does not believe that it is unfairly discriminatory for the ISE not to further expand to away options market makers the ability to enter Responses into the Block Order, Facilitation, and Solicited Order Mechanisms.

B. Consistency with Linkage Plan

The BSE Letter expressed concern that the ISE's proposed rule does not require that the EAM's facilitation price be equal to or greater than the ISE best bid or offer or the national best bid or offer and that, therefore, facilitated orders could trade at prices inferior to these on other exchanges, *i.e.*, a trade-through, in contravention of the ISE's obligations under the Linkage Plan. In Amendment No. 4, the ISE revised the proposed rule text to bar executions in the Block Order and Facilitation Mechanisms of orders of 50 to 499 contracts at prices inferior to the national best bid or offer. Accordingly, the Commission believes the ISE's proposal is now consistent with the Linkage Plan.

In addition, the BSE Letter expressed concern that the ISE's rules do not address how incoming Options Intermarket Linkage orders interact with the Block Order and Facilitation Mechanisms and the orders being submitted to the Mechanisms. The Linkage Plan does not require incoming orders sent to the ISE through the Options Intermarket Linkage to interact with orders submitted to the Mechanisms, and this is not inconsistent with the Options Intermarket Linkage.

C. Trading and Reporting at Non-Standard Increments

The BSE Letter expressed concerns that the ISE's proposal "is attempting to introduce subpenny trading in the options arena," and recommended that the Commission seek additional comment on this issue in light of its proposal "in new Regulation NMS to eliminate subpenny trading in equities." The BSE believes that "it is inconsistent for the Commission to approve the ISE proposal for subpenny trading while at the same time it seeks to eliminate the practice for the equities market."

The ISE responded to this comment by reiterating that its proposal would introduce a single price point between the existing \$.05 and \$.10 trading increments to permit the ISE to achieve what floor-based exchanges currently achieve by executing half of a trade at one standard trading increment and half at one standard trading increment higher, thereby creating an average price for the trade that is at the mid-point between the standard increments. However, the ISE continued, reporting and clearing trades at the actual price, rather than achieving an average price, provides greater transparency to the market.<sup>15</sup> The Commission agrees with this analysis and believes that the ISE's proposal is consistent with the Act. The Commission notes that there are significant differences in the options and stock markets. Most notably, options are not quoted in pennies.

Accordingly, the Commission does not agree with the BSE that approving the ISE's proposal is inconsistent with its adoption of a rule to limit subpenny pricing of stocks.

In addition, the BSE Letter commented that the ISE's proposal does not explain how the ISE would report Split Price trades, and expressed concern that OPRA might not be prepared to report Split Price trades. The Commission believes the ISE's proposal is

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<sup>15</sup> See supra note 6.

clear that the trades would be reported and cleared at Split Prices. Moreover, the ISE confirmed in its response that OPRA and OCC could process Split Prices.

D. Section 11(a) under the Exchange Act

The BSE Letter and the CBOE Letter expressed the view that the ISE's Facilitation Mechanism violates Section 11(a) of the Act<sup>16</sup> and Rule 11a1-1(T) thereunder<sup>17</sup> because the EAM is not required to yield to certain non-customer orders. Section 11(a) of the Act prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. In addition to the exceptions set forth in the statute and Rule 11a1-1(T), Rule 11a2-2(T)<sup>18</sup> provides exchange members with an exemption from this prohibition. Known as the "effect versus execute" rule, Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange.

To comply with the rule's conditions, a member: (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>19</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member

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<sup>16</sup> 15 U.S.C. 78k(a).

<sup>17</sup> 17 CFR 240.11a1-1(T).

<sup>18</sup> 17 CFR 240.11a2-2(T).

<sup>19</sup> The member, however, may participate in clearing and settling the transaction.

has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the rule. The Commission believes that the ISE's Facilitation, Block Order, and Solicited Order Mechanisms satisfy the four conditions of Rule 11A2-2(T).<sup>20</sup> First, all orders are electronically submitted through remote terminals. Second, because a member relinquishes control of its order after it is submitted to the Facilitation, Block Order, and Solicited Order Mechanisms, the member does not receive special or unique trading advantages. Third, although the rule contemplates having an order executed by an exchange member who is not affiliated with the member initiating the order, the Commission recognizes that this requirement is satisfied when automated exchange facilities are used.<sup>21</sup> Finally, to the extent that ISE members rely on Rule 11a2-2(T) for a

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<sup>20</sup> The Commission and its staff, on numerous occasions, have considered the application of Rule 11a2-2(T) to electronic trading and order routing systems. See, e.g., Securities Exchange Act Release Nos. 49068 (January 13, 2004) (Order approving the Boston Options Exchange as a facility of the Boston Stock Exchange, Inc.); 44983 (October 25, 2001) (Order approving the Archipelago Exchange as the equities trading facility of PCX Equities Inc.); and 29237 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979) (regarding the Amex Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX's Communications and Execution System, and the Phlx's Automated Communications and Execution System); and 14563 (March 14, 1978) (regarding the NYSE's Designated Order Turnaround System). See also Letter from Larry E. Bergmann, Senior Associate Director, Division, Commission to Edith Hallahan, Associate General Counsel, Phlx (March 24, 1999) (regarding Phlx's VWAP Trading System); letter from Catherine McGuire, Chief Counsel, Division, Commission, to David E. Rosedahl, PCX (November 30, 1998) (regarding Optimark); and Letter from Brandon Becker, Director, Division, Commission, to George T. Simon, Foley & Lardner (November 30, 1994) (regarding Chicago Match).

<sup>21</sup> In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been

managed account transaction, they must comply with the limitations on compensation set forth in the rule. Therefore, the Commission believes that the ISE's Facilitation, Block Order, and Solicited Order Mechanisms comply with the requirements of Section 11(a) of the Act and Rule 11a2-2(T) thereunder.

E. Other Issues Raised by Comments

The BSE objected to the fact that if Public Customer bids or offers on the ISE are better than the facilitation price, those Public Customer bids or offers receive the facilitated price, such that the Public Customer receives price improvement rather than the customer order being facilitated. This feature of the ISE's Facilitation Mechanism was previously approved by the Commission and the Commission continues to believe it is consistent with the Act.<sup>22</sup>

The BSE Letter also expressed concern that the ISE's Facilitation Mechanism contains no prohibition on the cancellation of a facilitation order, which the BSE stated could leave a customer order potentially unexecuted and subject to market risk. The BSE contends that BOX's rules are better because they prohibit cancellation of facilitation orders. The Commission, however, previously found this feature of the ISE's Facilitation

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transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See Securities Exchange Act Release No. 15533 (January 29, 1979).

<sup>22</sup> See Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (File No. 10-127) (order approving the application of the ISE for registration as a national securities exchange) at 11397.

Mechanism to be consistent with the Act.<sup>23</sup> Moreover, the Commission notes that Paragraph .01 to Supplementary Material to ISE Rule 716 states, among other things:

It will be a violation of a Member's duty of best execution to its customer if it were to cancel a facilitation order to avoid execution of the order at a better price. The availability of the Facilitation Mechanism does not alter a Member's best execution duty to get the best price for its customer.

The BSE Letter also commented that the ISE's Facilitation Mechanism does not provide for the dissemination to ISE members of information regarding the price and size of the orders competing with the facilitation order, which the BSE believes restricts potential price improvement. Although the ISE's rules are different than those proposed by the BSE and approved by the Commission, the Commission nevertheless believes the ISE's rules in this regard are consistent with the Act.<sup>24</sup>

In addition, the BSE Letter asked why "Public Customer Order" would be replaced by "order" in ISE Rule 716(d)(1). The ISE explains in Amendment No. 3 that the purpose of the deletion of the phrase "Public Customer" is to allow the use of the Facilitation Mechanism for broker-dealer orders as well as Public Customer orders.<sup>25</sup>

The BSE Letter questioned the reference in the Supplementary Material to ISE Rule 716 to "Solicited Order" Mechanism, which at the time the ISE filed its proposal was not part of the ISE's rules. As noted above, Amendment No. 2 addressed this comment by removing the reference to "Solicited Order" Mechanism.<sup>26</sup> Amendment No.

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<sup>23</sup> Id. at 11398.

<sup>24</sup> Id. at 11397.

<sup>25</sup> See supra note 8.

<sup>26</sup> See supra note 7.

4, however, reinserted this language following the Commission's approval of the ISE's Solicited Order Mechanism.<sup>27</sup>

The BSE Letter asked why the proposed rule change would delete the phrase "on the Exchange" from ISE Rule 716(d)(3)(i). The ISE represents that the deletion of "on the Exchange," is a technical clarification that will not affect the operation of Rule 716.<sup>28</sup>

The Commission finds good cause for approving Amendment Nos. 2, 3, 4, and 5 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. The Commission believes that accelerated approval of Amendment Nos. 2, 3, 4, and 5 is appropriate because it will immediately allow broker-dealer and public customer orders to be executed at Split Prices.

Accordingly, the Commission believes that there is good cause, consistent with Section 19(b) of the Act, to approve Amendment Nos. 2, 3, 4, and 5 to the proposed rule change on an accelerated basis.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment Nos. 2, 3, 4, and 5 are 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

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<sup>27</sup> See supra notes 9 and 10.

<sup>28</sup> Telephone conversation between Katherine Simmons, Vice President and Associate General Counsel, ISE, and Theodore R. Lazo, Senior Special Counsel, Division, Commission (March 22, 2004).

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-ISE-2003-07 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-2003-07. 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-2003-07 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>29</sup> that the proposed rule change (SR-ISE-2003-07) and Amendment No. 1 thereto are hereby approved and that Amendment Nos. 2, 3, 4, and 5 thereto are hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>30</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>29</sup> 15 U.S.C. 78s(b)(2).

<sup>30</sup> 17 CFR 200.30-3(a)(12).