

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52894; File No. SR-ISE-2005-45)

December 5, 2005

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change and Amendment No. 1 Thereto Relating to the Elimination of Position and Exercise Limits on NDX Options

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 21, 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 the ISE. On November 14, 2005, 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. In addition, the Commission is granting accelerated approval of the proposed rule change, as amended.

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

The ISE proposes to amend its rules to eliminate position and exercise limits for options on the Nasdaq 100 Index (“NDX”). The text of the proposed rule change, as amended, is below. Proposed new language is in underlined; proposed deletions are in [brackets].

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¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1, which replaced and superseded the original filing in its entirety, added certain reporting requirements and margin provisions and expanded on the purpose of the proposed rule change.

Rule 2004. Position Limits for Broad-Based Index Options

(a) Rule 412 generally shall govern position limits for broad-based index options, as modified by this Rule 2004. There may be no position limit for certain Specified (as provided in Rule 2000) broad-based index options contracts. All other broad-based index options contracts shall be subject to a contract limitation fixed by the Exchange, which shall not be larger than the limits provided in the chart below.

Broad-Based Underlying Index	Standard Limit (on the same side of the market)	Restrictions
S&P SmallCap 600 Index	100,000 contracts	No more than 60,000 near-term
S&P MidCap 400 Index	45,000 contracts	No more than 25,000 near-term
Reduced Value S&P 1000 Index	50,000 contracts	No more than 30,000 near-term
Micro S&P 1000 Index	500,000 contracts	No more than 300,000 near-term
Nasdaq 100 Index	<u>None</u> [75,000 contracts]	None
Mini Nasdaq 100 Index	750,000 contracts	None

Remainder of the Chart – No Change.

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(b) – (d) No Change.

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Rule 2006. Exemptions from Position Limits

(a) Broad-based Index Hedge Exemption. The broad-based index hedge exemption is in addition to the other exemptions available under Exchange Rules, interpretations and policies.

The following procedures and criteria must be satisfied to qualify for a broad-based index hedge exemption:

(1) – (4) No Change.

(5) Positions in broad-based index options that are traded on the Exchange are exempt from the standard limits to the extent specified below.

Broad-Based Index Option Type	Broad-Based Index Hedge Exemption (is in addition to standard limit)
Nasdaq 100 Stock Index ($\frac{1}{10}$ th value) (MNX)	1,500,000 contracts
[Nasdaq 100 Stock Index (full value) (NDX)]	[150,000 contracts]
Other broad-based indexes	75,000

(6) – (12) No Change.

(13) Each member (other than Exchange market-makers) that maintains a broad-based index option[s] position on the same side of the market in excess of 100,000 contracts in NDX [a Specified (as provided in Rule 2000) number of contracts] for its own account or for the account of a customer, shall report information as to whether the positions are hedged and provide documentation as to how such contracts are hedged, in the manner and form required by the Exchange. The Exchange may impose other reporting requirements as well as the limit at which the reporting requirement may be triggered.

(14) Whenever the Exchange determines that additional margin is warranted in light of the risks associated with an under-hedged NDX options position[in Specified (as provided in Rule 2000) broad-based indices], the Exchange may impose additional

margin upon the account maintaining such under-hedged position pursuant to its authority under Rule 1204. The clearing firm carrying the account also will be subject to capital charges under Rule 15c3-1 under the Exchange Act to the extent of any margin deficiency resulting from the higher margin requirements.

(b) No Change.

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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 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 Exchange proposes to eliminate position and exercise limits for options on the NDX, a broad-based securities index. Under ISE Rule 2004, the current position and exercise limit for options on the NDX is 75,000 contracts on the same side of the market. Given the institutional demand for options on the NDX, the Exchange believes the current position and exercise limit of 75,000 contracts to be too low and a deterrent to the successful trading of the product.

Additionally, the ISE believes that these limits for options on the NDX 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.⁴

The Commission has previously granted relief from position and exercise limits with respect to options on indexes that the ISE believes are similar to the NDX without any adverse affects on the market as a result.⁵ The Exchange believes that the circumstances and considerations relied upon in approving the elimination of position and exercise limits for

⁴ See Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998).

⁵ See Securities Exchange Act Release No. 44994 (October 26, 2001), 66 FR 55722 (November 2, 2001) (order granting permanent approval to a Chicago Board Options Exchange, Incorporated (“CBOE”) pilot program to eliminate position and exercise limits for options on the S&P 500 Index (“SPX”), the S&P 100 Index (“OEX”), and the Dow Jones Industrial Average (“DJX”)) (“SPX/OEX/DJX Permanent Approval Order”). See also Securities Exchange Act Release No. 40969 (January 22, 1999), 64 FR 4911 (February 1, 1999) (order approving the CBOE’s original pilot program) (“SPX/OEX/DJX Pilot Approval Order”). Telephone conversation between Samir M. Patel, Assistant General Counsel, ISE, and Ira L. Brandriss, Special Counsel, Division of Market Regulation, Commission, on November 23, 2005 (“Telephone Conversation with ISE”).

options on the SPX, OEX, and DJX on the CBOE equally apply to the Exchange's proposed rule change regarding position and exercise limits for options on the NDX.

In approving the elimination of position and exercise limits for options on the SPX, OEX, and DJX, the Commission noted their active trading volume and the deep, liquid markets for the securities underlying the indexes, as well as their market capitalization.⁶ The Exchange notes that the average daily trading volume ("ADTV") of the underlying components of and options on the NDX as well as the market capitalization of the index are comparable to the ADTV and market capitalization figures for SPX, OEX, and DJX. As of October 18, 2005, the approximate market capitalizations of SPX, OEX and DJX were \$10.87 trillion, \$5.95 trillion and \$3.53 trillion, respectively. The ADTVs for all underlying components of the indexes were 1,825 million, 800 million, and 370 million shares, respectively, and the ADTV for options on the indexes were 288,644 contracts, 74,725 contracts, and 22,282 contracts, respectively.⁷ The market capitalization of the NDX was \$1.82 trillion, the ADTV for the underlying securities of the index was 716 million shares, and the options ADTV was 51,661 contracts.

Additionally, in approving the elimination of position and exercise limits for options on the SPX, OEX, and DJX, the Commission also noted the financial requirements imposed by both the CBOE and the Commission in an effort to guard against a CBOE member or its customer(s) from maintaining a large unhedged position in those securities. The Exchange believes that the current financial requirements imposed by the ISE and by the Commission adequately address concerns that a member or its customer may try to maintain an inordinately large unhedged

⁶ See SPX/OEX/DJX Pilot and Permanent Approval Orders. Telephone Conversation with ISE.

⁷ ADTVs are calculated over the previous three months of trading.

position in NDX options. The Exchange notes that, under its rules, it has the authority to impose additional margin upon accounts maintaining underhedged positions,⁸ and is further able to monitor accounts to determine when such action is warranted. As noted in the Exchange's rules, the clearing firm carrying such an account would be subject to capital charges under Rule 15c3-1 under the Act⁹ to the extent of any resulting margin deficiency.¹⁰ 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. Additionally, 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.

Finally, in approving the elimination of position and exercise limits for options on the SPX, OEX, and DJX, the Commission relied on the CBOE's ability to provide surveillance and reporting safeguards to detect and deter trading abuses that could arise from the elimination of position and exercise limits in those securities. The Exchange believes that the updated surveillance procedures and reporting requirements at the ISE,¹¹ coupled with the surveillance procedures and reporting requirements of the other options exchanges, are capable of properly identifying unusual and/or illegal trading activity. These procedures utilize daily monitoring of

⁸ See, e.g. Commentary .02 to ISE Rule 412.

⁹ See 17 CFR 240.15c3-1.

¹⁰ See also the proposed change to ISE Rule 2006(a)(14), to include a specific reference to options on the NDX. Telephone Conversation with ISE.

¹¹ The Exchange has separately submitted, on a confidential basis, updated surveillance procedures regarding trading in NDX options.

market movements via automated surveillance techniques to identify unusual activity in both options and in underlying stocks. Additionally, the Exchange intends to impose a reporting requirement on ISE members (other than Exchange market-makers) who trade NDX options.¹² This reporting requirement would require Exchange members who maintain in excess of 100,000 NDX contracts on the same side of the market, for their own accounts or for the account of customers, to report information as to whether the positions are hedged and provide documentation as to how such contracts are hedged, in a manner and form required by the Exchange.¹³ The Exchange also would be permitted to specify other reporting requirements, as well as the limit at which the reporting requirement may be triggered.¹⁴

The Exchange believes that eliminating position and exercise limits for NDX options will allow ISE members and their customers greater hedging and investment opportunities.

2. Statutory Basis

The ISE believes the proposed rule change is consistent with Section 6(b) of the Act,¹⁵ in general, and furthers the objectives of Section 6(b)(5),¹⁶ in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the

¹² ISE does not currently trade options on any security for which there are no position and exercise limits. As such, the Exchange has never imposed this reporting requirement on its members. The Exchange will issue a Regulatory Information Circular to its members informing them of the elimination of position and exercise limits for options on the NDX and the resulting reporting requirement.

¹³ See proposed changes to ISE Rule 2006(a)(13).

¹⁴ Id.

¹⁵ 15 U.S.C. 78f(b).

¹⁶ 15 U.S.C. 78f(b)(5).

mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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 the 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 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. 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-2005-45 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-ISE-2005-45. 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, 100 F Street, NE, 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-2005-45 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 consideration, 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.¹⁷ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁸ which requires, among other things, that the rules of the Exchange be designed to promote just and equitable principles of trade, to

¹⁷ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁸ 15 U.S.C. 78f(b)(5).

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.

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, and to reduce the possibility for the disruption of the options market itself.

The Commission notes that it continues to believe that the fundamental purposes of position and exercise limits remain valid. Nevertheless, the Commission believes that experience with the trading of index options as well as enhanced reporting requirements and exchange surveillance capabilities make it possible to approve the elimination of position and exercise limits on certain broad-based index options. Thus, in 2001, the Commission approved a CBOE proposal to eliminate permanently position and exercise limits for options on the SPX, OEX, and DJX,¹⁹ and in 2002 approved a proposal by the American Stock Exchange LLC (“Amex”) to eliminate permanently position and exercise limits for options on the Major Market Index (“XMI”) and the Institutional Index (“XII”). Recently the Commission also approved proposals by the CBOE and the Amex to eliminate position and exercise limits for options on the NDX trading on those exchanges.²⁰ The Commission believes that the considerations upon

¹⁹ See SPX/OEX/DJX Permanent Approval Order, supra note 5.

²⁰ See Securities Exchange Act Release Nos. 52650 (October 21, 2005), 70 FR 62147 (October 28, 2005) (order approving File No. SR-CBOE-2005-41); and 52649 (October 21, 2005), 70 FR 62146 (October 28, 2005) (order approving File No. SR-Amex-2005-063) (“CBOE and Amex NDX Approval Orders”).

which it relied in approving those proposals equally apply with respect to the instant proposed rule change by the ISE.

As noted by the Exchange, the market capitalization of the NDX as of October 18, 2005 was \$1.82 trillion. The ADTV for a period of three months prior to that date for all underlying components of the index was 716 million shares. As it stated in the CBOE and Amex NDX Approval Orders, the Commission believes that the enormous market capitalization of the NDX and the deep, liquid markets for the underlying component securities significantly reduce concerns regarding market manipulation or disruption in the underlying market. Removing position and exercise limits for NDX options may also bring additional depth and liquidity, in terms of both volume and open interest, to NDX options without significantly increasing concerns regarding intermarket manipulation or disruption of the options or the underlying securities.

In addition, the Commission believes that financial requirements imposed by both the Exchange and the Commission adequately address concerns that a ISE member or its customer may try to maintain an inordinately large unhedged position in NDX options. Current risk-based haircut and margin 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.²¹ As specified in the proposal, the ISE also would have the authority under its rules to impose a higher margin requirement upon an account maintaining an under-hedged position in NDX options when it determines a higher requirement is warranted. As also noted in the applicable ISE rules, the clearing firm carrying the account would be subject

²¹ See SPX/OEX/DJX Pilot Approval Order, supra note 5.

to capital charges under Rule 15c3-1 under the Act to the extent of any margin deficiency resulting from the higher margin requirement.

Finally, in approving the elimination of position and exercise limits for options on the indexes noted above, the Commission took note of the enhanced surveillance and reporting safeguards that the relevant exchange had adopted to allow it to detect and deter trading abuses that might arise as a result.²² The ISE's updated safeguards, including the 100,000-contract reporting requirement described above, would allow the ISE to monitor large positions in order to identify instances of potential risk and to assess and respond to any market concerns at an early stage. In this regard, the Commission expects the ISE to take prompt action, including timely communication with the Commission and other marketplace self-regulatory organizations responsible for oversight of trading in component stocks, should any unanticipated adverse market effects develop. Moreover, as previously noted, the Exchange has the flexibility to specify other reporting requirements, as well as to vary the limit at which the reporting requirements may be triggered.

The ISE has requested that the Commission find good cause for approving the proposed rule change prior to the thirtieth day after publication of notice thereof in the Federal Register. As already noted, the Commission recently approved similar proposals eliminating position and exercise limits for NDX options on the CBOE and the Amex. The Commission believes that granting accelerated approval of the proposal will allow the ISE to conform its rules to those of other exchanges trading NDX options without delay. Accordingly, the Commission finds good

²² See, in particular, SPX/OEX/DJX Pilot Approval Order, supra note 5.

cause, pursuant to Section 19(b)(2) of the Act,²³ for approving the proposed rule change, as amended, prior to the thirtieth day after the date of publication of notice thereof in the Federal Register.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (SR-ISE-2005-45), as amended, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁵

Jonathan G. Katz
Secretary

²³ 15 U.S.C. 78s(b)(2).

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).