

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49943; File No. SR-ISE-2001-22]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the International Securities Exchange, Inc., To Establish a Solicited Order Mechanism

June 30, 2004.

I. Introduction

On July 26, 2001, 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")¹ and Rule 19b-4 thereunder,² a proposed rule change to establish a mechanism for matching a member's unsolicited agency orders with orders the member solicits from other broker-dealers. On January 4, 2002, June 26, 2002, and January 6, 2004, ISE filed Amendment Nos. 1, 2, and 3 to the proposed rule change, respectively.³ Notice of the proposed rule change, as amended, was published for comment in the **Federal Register** on February 5, 2004.⁴ The Commission received no comments on the proposal. This order approves the proposed rule change.

II. Description of the Proposal

Under ISE Rule 717(e), an Electronic Access Member ("EAM") is required to expose an unsolicited agency order (the "Agency Order") for at least 30 seconds before crossing it against an order that it has solicited from other broker-dealers. Currently, an EAM can comply with this requirement only by entering the Agency Order on the Exchange, waiting 30 seconds, and then entering the solicited order.

The proposed rule change would provide an alternative, enabling EAMs to pair solicited orders against Agency Orders for execution through a Solicited Order Mechanism ("Mechanism") designed for this purpose.⁵ Such trades would be required to be for at least 500 contracts and would be executed only if the price is at or between the ISE best bid or offer ("BBO"). Both orders

entered into the Mechanism would be required to be all-or-none limit orders.⁶

When a proposed solicited cross is entered into the Mechanism, the Exchange would send a message to Crowd Participants,⁷ giving them ten seconds to enter responses with the prices and sizes at which they would be willing to participate in the execution of the Agency Order. If at the end of the ten seconds there is sufficient size to execute the entire Agency Order at an improved price (or prices), the Agency Order would be executed at that price (or prices),⁸ and the solicited order would be canceled.

The aggregate of all orders, quotes, and responses at each price would be used to determine whether the entire Agency Order could be executed in this manner. Public customer orders would be given priority in the execution, and then all other non-customer interest at the same price would participate pro-rata based on size.

If at the end of the ten seconds there is not sufficient size to execute the entire Agency Order at an improved price (or prices), the Agency Order would be executed against the solicited order at the proposed price, provided that such price is equal to or better than the BBO on the Exchange,⁹ and there are no public customer orders on the Exchange that are at the proposed price.

If there are one or more public customer orders on the book at the proposed execution price and there is sufficient size to execute the entire Agency Order, the Agency Order would be executed against that size and the solicited order would be canceled.¹⁰ If there are one or more public customer orders on the book at the proposed execution price but there is not sufficient size to execute the entire Agency Order, both the Agency Order

and the solicited order would be canceled.

The proposed rule also would stipulate that, prior to entering an Agency Order into the Mechanism, an EAM must deliver to the customer a written notification informing the customer that its order may be executed using the Mechanism. The document would be required to disclose the terms and conditions of the Mechanism in a form approved by the Exchange.

The proposed rule change would include Supplementary Material stating that the Mechanism provides a facility for members that locate liquidity for their customer orders, and that members may not use the Mechanism to circumvent Exchange rules limiting principal transactions.¹¹ This would include a member entering contra orders that are solicited from affiliated broker-dealers or broker-dealers with which the member has an arrangement that allows the member to realize similar economic benefits from the solicited transaction as it would achieve by executing the order in whole or in part as principal.

The proposed rule change also adds a reference to the Mechanism in its rules that prohibit anticipatory hedging activities prior to the entry of an order on the Exchange.¹²

III. Discussion

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,¹³ and in particular with the requirements of section 6(b)(5) of the Act.¹⁴ The Commission believes that the proposal, which would create a mechanism to execute large-size customer orders against orders solicited from broker-dealers, includes appropriate terms and conditions to assure that the customer orders are first exposed to the ISE crowd participants for the possibility of price improvement and that public customer orders on the Exchange are protected.

The proposal would provide a mechanism for an EAM to trade an

¹¹ See ISE Rule 717(d).

¹² See Supplementary Material to ISE Rule 400 (Just and Equitable Principles of Trade).

¹³ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation.

¹⁴ 15 U.S.C. 78f(b)(5). Section 6(b)(5) requires that the rules of a national securities exchange be designed to, among other things, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest. It also requires that those rules not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letters from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated January 3, 2002, June 25, 2002, and January 5, 2004.

⁴ See Securities Exchange Act Release No. 49141 (January 28, 2004), 69 FR 5625.

⁵ The rules relating to the Mechanism would be set forth in new paragraph (e) of ISE Rule 716.

⁶ Although orders solicited from public customers are not subject to the exposure requirement of Rule 717(e), they would be permitted to be entered into the Mechanism should Exchange members choose this alternative.

⁷ The term "Crowd Participants" is defined for purposes of ISE Rule 716 as the market makers appointed to an option options class under ISE Rule 803, as well as other members with proprietary orders at the inside bid or offer for a particular series.

⁸ Such execution would be subject to the condition that the price is equal to or better than the ISE BBO.

⁹ If an execution would take place at a price that is inferior to the BBO on the Exchange, both the solicited order and the Agency Order would be canceled.

¹⁰ The aggregate size of all orders, quotes, and responses would be used to determine whether the Agency Order could be executed. Public customer orders would be given priority in the execution, and then all other non-customer interest at the same price would participate pro-rata based on size.

Agency Order of 500 contracts or more against a contra side order of the same size it has solicited from a broker-dealer,¹⁵ but only when a better price for the full size of the Agency Order is not available in the aggregate of all quotes, orders, and responses from Crowd Participants. The Mechanism would require the Agency Order to be exposed to Crowd Participants for 10 seconds before the solicited order could trade against it. In no case would the customer receive a price inferior to the Exchange's BBO.

Under the proposal, if the execution price is not improved for the full size of the customer's order (*i.e.*, the Agency Order), the Agency Order would be executed in full against the solicited order at the originally proposed price (unless there are public customer orders on the book at that price or the Exchange BBO has improved over that price). The Commission believes that customers seeking to transact orders of the size eligible for entry into the Mechanism "500 contracts or more" can assess the implications of the Mechanism's terms of use. The Commission notes, moreover, that the proposed rule change would require EAMs to provide customers with the terms and conditions of the Mechanism in writing before entering orders into it on their behalf.

In addition, the Commission notes that the proposed rule change would not permit solicited orders to trade when there is a public customer order on the book at the proposed execution price. In such circumstances, if there is sufficient size in the aggregate to fill the Agency Order, first the public customer order, and then any other quotes, orders, and responses, are executed against the Agency Order, and the solicited order is canceled. If there is insufficient size, both the Agency Order and solicited order are canceled.

The Commission further notes that ISE has included a provision stating that an EAM may not use the Mechanism to circumvent the Exchange rules limiting principal transactions. For example, this

¹⁵ The Commission notes that, under ISE Rule 717(g), an EAM generally is not permitted to represent an order for the account of an ISE market maker. Thus, an EAM would not be permitted to use the Mechanism to execute an Agency Order against an order solicited from an ISE market maker. Telephone conversation between Michael Simon, Senior Vice President and General Counsel, ISE, and Ira Brandriss, Assistant Director, Division, Commission, on June 29, 2004. The Commission notes that the ISE has filed another proposed rule change to amend Rule 717(g) to permit an EAM to enter an order on behalf of an ISE market maker under specified conditions. See File No. SR-ISE-2004-17. This Order, however, approves the proposed rule change only to the extent that the restriction of current ISE Rule 717(g) applies.

provision would prohibit an EAM from entering contra side orders solicited from broker-dealers with which the EAM is affiliated or from broker-dealers with which the EAM has an arrangement that would allow it to realize economic benefits similar to internalization.

Finally, the Commission notes that ISE's rules prohibit anticipatory hedging based on knowledge of an imminent transaction before the terms and conditions of the transaction are disclosed to the trading crowd. These rules already apply to solicited order transactions. ISE proposes to amend those rules to establish that entry of the terms and conditions of a solicited order transaction are deemed "disclosed" when they are entered into the Mechanism. The Commission believes this proposed amendment is reasonable and conforms to a similar provision regarding transactions entered into the Exchange's Facilitation Mechanism.

IV. Conclusion

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to section 19(b)(2) of the Act, that the proposed rule change (SR-ISE-2001-22), as amended, be and hereby is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04-15455 Filed 7-7-04; 8:45 am]

BILLING CODE 8010-01-P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49957; File No. SR-ISE-2004-22]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the International Securities Exchange, Inc., Relating to Fee Changes

July 1, 2004.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 1, 2004, the International Securities Exchange, Inc. ("ISE" or "Exchange") filed with the Securities and Exchange Commission (the "Commission") the

proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The ISE submitted Amendment No. 1 to the proposed rule change on June 21, 2004.³ 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 Exchange is proposing to amend its Schedule of Fees to adopt a \$.10 per contract surcharge and temporary fee waivers for certain transactions in options based on the S&P MidCap 400 Index.

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, as amended, and noted that it did not solicit or receive comments 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 to amend its Schedule of Fees to adopt a \$.10 per contract surcharge and temporary fee waivers for certain transactions in options based on the S&P MidCap 400 Index.

The Exchange's Schedule of Fees currently has in place a surcharge fee item that calls for a \$.10 per contract fee for transactions in certain licensed products. The Exchange has entered into a license agreement to use various indexes and trademarks of Standard & Poor's, a division of The McGraw-Hill Companies, Inc., in connection with the listing and trading of index options on the S&P MidCap 400 Index. As with

³ See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, dated June 18, 2004 ("Amendment No. 1"). Amendment No. 1 replaced and superceded the original filing in its entirety. In Amendment No. 1, the Exchange provided additional clarification regarding its proposed changes and made a correction to the proposed fee schedule.

¹⁶ 17 CFR 200.30-3(a)(12).

¹⁵ U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.