SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50015; File No. SR-ISE-2003-22)

July 14, 2004

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 by the International Securities Exchange, Inc. Relating to Permanent Approval of a Pilot Program for Quotation Spreads

I. Introduction

On September 24, 2003, the International Securities Exchange, Inc. ("ISE" or "Exchange"), filed with the Securities and Exchange Commission ("SEC" or "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 requesting permanent approval of a pilot program permitting the allowable market maker quotation spread for all options listed on the ISE to be $5, regardless of the price of the bid ("Pilot Program"). On May 20, 2004, the ISE filed Amendment No. 1 to the proposal.[3] Amendment No. 1 revised the proposal to expressly include in the Pilot Program all index options listed on the ISE as well as all equity options listed on the ISE.

The proposed rule change and Amendment No. 1 were published for comment in the Federal Register on May 27, 2004.[4] The Commission received no comments regarding the proposal. This order approves the proposed rule change, as amended.

II. Description

On March 19, 2003, the Commission approved an ISE proposal to establish the Pilot Program on a six-month pilot basis until September 19, 2003.[5] The Pilot Program, which

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission, dated May 19, 2004, and accompanying Form 19b-4 ("Amendment No. 1").

4 See Securities Exchange Act Release No. 49754 (May 21, 2004), 69 FR 30352.

initially included options on up to 50 equity securities listed on the ISE, was extended several times and expanded to include all options listed on the ISE.[6]

The Pilot Program permits an ISE market maker to quote any equity or index option listed on the ISE with a difference of no more than $5 between the bid and the offer following the opening rotation.[7] Prior to the opening rotation, the maximum bid/ask differentials range from $.25 to $1.00, depending on the price of the option.[8]

As required by the Pilot Program Approval Order, the ISE submitted a report providing information concerning the quotations in the 50 equity options initially included in the Pilot Program. In addition, following the expansion of the Pilot Program,[9] the ISE submitted a second Pilot Program report providing quotation information concerning all of the options included in the ISE's expanded Pilot Program.

III. Discussion

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5 See Securities Exchange Act Release No. 47532 (March 19, 2003), 68 FR 55685 (March 26, 2003) ("Pilot Program Approval Order").

6 See Securities Exchange Act Release Nos. 48514 (September 22, 2003), 68 FR 55685 (September 26, 2003) (notice of filing and immediate effectiveness of File No. SR-ISE-2003-21) (extending the Pilot Program through January 31, 2004); 49149 (January 29, 2004), 69 FR 05627 (notice of filing and immediate effectiveness of File No. SR-ISE-2004-02) (extending the Pilot Program through March 31, 2004); 49509 (March 31, 2004), 69 FR 18411 (April 7, 2004) (notice of filing and immediate effectiveness of File No. SR-ISE-2004-10) (extending the Pilot Program through June 29, 2004, and expanding the Pilot Program to include all options listed on the ISE) ("Pilot Expansion Notice"); and 49918 (June 25, 2004), 69 FR 40427 (July 2, 2004) (notice of filing and immediate effectiveness of File No. SR-ISE-2004-23) (extending the Pilot Program through July 29, 2004).

7 See ISE Rule 803(b)(4).

8 Specifically, prior to the opening rotation, ISE Rule 803(b)(4) requires options market makers to bid and offer so as to create differences of no more than $.25 between the bid and offer for each options contract for which the bid is less than $2; no more than $.40 where the bid is at least $2 but does not exceed $5; no more than $.50 where the bid is more than $5 but does not exceed $10; no more than $.80 where the bid is more than $10 but does not exceed $20; and no more than $1 where the bid is $20 or greater. The bid/offer differentials do not apply to in-the-money options series when the spread in the underlying securities market is wider than the differentials set forth above. For such series, ISE Rule 803(b)(4) permits the bid/ask differential to be as wide as the quotation on the primary market of the underlying security.

9 See Pilot Expansion Notice, supra note 6.

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.[10] In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act[11] in that it is 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.

In the Pilot Program Approval Order,[12] the Commission noted that although the Commission believes generally that maximum quotation spread parameters in the options market could provide an important safeguard to ensure that market maker quotes in options are not unnecessarily wide, the Commission nevertheless believed that the ISE provided sufficiently strong incentives for market makers to disseminate competitive quotes without maximum quotation spread parameters. In this regard, the Pilot Program Approval Order noted that each ISE market maker uses an automatic quotation system to quote independently, customers and professional traders can enter limit orders on the ISE's book, and market makers are only allocated trades when they are quoting at the best price. Moreover, the larger the size of a market maker's quote, the larger portion of a trade it is allocated. The Commission believed that these attributes and rules of the ISE provided strong market incentives for market makers to maintain narrow and competitive quotation spreads.[13]

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10 In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

11 15 U.S.C. 78f(b)(5).

12 See note 5, supra.

13 See Pilot Program Approval Order, supra note 5.

The Commission believes that the two Pilot Program reports submitted by the ISE indicate that market maker quotation spreads for options included in the Pilot Program have not widened significantly during the operation of the Pilot Program. Accordingly, the Commission believes that permanent approval of the Pilot Program is consistent with the Act.

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposal, as amended, is consistent with the requirements of the Act and rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[14] that the proposed rule change (SR-ISE-2003-22), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[15]

Margaret H. McFarland
Deputy Secretary

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14 15 U.S.C. 78s(b)(2).

15 17 CFR 200.30-3(a)(12).