SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51835; File No. SR-ISE-2004-16)

June 13, 2005

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Establishing a Directed Order Process

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 May 20, 2004, 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, II, and III below, which Items have been prepared by the ISE. On April 26, 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.

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

The ISE proposes to adopt new ISE Rule 811 to allow Exchange market makers to receive Public Customer Orders directed to them from Electronic Access Members ("EAMs") through the Exchange's system ("Directed Orders"). Proposed new language is in italics.

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

2 17 CFR 240.19b-4.

3 Amendment No. 1 replaced and superseded the original filing in its entirety. Amendment No. 1 to the proposed rule change: (i) added a provision to the proposed rule change related to the processing of Directed Orders when the market maker to which it is directed is the primary market maker in the option and the ISE's bid/offer is inferior to the national best bid/offer; (ii) revised the purpose section of the filing and maked certain non-substantive changes to the text of the proposed rule change; and (iii) removed a proposed amendment to ISE Rule 810 related to information barriers to allow market maker to handle directed order because the Exchange has received approval of a separate proposed rule change to ISE Rule 810 in this respect (see Securities Exchange Act Release No. 50433 (September 23, 2004), 69 FR 58563 (September 30, 2004) (SR-ISE-2004-18)).

Rule 811. Directed Orders

(a) Definitions.

(1) A "Directed Order" is a Public Customer Order routed from an Electronic Access Member to an Exchange market maker through the Exchange's System.

(2) A "Directed Market Maker" is a market maker that receives a Directed Order.

(3) The "NBBO" is defined in Rule 1900.

(b) Exchange market makers may only receive and handle orders on an agency basis if they are Directed Orders and only in the manner prescribed in this Rule 811. A market maker can elect whether or not to accept Directed Orders on a daily basis. If a market maker elects to be a Directed Market Maker, it must accept Directed Orders from all Electronic Access Members. A Directed Market Maker cannot reject a Directed Order.

(c) Obligations of Directed Market Makers.

(1) Directed Market Makers must hold the interests of orders entrusted to them above their own interests and fulfill in a professional manner all other duties of an agent, including, but not limited to, ensuring that each such order, regardless of its size or source, receives proper representation and timely, best possible execution in accordance with the terms of the order and the rules and policies of the Exchange.

(2) Directed Market Makers must ensure that their acceptance and execution of Directed Orders as agent are in compliance with applicable Federal and Exchange rules and policies.

(3) Within three (3) seconds of receipt of a Directed Order, Directed Market Makers must either enter the Directed Order into the PIM pursuant to Rule 723 or release the

Directed Order to the Exchange's limit order book pursuant to paragraph (e) of this Rule.

(i) If the Directed Market Maker is quoting at the NBBO on the opposite side of the Directed Order, the Directed Market Maker is prohibited from adjusting the price of its quote to a price that is less favorable than the price available at the NBBO or reducing the size of its quote prior to submitting the Directed Order to the PIM, unless such quote change is the result of an automated quotation system that operates independently from the existence or non-existence of a pending Directed Order. Otherwise changing a quote on the opposite side of the Directed Order except as specifically permitted herein will be a violation of Rule 400 (Just and Equitable Principles of Trade).

(ii) If a Directed Market Maker fails to either enter a Directed Order into the PIM or release the order within three (3) seconds of its receipt, the Directed Order will be automatically released by the System and processed according to paragraph (e) of this Rule.

(d) Directed Market Maker Guarantee. If the Directed Market Maker is quoting at the NBBO on the opposite side of the market from a Directed Order at the time the Directed Order is received by the Directed Market Maker, and the Directed Order is marketable, the System will automatically guarantee execution of the Directed Order against the Directed Market Maker at the price and the size of its quote (the "Guarantee"). The Directed Market Maker cannot alter the Guarantee.

(e) Except as provided in this paragraph (e), when a Directed Order is released, the System processes the order in the same manner as any other order received by the Exchange.

Directed Orders will not be automatically executed at a price that is inferior to the NBBO and, except as provided in subparagraph (e)(3), will be handled pursuant to Rule 803(c)(2) when the ISE best bid or offer is inferior to the NBBO.

(1) A marketable Directed Order will be matched against orders and quotes according to Rule 713 except that, at any given price level, the Directed Market Maker will be last in priority.

(i) If, after all other interest at the NBBO is executed in full, there is any remaining unexecuted quantity of the Directed Order and the Directed Market Maker is quoting at the NBBO or a Guarantee exists, a broadcast message will be sent to all Members. After three (3) seconds, any additional interest at the same or better price will be executed according to Rule 713.

(ii) If there continues to be any remaining unexecuted quantity of the Directed Order, it will be executed against any interest at the same price from the Directed Market Maker. If a Guarantee exists at that price, an execution will occur for at least the size of the Guarantee.

(iii) If there continues to be any remaining unexecuted quantity of the Directed Order and the Directed Order is marketable at the next price level without trading through the NBBO, the Directed Order will be allocated according to Rule 713 except that the Directed Market Maker will be last in priority. If an execution at any given price level would cause the Directed Order to be executed at a price inferior to the NBBO, the order will be presented to the PMM for handling according to Rule 803(c)(2).

(iv) Subparagraph (e)(1)(iii) will be repeated until the Directed Order is (A) fully executed, (B) presented to the Primary Market Maker for handling according to Rule 803(c)(2), or (C) no longer marketable, in which case it will be placed on the limit order book.

(2) If a Directed Order is not marketable at the time it is released:

(i) If a Guarantee exists, a broadcast message will be sent to all Members. After three (3) seconds, the Directed Order will be executed against any contra interest at the Guarantee price or better according to Rule 713. Thereafter, the Directed Order will be executed against the Directed Market Maker for at least the size of the Guarantee. If there is any remaining unexecuted quantity of the Directed Order, it will be placed on the Exchange's limit order book.

(ii) If no Guarantee exists, the Directed Order will be placed on the Exchange's limit order book. In this case, the Directed Market Maker may not enter a proprietary order to execute against the Directed Order during the three (3) seconds following the release of the Directed Order.

(3) If, at the time a Directed Order is released by the Directed Market Maker, the Directed Order is marketable but the ISE best bid or offer is inferior to the NBBO, and the Directed Market Maker is the Primary Market Maker in the option class for the Directed Order, then a broadcast message shall be sent to all Members displaying the Directed Order. After three (3) seconds, the Directed Order will be executed against any contra interest at the NBBO price or better according to Rule 713, except that the Directed Market Maker will be last in priority. Thereafter, if

there is any remaining unexecuted quantity of the Directed Order, it will be presented to the Primary Market Maker for handling according to Rule 803(c)(2).

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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 IV below. The ISE 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 adopt new ISE Rule 811 to allow Exchange market makers to receive Directed Orders. A Directed Order is defined as a Public Customer Order routed from an EAM to an Exchange market maker through the Exchange's system.[4] A "Directed Market Maker" is an Exchange market maker that receives a Directed Order. Market makers may elect whether to receive Directed Orders on a daily basis. Directed Market Makers must accept Directed Orders from all EAMs and may not reject any Directed Orders. Directed Market Makers must either enter Directed Orders into the Price Improvement Mechanism ("PIM") pursuant to ISE Rule 723 or release the Directed Orders to the Exchange's limit order book. The ISE would give a Directed Market Maker three seconds to take one of these actions, after which

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4 The proposal is similar to Chapter VI, Section 5(b) and (c), and Section 10, of the rules of the Boston Stock Exchange.

the Exchange system would automatically release the Directed Order. Directed Orders are anonymous, so that Directed Market Makers would not know which EAM routed a Directed Order.

When a Directed Order is not entered into the PIM, and thus is released to the Exchange's limit order book, the Exchange would process the order like any other incoming order, other than as follows:

i. When an order is directed to a market maker that is quoting at the national best bid or offer ("NBBO"), the system automatically guarantees the price and size of the market maker's quote (the "Guarantee"). This assures that if the price or size of the Directed Market Maker's quote changes between the time the Directed Order was received and the time that it is released (because, for example, there is a change in the market for the underlying security), the Directed Order is not disadvantaged.

ii. At any given price level, a Directed Order is executed according the Exchange's standard allocation process provided in ISE Rule 713, except that the Directed Market Maker is put last in priority and the Directed Order is exposed to all Members for three seconds prior to executing any portion of the Directed Order against the Directed Market Maker. This assures that the Directed Market Maker does not benefit from the fact that it had knowledge of the Directed Order prior to its entry into the Exchange's system.

Applying these principles, a marketable Directed Order released into the Exchange's system would trade as follows:

- When the Directed Order is released, the system would execute the Directed Order pursuant to ISE Rule 713, initially excluding the Directed Market Maker.

- If there is any remaining unexecuted quantity of the Directed Order, and the Directed Market Maker is quoting at the same price or there is a Guarantee at the same price, the system would generate a broadcast message to all Members, who would have three seconds to respond with additional interest at the same or a better price.
- After this three second exposure, the system would again execute the Directed Order pursuant to the ISE Rule 713 algorithm against all interest except for the Directed Market Maker. If there continues to be any remaining unexecuted quantity of the Directed Order, the system would automatically execute the Directed Order against the Directed Market Maker's quote and/or Guarantee (if the Directed Market Maker has a quote at the same price as the Guarantee for a greater size, the order would receive the greater size).
- Following any execution against the Directed Market Maker, and if there continues to be any unexecuted quantity: if the order is not marketable, the system would place the order on the limit order book; or, if the order is marketable at that price without trading through the NBBO, execute the order at the next price level. At each such price level, the Directed Order is executed pursuant to the ISE Rule 713 algorithm except that the Directed Market Maker is put last in priority.
- At each price level, the Exchange's system would assure that the Directed Order is not automatically executed at a price that is inferior to the NBBO. When the ISE best bid or offer is inferior to the NBBO, marketable orders would be presented to the Primary Market Maker ("PMM") for handling pursuant to ISE Rule 803(c)(2), unless the PMM is the Directed Market Maker that released the Directed Order, in which case the Directed Order would first be exposed to all Members, as described below.

When a non-marketable Directed Order is released and a Guarantee exists, the Exchange's system would broadcast a message to all Members for three seconds before executing the Directed Order against the Guarantee. This would happen where the Directed Market Maker was quoting at the NBBO at the time that a marketable Directed Order was received, but the NBBO moved prior to the release of the Directed Order so that the Directed Order was no longer marketable.

If, at the time a Directed Order is released by the Directed Market Maker, the Directed Order is marketable but the ISE best bid or offer is inferior to the NBBO, and the Directed Market Maker is the PMM in the option class for the Directed Order, then a broadcast message would be sent to all Members displaying the Directed Order. After three (3) seconds, the Directed Order would be executed against any contra interest at the NBBO price or better according to ISE Rule 713, except that the PMM would be last in priority. Thereafter, if there is any remaining unexecuted quantity of the Directed Order, it would be presented to the PMM for handling according to ISE Rule 803(c)(2). This assures that the PMM does not benefit from the fact that it had knowledge of the Directed Order prior to its entry into the Exchange's system by allowing other market participants an opportunity to execute against the Directed Order before the PMM.

In addition to the procedures described above, the proposed rule contains two restrictions regarding Directed Market Makers. First, if the Directed Market Maker is quoting at the NBBO on the opposite side of the Directed Order, the Directed Market Maker is prohibited from adjusting the price of its quote to a price that is less favorable than the price available at the NBBO or reducing the size of its quote prior to submitting the Directed Order to the PIM, unless such quote change is the result of an automated quotation system that operates independently from the existence or non-existence of a pending Directed Order. Otherwise changing a quote on the opposite side of the Directed Order except as specifically permitted herein would be a violation of ISE Rule 400 (Just and Equitable Principles of Trade). The Exchange would conduct routine surveillance of such quote changes to identify potential violations of ISE Rule 400.

The purpose of this limitation is to prohibit a Directed Market Maker from manipulating the market by moving the NBBO to an inferior price prior to submitting an order into the PIM. The occasion where this type of manipulation might be possible is remote, as a Directed Market Maker would have to be the only market maker quoting at the NBBO in the national market system. Nevertheless, we believe the restriction is carefully tailored so that price discovery through the use of automated quotation systems would not be unnecessarily disrupted, while assuring that Directed Market Makers are not permitted to disadvantage orders they represent as agent.

The second restriction applies when a Directed Market Maker releases a non-marketable Directed Order without a Guarantee (that is, where the Directed Market Maker is not quoting at the NBBO). In that situation, the Directed Market Maker must wait at least three seconds before entering a contra order to execute against the Directed Order as principal. The purpose of this restriction is to allow other market participants an opportunity to execute against the Directed Order before the Directed Market Maker who had knowledge of the Directed Order before it was released.

2. Statutory Basis

The ISE believes the basis under the Exchange Act for this proposed rule change is the requirement under Section 6(b)(5) that an exchange have rules that are designed to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, this proposed rule change would allow the Exchange to better compete with other options exchanges, while assuring the fair handling of Directed Orders.

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

The ISE does not believe that the proposed rule change, as amended, would impose any burden on competition not necessary or appropriate in 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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the ISE consents, the Commission will:

(A) by order approve such proposed rule change; or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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 Number SR-ISE-2004-16 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-ISE-2004-16. 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-2004-16 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.[5]

Margaret H. McFarland
Deputy Secretary

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[5] 17 CFR 200.30-3(a)(12).