SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49943; File No. SR-ISE-2001-22)

June 30, 2004

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

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

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[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.

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.

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[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.

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

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[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.

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

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[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

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 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

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also requires that those rules not be designed to permit unfair discrimination
between customers, issuers, brokers, or dealers.

[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,

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 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

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however, approves the proposed rule change only to the extent that the restriction
of current ISE Rule 717(g) applies.

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

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[16]   17 CFR 200.30-3(a)(12).