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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-57812; File No. SR-ISE-2008-28]

### Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Amendment No. 1 to the Proposed Rule Change and Order Granting Accelerated Approval of Proposed Rule Change, As Modified by Amendment No. 1 Thereto, Relating to the Exposure of Public Customer Orders

May 12, 2008.

#### I. Introduction

On March 18, 2008, the International Securities Exchange, LLC (the "Exchange" or the "ISE") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposal to expose public customer orders that are not executable on the Exchange before sending an order through the intermarket linkage system (a "Linkage Order") on behalf of the public customer. The proposed rule change was published for comment in the **Federal Register** on March 31, 2008.<sup>3</sup> The Commission received one comment letter regarding the proposal.<sup>4</sup> ISE filed Amendment No. 1 to the proposed rule change on May 7, 2008.<sup>5</sup>

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 57551 (March 25, 2008), 73 FR 16917.

<sup>4</sup> See letter from Lisa J. Fall, General Counsel, Boston Options Exchange ("BOX"), to Nancy M. Morris, Secretary, Commission, dated May 2, 2007 ("BOX Comment").

<sup>5</sup> In Partial Amendment No. 1, the Exchange: (1) Amended the rule text to add subsection (e) to Supplementary Material .02 to Rule 803 to state that a "pattern or practice of submitting unrelated orders that cause an exposure period to conclude early will be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 400 and other Exchange Rules"; and (2) confirmed that the obligation of primary market makers under existing Rule 803(c)(2)(ii) to address public customer orders that are not automatically executed because there is a better price on another exchange includes the handling of the balance of an order that initially receives a partial execution on the Exchange.

The Commission is publishing this notice to solicit comments on the proposed rule change, as modified by Amendment No. 1, from interested persons and is simultaneously approving the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

#### II. Description of the Proposal

As described in the proposal, the ISE will not automatically execute a customer's options order when the ISE's best bid or offer ("BBO") is inferior to the national best bid or offer ("NBBO").<sup>6</sup> Under ISE Rule 803(c)(2)(ii), the primary market maker ("PMM") is obligated to address public customer orders that are not automatically executed because there is a better price on another exchange.<sup>7</sup> Rule 803(c) specifies that the PMM can either execute the order or send a Linkage Order to any other exchange displaying the best price in an attempt to get the better price for the public customer.<sup>8</sup> Under the current procedure, if the PMM does not execute the public customer order, it sends a Linkage Order(s) to a competing exchange(s) even though there may be other ISE market makers who would be willing to execute the public customer order at the better price.<sup>9</sup>

Under the proposal, before the PMM sends a Linkage Order on behalf of a public customer, the public customer order will be exposed at the NBBO price for a period established by the Exchange not to exceed one second.<sup>10</sup> During the exposure period, Exchange market makers may enter responses up to the size of the order being exposed in the regular trading increment applicable to the option. If at the end of the exposure period, the order is executable at the then-current NBBO and ISE is not quoting at the then-current NBBO, the order will be executed against responses that equal or better the then-current NBBO.<sup>11</sup> The exposure period will be

<sup>6</sup> See ISE Rule 714.

<sup>7</sup> The Exchange noted in Amendment No. 1 that this obligation of the PMM to address these public customer orders includes the handling of the balance of an order that initially receives a partial execution on ISE.

<sup>8</sup> ISE Rules, Chapter 19 (Intermarket Linkage Rules).

<sup>9</sup> When a PMM sends a Linkage Order to another exchange, it is charged the other exchange's execution fee.

<sup>10</sup> The Exchange will issue a Circular to inform members of the time period. The Exchange clarified in Amendment No. 1 that this exposure process will apply to the balance of an order that received a partial execution on ISE. See *supra* note 7.

<sup>11</sup> Executions will be allocated pro-rata based on size (*i.e.*, the percentage of the total number of contracts available at the same price that is

terminated if the exposed order becomes executable on the ISE at the prevailing NBBO or if the Exchange receives an unrelated order that could trade against the exposed order at the prevailing NBBO price.<sup>12</sup> If, after an order is exposed, the order cannot be executed in full on the Exchange at the then-current NBBO or better, and it is marketable against the then-current NBBO, the PMM will send a Linkage Order on the customer's behalf for the balance of the order as provided in Rule 803(c)(2)(ii). If the balance of the order is not marketable against the then-current NBBO, it will be placed on the ISE book.

Immediate-or-cancel orders are cancelled if they cannot be executed on the ISE upon entry. Therefore, such orders are not handled by the PMM under Rule 803(c)(2)(ii) and will not be exposed under this proposal.

The Commission received one comment letter regarding the proposed rule change.<sup>13</sup> The commenter believes that ISE's proposal is not consistent with Rule 602 of Regulation NMS ("Quote Rule"),<sup>14</sup> which "requires a responsible broker-dealer to execute an order at its quote when that order is presented."<sup>15</sup> Specifically, the commenter believes that, if a PMM or CMM is at the ISE best bid or offer on the opposite side of the market at the time the public customer order is received, that public customer order has been "presented" to the PMM or CMM under the Quote Rule.<sup>16</sup> As a result, the commenter concludes that the proposal is inconsistent with the Quote Rule because it would permit public customer orders to be executed after the exposure period at a price or size inferior to the price or size on ISE at order presentment.<sup>17</sup> The commenter also requests clarification of the handling of the balance of a public customer order, a portion of which is automatically executed on ISE at the NBBO. In that scenario, the commenter was unclear whether the balance of the order would be routed as Linkage Orders or handled under the proposed exposure period. In this regard, ISE

represented by the size of a market maker's response).

<sup>12</sup> The order will be executed against orders and quotes on the book and responses received during the exposure period in price priority. At the same price, customer orders will be executed first in time priority and then all other interest (orders, quotes and responses) will be allocated pro-rata based on size.

<sup>13</sup> See BOX Comment, *supra* note 4.

<sup>14</sup> 17 CFR 242.602.

<sup>15</sup> See BOX Comment, *supra* note 4, at 2.

<sup>16</sup> See generally BOX Comment, *supra* note 4, at 2 to 6.

<sup>17</sup> *Id* at 6.

confirmed in Amendment No. 1 that the exposure period will apply to the balance of a public customer order that has received partial execution on ISE.

### 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 modified by Amendment No. 1, 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](mailto:rule-comments@sec.gov). Please include File Number SR-ISE-2008-28 on the subject line.

#### *Paper Comments*

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number ISE-2008-28. 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 Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of 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 available publicly. All submissions should refer to File Number SR-ISE-2008-28 and should be submitted on or before June 9, 2008.

### IV. Discussion and Commission Findings

After carefully considering the proposal and the comment submitted, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>18</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,<sup>19</sup> which requires, in part, that the rules of a national securities exchange be 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. Specifically, the proposal will expose public customer orders that are not executable on the Exchange before sending a Linkage Order on behalf of the public customer. The Commission notes that exposing public customer orders before the PMM sends a Linkage Order on the public customer's behalf will give additional ISE participants an opportunity to provide public customer orders an execution at the NBBO (or better) on ISE and may reduce PMM costs by reducing the number of Linkage Orders sent to other exchanges. Thus, the Commission believes that the exposure rules outlined above will allow ISE to provide more efficient and competitive executions for these orders, subject to priority principles.

The Commission also believes that the proposal is consistent with the Quote Rule.<sup>20</sup> The Quote Rule, among other things, requires a responsible broker or dealer to execute orders presented to it by another broker or dealer, at a price at least as favorable as the responsible broker or dealer's published bid or offer, unless an exception applies. The Commission believes that when an order is received on ISE that a responsible broker or dealer is not permitted to execute pursuant to ISE's rules or the Linkage Plan,<sup>21</sup> and the

<sup>18</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>19</sup> 15 U.S.C. 78f(b)(5).

<sup>20</sup> 17 CFR 242.602.

<sup>21</sup> The Plan for the Purpose of Creating and Operating an Options Intermarket Linkage and ISE's rules contain provisions restricting the ability of an ISE member to trade-through certain prices on away markets. ISE has represented that it does not automatically execute a customer's order when ISE is not at the NBBO. In addition, public customer

submitting member has chosen to allow ISE to expose the order to other additional interest rather than submitting an immediate-or-cancel ("IOC") order,<sup>22</sup> the order is not "presented" under the Quote Rule. The Commission therefore does not believe it is necessary for ISE to "stop" a public customer order against the existing best priced quotes and orders on ISE's book at the beginning of the exposure period to comply with the Quote Rule.

The Commission finds good cause to approve the proposal prior to the thirtieth day after the proposal was published for comment in the **Federal Register**. The Commission believes that the change made in Amendment No. 1 generally strengthens the proposal. In Amendment No. 1, ISE made explicit that a pattern or practice of submitting unrelated orders that cause an exposure period to conclude early will be deemed conduct inconsistent with just and equitable principles of trade and a violation of ISE Rule 400 and other Exchange rules. This addition will provide guidance to market participants regarding compliance with the requirements of ISE's rules, and is consistent with the rules of another options exchange.<sup>23</sup> Further, this provision will help limit potential "gaming" of the exposure period. For these reasons, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,<sup>24</sup> to grant accelerated approval of the proposed rule change, as modified by Amendment No. 1.

### V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>25</sup> that the proposed rule change (File No. SR-ISE-2008-28), as modified by Amendment No. 1, is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>26</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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orders will be exposed under ISE's proposal only when ISE is not at the NBBO.

<sup>22</sup> ISE has represented that IOC orders are cancelled if they cannot be executed on ISE upon entry, and are not handled by the PMM under Rule 803(c)(2)(ii) and will not be exposed under this proposal. Therefore, public customers may avoid the proposed exposure period by submitting IOC orders.

<sup>23</sup> See CBOE Rule 6.14.01.

<sup>24</sup> 15 U.S.C. 78s(b)(2).

<sup>25</sup> 15 U.S.C. 78s(b)(2).

<sup>26</sup> 17 CFR 200.30-3(a)(12).