

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-57104; File No. SR-ISE-2007-113)

January 4, 2008

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change as Modified by Amendment No. 1 Thereto to Allow the Exchange to List Up to Seven Expiration Months for Broad-Based Security Index Options Upon Which an Exchange Calculates a Constant Three-Month Volatility Index

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> notice is hereby given that on November 30, 2007, the International Securities Exchange, LLC (the “Exchange” or the “ISE”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been substantially prepared by ISE. On January 4, 2008, the Exchange filed Amendment No. 1 to the proposed rule change. The Exchange has filed the proposal pursuant to Section 19(b)(3)(A) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder,<sup>4</sup> which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The ISE proposes to amend its Rule 2009(a)(3) (Terms of Index Option Contracts) to allow the Exchange to list up to seven expiration months for broad-based security index options upon which an exchange calculates a constant three-month volatility index. The text of the proposed rule change is available on the Exchange’s Web site [www.ise.com](http://www.ise.com), at the principal office of the Exchange, and at the Commission’s Public Reference Room.

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

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

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, ISE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. 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 purpose of this rule filing is to amend Rule 2009(a)(3) (Terms of Index Options Contracts) to allow the Exchange to list up to seven expiration months for broad-based security index options upon which a constant three-month volatility index is calculated. Currently, Rule 2009(a)(3) permits the Exchange to list only six expiration months in any index options at any one time.

Volatility products offer investors a unique set of tools for speculating and hedging. For example, the Chicago Board Options Exchange ("CBOE") Volatility Index ("VIX") options, first introduced in February 2006, have proven to be one of CBOE's most successful new products ever listed, currently averaging over 90,000 contracts traded per day. CBOE has stated that it plans to introduce new volatility products and new volatility indexes in the near future. One such index is the CBOE S&P 500 Three- Month Volatility Index ("VXV").<sup>5</sup> Similar to the

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<sup>5</sup> CBOE calculates volatility indexes on other broad-based security indexes, such as the Dow Jones Industrial Average index ("DJX"), the Nasdaq-100 index ("NDX"), and the Russell 2000 index ("RUT"). CBOE may calculate a constant three-month volatility index on DJX, NDX, or RUT in the future. See Securities Exchange Act Release No. 56821 (November 20, 2007), 72 FR 66210 (November 27, 2007).

VIX, the VXV is a measure of S&P 500 implied volatility—the volatility implied by S&P option prices—but instead of reflecting a constant 1-month implied volatility period, VXV is designed to reflect the implied volatility of an option with a constant 3 months to expiration. Since there is only one day on which an option has exactly 3 months to expiration, VXV is calculated as a weighted average of options expiring immediately before and immediately after the three-month standard.

Accordingly, an index calculator would need to use four consecutive expiration months in order to calculate a constant three-month volatility index. Under the current application of ISE Rule 2009(a)(3), the Exchange generally lists three consecutive near term months and three months on a quarterly expiration cycle. One of the three consecutive near term months is always a quarterly month; however, that near term contract month (which is also a quarterly month) is not included as part of the three months listed on a quarterly expiration cycle. Therefore, in order to permit the addition of four consecutive near term months under current Rule 2009(a)(3), the Exchange would only be able to list two months on a quarterly expiration cycle. Because of customer demand and other investment strategy reasons for having three months on a quarterly expiration cycle, the Exchange is seeking to increase, from six to seven, the number of expiration months for broad-based security index options upon which a constant three-month volatility index is calculated.

Without this proposed rule change, if a three-month volatility index is calculated using only three consecutive near term months, this would result in the VXV being calculated with options expiring three months apart about one-third of the time. Another one-third of the time, VXV would be calculated with options expiring two months apart. And the final one-third of the time, VXV would be calculated with options expiring one month apart. As a result, the

calculation of the three-month VIX under the current rules would render the VIX subject to inconsistencies that may make the index unattractive as an underlying for volatility products. The proposed rule change will permit the Exchange, eight times a year, to add an additional seventh month in order to maintain four consecutive near term contract months.<sup>6</sup>

Therefore, the Exchange believes that the addition of a fourth consecutive near-term month for broad-based security index options upon which a constant three-month volatility index is calculated will result in a consistent calculation in which the option series that bracket three months to expiration will always expire one month apart. In order to accommodate the listing of a fourth consecutive near term month and to maintain the listing of three months on a quarterly expiration cycle, the Exchange proposes the increase, from six to seven, the number of expiration months for broad-based security indexes on which a constant three-month volatility index is calculated.

#### Capacity

ISE has analyzed its capacity and represents that it believes the Exchange and the Options Price Reporting Authority have the necessary systems capacity to handle the additional traffic associated with the additional listing of a seventh contract month in order to maintain four consecutive near term contract months for those broad-based security index options upon which a constant three-month volatility index is calculated.

#### 2. Statutory Basis

Because the increase in the number of expiration months is limited to broad-based security indexes upon which a constant three-month volatility index is calculated and because the

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<sup>6</sup> Examples illustrating the need for a seventh month in order to maintain four consecutive near term contract months can be found in Securities Exchange Act Release No. 56821 (SR-CBOE-2007-82), supra note 5.

series could be added without presenting capacity problems, the Exchange believes the rule proposal is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of Section 6(b) of the Act.<sup>7</sup> Specifically, the Exchange believes that the proposed rule change is consistent with the Section 6(b)(5) of the Act<sup>8</sup> requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest.

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

The proposed rule change does not impose any burden on competition that is 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

Because the forgoing rule change does not: (1) significantly affect the protection of investors or the public interest; (2) impose any significant burden on competition; and (3) become operative for 30 days after the date of this filing, or such shorter time as the Commission

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<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>9</sup> and Rule 19b-4(f)(6) thereunder.<sup>10</sup>

A proposed rule change filed under 19b-4(f)(6) normally may not become operative prior to 30 days after the date of filing.<sup>11</sup> However, Rule 19b-4(f)(6)(iii)<sup>12</sup> permits the Commission to designate a shorter time if such action is consistent with the protection of investors and the public interest. The Exchange has requested that the Commission waive the 30-day operative delay, to permit the Exchange to list options on the Fund immediately. The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest. The proposal is substantially similar to a proposal recently submitted by CBOE and approved by the Commission,<sup>13</sup> and it raises no new regulatory issues.

The Commission believes that increasing, from six to seven, the number of expiration months for broad-based security indexes on which an Exchange calculates a constant three-month volatility index (to accommodate a fourth consecutive near-term month while maintaining the listing of three months on a quarterly expiration cycle) will result in a more consistent and predictable calculation in which the option series that bracket three months to expiration will always expire one month apart, thereby promoting just and equitable principles of trade while protecting investors and the public interest.

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<sup>9</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>10</sup> 17 CFR 240.19b-4(f)(6).

<sup>11</sup> 17 CFR 240.19b-4(f)(6)(iii). In addition, Rule 19b-4(f)(6)(iii) requires that a self-regulatory organization submit to the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Commission has determined to waive this five-day pre-filing notice requirement.

<sup>12</sup> Id.

<sup>13</sup> See supra note 5.

The Commission also notes ISE's representations that it possesses the necessary systems capacity to handle the additional traffic associated with the additional listing of a seventh contract month in order to maintain four consecutive near term contract months for those broad-based security index options upon which the Exchange calculates a constant three-month volatility index.

For these reasons, the Commission designates the proposed rule change to be operative upon filing with the Commission.<sup>14</sup>

At any time within 60 days of the filing of such proposed rule change the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Act.<sup>15</sup>

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change 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-2007-113 on the subject line.

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<sup>14</sup> For the purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>15</sup> For purposes of calculating the 60-day abrogation period, the Commission considers the proposed rule change to have been filed on January 4, 2008, the date ISE filed Amendment No. 1.

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 SR-ISE-2007-113. 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 10:00 am and 3:00 pm. Copies of the 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 2007-113 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>16</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>16</sup> 17 CFR 200.30-3(a)(12).