

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-59287; File No. SR-ISE-2006-26)

January 23, 2009

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of the Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, Relating to Professional Account Holders

I. Introduction

On May 5, 2006, the International Securities Exchange, LLC (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change 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> to amend ISE rules to give certain non-broker-dealer orders, identified as “professional orders,” the priority given broker-dealer orders and market maker quotes rather than the priority currently given all public customer orders and to charge the same transaction fees for professional orders as charged for the orders of broker-dealers and market makers. On January 25, 2008, the Exchange filed Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on February 7, 2008.<sup>3</sup> The Commission received ten comment letters on the proposal.<sup>4</sup> The Exchange filed

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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> See Securities Exchange Act Release No. 57254 (February 1, 2008), 73 FR 7345 (February 7, 2008) (“Notice”).

<sup>4</sup> See letters from Abe Lampert, dated May 25, 2006 (“Lampert Letter”); Charles B. Cox III, dated May 26, 2006 (“Cox Letter I”); B. Thomas Rule, dated May 28, 2006 (“Rule Letter”); Bryan Weisberg, dated May 31, 2006 (“Weisberg Letter”); Andrea Schneider, dated June 18, 2006 (“A. Schneider Letter”); Gerald Schneider, dated February 6, 2008 (“G. Schneider Letter”); Andrew Carr, dated March 4, 2008 (“Carr Letter”); Charles B. Cox III, dated March 4, 2008 (“Cox Letter II”); Charles B. Cox III, dated April 16, 2008 (“Cox Letter III”); and Securities Industry and Financial Markets Association (“SIFMA”), dated July 23, 2008 (“SIFMA Letter”).

Amendment No. 2 to the proposed rule change on June 17, 2008,<sup>5</sup> and submitted a response to the SIFMA Letter on January 12, 2009.<sup>6</sup> This order provides notice of Amendment No. 2 and approves the proposal, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

## II. Description of ISE's Proposal

Currently, ISE grants certain advantages to Public Customer Orders<sup>7</sup> over Non-Customer Orders.<sup>8</sup> In particular, Public Customer Orders receive priority over Non-Customer Orders and market maker quotes at the same price. In addition, subject to certain exceptions, Public Customer Orders do not incur transaction charges.<sup>9</sup> The ISE states that the purpose, generally, of providing these marketplace advantages to Public Customer Orders is to attract retail investor order flow to the Exchange by leveling the playing field for retail investors over market professionals and providing competitive pricing.<sup>10</sup> According to the Exchange, market professionals have access to sophisticated trading systems that contain functionality not available

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<sup>5</sup> In Amendment No. 2, ISE deleted proposed changes to ISE Rules 715 and 723 (d)(2). These revisions clarify that the proposed rule change would not limit a Public Customer's access to the Exchange's Price Improvement Mechanism ("PIM"). See infra note 75.

<sup>6</sup> See letter from Michael J. Simon, Secretary, ISE, to Florence Harmon, Acting Secretary, Commission, dated January 12, 2009 ("ISE Response Letter").

<sup>7</sup> A "Public Customer" is defined in ISE's rules as "a person that is not a broker or dealer in securities." A "Public Customer Order" is defined as "an order for the account of a Public Customer." ISE Rules 100(a)(38) and (39).

<sup>8</sup> A "Non-Customer" is defined in ISE's rules as "a person or entity that is a broker or dealer in securities." A "Non-Customer Order" is defined as "any order that is not a Public Customer Order." ISE Rules 100(a)(27) and (28).

<sup>9</sup> For example, Public Customer Orders currently incur fees for certain transactions in "Premium Products" (defined in the ISE Schedule of Fees) and Complex Orders that take liquidity on the Exchange's complex order book. In addition, transaction fees are charged for Public Customer Orders entered in response to special order broadcasts, such as Facilitation orders, Solicitation orders, Block orders, and orders entered in the Exchange's PIM. Public Customer Orders also are subject to fees for order cancellations. See ISE Schedule of Fees.

<sup>10</sup> See Notice, supra note 3, at 73 FR 7346.

to a retail customer, including things such as continuously updated pricing models based upon real-time streaming data, access to multiple markets simultaneously, and order and risk management tools.<sup>11</sup>

With respect to the marketplace advantages of priority in trading and waiver of fees, the Exchange does not believe at this time that the definitions of Public Customer and Non-Customer properly distinguish between the kind of non-professional retail investors for whom these advantages were intended and certain professionals. The Exchange believes that distinguishing solely between registered broker-dealers and non-broker-dealers with respect to these advantages is no longer appropriate in today's marketplace, because some non-broker-dealer individuals and entities have access to information and technology that enables them to trade listed options in the same manner as a broker or dealer in securities. The Exchange maintains that these individual traders and entities (collectively, "professional account holders") have the same technological and informational advantages as broker-dealers trading for their own accounts, which enables professional account holders to compete effectively with broker-dealer orders and market maker quotes for execution opportunities in the ISE marketplace.<sup>12</sup> The Exchange therefore does not believe that it is consistent with fair competition for these professional accounts holders to continue to receive the same marketplace advantages that retail investors have over broker-dealers trading on the ISE.<sup>13</sup>

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<sup>11</sup> See Notice, supra note 3, at 73 FR 7346 n.7.

<sup>12</sup> The Exchange also maintains that, under its current rules, retail investors are prevented from fully benefiting from the priority advantage when professional account holders are afforded the same Public Customer Order priority that retail investors enjoy. See Notice, supra note 3, at 73 FR 7346.

<sup>13</sup> Id.

ISE thus proposes to create two new order types: Priority Customer Orders and Professional Orders. Priority Customer Orders would be orders for the account of a Priority Customer, which would be defined as a person or entity that is not a broker-dealer in securities and that does not place more than 390 orders<sup>14</sup> in listed options per day on average during a calendar month for its own beneficial account(s). Professional Orders would be defined as orders for the account of a person or entity that is not a Priority Customer, and would include proprietary orders of ISE members and non-member broker-dealers.<sup>15</sup> Priority Customer Orders would have priority over Professional Orders at the same price. Thus, Public Customers who now have priority over market makers and broker-dealers at the same price would be on parity with market makers and broker-dealers at the same price, if those Public Customers placed more than 390 orders in listed options per day on average during a calendar month. These Professional Orders also would be assessed the same fees that ISE charges for broker-dealer transactions.

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<sup>14</sup> The Exchange states that 390 orders is equal to the total number of orders that a person would place in a day if that person entered one order every minute from market open to market close. According to ISE, a study of one of the largest retail-oriented options brokerage firms indicated that on a typical trading day, options orders were entered with respect to each of 5,922 different customer accounts. There was only one order entered with respect to 3,765 of the 5,922 different customer accounts on this day, and there were only 17 customer accounts with respect to which more than 10 orders were entered. The highest number of orders entered with respect to any one account over the course of an entire week was 27. In addition, many of the largest retail-oriented electronic brokers offer lower commission rates to customers they define as “active traders.” The Exchange reviewed the publicly available information from the web sites for Charles Schwab & Co., Inc.; Fidelity Investments; TD Ameritrade, Inc.; and optionsXpress, Inc., and found all of them define an “active trader” as someone who executes only a relatively small number of options trades per month. The highest required trading activity to qualify as an active trader among these four firms was 35 trades per quarter. See Notice, supra note 3, at 73 FR 7347 n.10-11.

<sup>15</sup> Members would be required to represent as Professional Orders for the next calendar quarter the orders for any customer that had an average of more than 390 orders per day during any month of a calendar quarter. See proposed Text of Regulatory Circular filed by ISE as part of the proposed rule change (“Proposed Regulatory Circular”).

The Exchange believes that the use of these new terms in the execution rules and fee schedule would result in professional account holders participating in the ISE's allocation process on equal terms with broker-dealer orders and market maker quotes. It would also result in members paying the same transaction fees for the execution of orders for a professional account as they do for broker-dealer orders. The Exchange believes that identifying professional account holders as participants who place more than one order per minute on average per day during a calendar month is an appropriately objective approach that would reasonably distinguish such persons and entities from retail investors. The Exchange proposes the threshold of 390 orders per day on average over a calendar month because it believes this amount far exceeds the number of orders that are entered by retail investors in a single day, while being a sufficiently low number of orders to cover the professional account holders that are competing with broker-dealers in the ISE marketplace. ISE further notes that basing the standard on the number of orders that are entered in listed options for a beneficial account(s) assures that professional account holders could not inappropriately avoid the purpose of the rule by spreading their trading activity over multiple exchanges, and using an average number over a calendar month would prevent gaming of the 390 order threshold.<sup>16</sup>

ISE's proposal would require Electronic Access Members ("EAMs") to indicate whether Public Customer Orders are Priority Customer Orders or Professional Orders. EAMs would be required to review their customers' activity on at least a quarterly basis to determine whether orders that are not for the account of a broker or dealer should be represented as Priority Customer Orders or Professional Orders. Members would be required to make any appropriate changes to the way in which they are representing orders within five days after the end of each

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<sup>16</sup> See Notice, supra note 3, at 73 FR 7346-47.

calendar quarter. If during a calendar quarter the Exchange identified a customer for which orders are being represented as Priority Customer Orders, but that customer has averaged more than 390 orders per day during a month, the Exchange would notify the member and the member would be required to change the manner in which it is representing the customer's orders within five days.<sup>17</sup>

All Public Customers would continue to be treated in the same manner under all ISE rules, other than those rules for priority and transaction fees. For example, ISE rules relating to the Intermarket Linkage affecting Public Customers<sup>18</sup> would continue to apply to all customers who are not broker-dealers – even those customers whose orders are identified as Professional Orders. Similarly, rules regarding customer suitability and other protections for customers would continue to apply with respect to all customers who are not broker-dealers.<sup>19</sup>

### III. Commission Findings and Order Granting Accelerated Approval to the Proposed Rule Change as Modified by Amendment Nos. 1 and 2

After careful consideration of the proposed rule change, as well as the comment letters and the ISE Response Letter, the Commission finds that the proposed rule change is consistent with the Act. As the options markets have become more electronic and more competitive over the last several years, the Commission believes that the distinction between a professional who is registered as a broker-dealer and a public customer who is not so registered, but who may trade to the same extent as a broker-dealer, has become blurred.<sup>20</sup> Moreover, the category of public

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<sup>17</sup> See Proposed Regulatory Circular, supra note 15.

<sup>18</sup> See Chapter 19 of the ISE Rules.

<sup>19</sup> See Chapter 6 of the ISE Rules. Telephone conversation between Nancy Burke-Sanow, Assistant Director, Division of Trading and Markets (“Division”), Commission, et al., and Katherine Simmons, Deputy General Counsel, ISE, on March 3, 2008.

<sup>20</sup> See, e.g., Nina Mehta, Options Maker-Taker Markets Gain Steam, TRADERSmagazine.com, October 2007, <http://www.tradersmagazine.com/issues/20071004/2933-1.html>.

customer today includes sophisticated algorithmic traders including former market makers and hedge funds that trade with a frequency resembling that of broker-dealers.<sup>21</sup> The Commission believes that the Act does not require the ISE to treat those customers who meet the high level of trading activity established in the proposal identically to customers who do not meet that threshold.<sup>22</sup>

Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)<sup>23</sup> of the Act and the rules thereunder,<sup>24</sup> and in particular with:

Section 6(b)(4) of the Act, which requires exchanges to provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities;<sup>25</sup>

Section 6(b)(5) of the Act, which requires that the rules of a national securities exchange, among other things, be designed to promote just and equitable principles of trade, 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; and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers;<sup>26</sup> and

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<sup>21</sup> Id.

<sup>22</sup> The Commission notes that one of the commenters, discussing the proposed rule change before the Exchange filed Amendment No. 1, stated that she placed an average of 170 orders per day. See A. Schneider Letter supra note 4. Under the proposed rule change, as amended, a Public Customer that places this number of orders would be substantially short of the proposed threshold of more than 390 orders per day and thus would not be affected by the rule.

<sup>23</sup> 15 U.S.C. 78f(b).

<sup>24</sup> In approving the proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f). See also infra notes 50-71 and accompanying text.

<sup>25</sup> 15 U.S.C. 78f(b)(4).

<sup>26</sup> 15 U.S.C. 78f(b)(5).

Section 6(b)(8) of the Act, which requires the rules of an exchange not to impose any burden on competition not necessary or appropriate in furtherance of the Act.<sup>27</sup>

In addition, the Commission finds that the proposed rule change is consistent with Section 11(a) of the Act.<sup>28</sup>

A. Customer Priority on the Options Exchanges

Currently, the ISE accords priority to all Public Customer Orders at the best bid or offer on the basis of price-time priority before allocating any remaining contracts among Non-Customer Orders and market maker quotes at the same best price. ISE now proposes that only Priority Customer Orders, as defined above, would receive such priority.

In considering this aspect of the proposal, the Commission examined the basis upon which exchanges have granted priority to public customers in the past. The Commission further considered the threshold question of when and whether the orders of public customers must be entitled to priority over the orders of broker-dealers.

In certain contexts, the Commission has characterized an exchange's practice of according priority to public customers' orders as a matter of "tradition."<sup>29</sup> Alternatively, the

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<sup>27</sup> 15 U.S.C. 78f(b)(8).

<sup>28</sup> 15 U.S.C. 78k(a). See infra Section III.A.1.

<sup>29</sup> See, e.g., Securities Exchange Act Release Nos. 21695 (January 28, 1985), 50 FR 4823 (February 1, 1985) (in considering Chicago Board Options Exchange's ("CBOE") proposal to implement a retail automatic execution system ("RAES") pilot program, the Commission referred to "the traditional priority accorded to public customer orders"); and 22610 (November 8, 1985), 50 FR 47480 (November 18, 1985) (in considering a proposal by the American Stock Exchange ("Amex") to implement an automatic execution feature of its AUTOAMOS system on a pilot basis, the Commission stated that the pilot "ensures the traditional priority accorded public customer orders"). In each of these instances, the Commission was referring specifically to public customer orders that are placed on the book. Such placements may affect the application of priority principles. See, e.g., infra Section III.A.3.



Commission has referred to public customer priority as “the generally accepted auction trading principle of priority of public limit orders over member proprietary orders at the same price.”<sup>30</sup>

These references in Commission releases support the Commission’s view that the customer priority rule under discussion was not a matter of public customer entitlement derived from the Act, but rather a matter of convention to accommodate public customer orders, or an auction principle applied as a matter of longstanding practice by exchanges. In addition, public customer orders are a source of liquidity in the market, and exchanges have sought to attract such orders by providing public customers certain guarantees that their orders would be executed even in the face of competition from broker-dealers.

The Commission previously has approved exchange rules that apply this “traditional priority” as consistent with the Act but, as discussed below, has approved exchange rules that do not accord priority to public customer orders.<sup>31</sup> In analyzing the concept of public customer priority, the Commission has considered whether public customer priority, or the absence of such priority, is consistent with Section 11(a) of the Act, the agency obligations of the specialist, the protection of investors and the public interest, and the Act, in general.

1. Section 11(a) of the Act

Section 11(a) of the Act prohibits any member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion unless an exception

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<sup>30</sup> See, e.g., Securities Exchange Act Release No. 22817 (January 21, 1986), 51 FR 3547 (January 28, 1986) (notice of CBOE’s proposal to implement RAES on a permanent basis for options on the Standard and Poor’s 100 Index (“OEX”) (SR-CBOE-85-32) and to extend RAES to selected classes of individual stock options on a six-month pilot basis (SR-CBOE-85-16) (“January 1986 Release”). See also infra note 40.

<sup>31</sup> See infra notes 41-44 and accompanying text.

applies.<sup>32</sup> Thus, in some contexts, the Commission has cited Section 11(a) of the Act as a basis for exchange rules that accord customer orders priority, referring to “the traditional auction market concepts of customer priority embodied in Section 11(a) of the Act.”<sup>33</sup>

Section 11(a)(1) contains a number of exceptions for principal transactions by members and their associated persons. One such exception, set forth in subparagraph (G) of Section 11(a)(1) and in Rule 11a1-1(T), permits any transaction for a member's own account provided, among other things, that the transaction yields priority, parity, and precedence to orders for the account of persons who are not members or associated with members of the exchange. Exchange rules, therefore, may require members to yield priority to the orders of public customers to satisfy this exception to Section 11(a). Another exception permits market makers to effect transactions on exchanges in which they are members.<sup>34</sup>

In addition to the exceptions noted above, Rule 11a2-2(T) under the Act<sup>35</sup> provides exchange members with an exception from the prohibitions in Section 11(a). Rule 11a2-2(T), known as the “effect versus execute” rule, permits an exchange member, subject to certain conditions, to effect transactions for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion (collectively, “covered accounts”) by arranging for an unaffiliated member to execute the transactions on the exchange.

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<sup>32</sup> 15 U.S.C. 78k(a).

<sup>33</sup> See, e.g., Securities Exchange Act Release No. 27205 (August 31, 1989), 54 FR 37180 (September 7, 1989) (Commission order approving a proposal of the Philadelphia Stock Exchange (“Phlx”) relating to the crossing of agency orders). See also, e.g., Securities Exchange Act Release No. 33708 (March 3, 1994), 59 FR 11339 (March 10, 1994) (Commission order approving a proposal of the Midwest Stock Exchange, Inc. relating to agency crosses between the disseminated exchange market).

<sup>34</sup> Section 11(a)(1)(A).

<sup>35</sup> 17 CFR 240.11a2-2(T).

To comply with the “effect versus execute” rule's conditions, a member: (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>36</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the rule.<sup>37</sup>

The Commission previously has found that the manner of operation of ISE’s Facilitation Mechanism enables Exchange members to meet the conditions of the effect versus execute rule and thereby avail themselves of the exception that the rule provides from the prohibitions of Section 11(a).<sup>38</sup> Similarly, the Commission believes that the manner of operation of ISE’s overall electronic trading system, not only the Facilitation Mechanism, enables members to meet the four conditions of the effect versus execute rule and would continue to do so under the proposal.<sup>39</sup> For this reason, the Commission believes that the proposed rule change, which

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<sup>36</sup> The member, however, may participate in clearing and settling the transaction. See Securities Exchange Act Release No. 14563, (March 14, 1978), 43 FR 11542 (March 17, 1978).

<sup>37</sup> 17 CFR 240.11a2-2(T).

<sup>38</sup> See, e.g., Securities Exchange Act Release No. 51666 (May 9, 2005), 70 FR 25631 (May 13, 2005).

<sup>39</sup> The Commission notes that, first, all orders are electronically submitted to the ISE through remote terminals. Second, because a member relinquishes control of its order after it is submitted to the system, the member does not receive special or unique trading advantages. Third, although the effect-versus-execute rule contemplates having an order executed by an exchange member who is not affiliated with the member initiating the order, the Commission recognizes that this requirement is satisfied when automated exchange facilities are used. (In considering the operation of automated execution systems operated by an exchange, the Commission has noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions

would permit orders of ISE members to be executed under certain circumstances even if a Professional Order is on the ISE's book, is consistent with the requirements of Section 11(a) of the Act and Rule 11a2-2(T) thereunder.

## 2. Protecting Investors and the Public Interest

In analyzing the merits of exchange proposals affecting public customer order priority, the Commission has considered whether the proposed rule change is consistent with Section 6(b)(5) of the Act, which requires that the rules of an exchange, among other things, be designed “to protect investors and the public interest.”<sup>40</sup>

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obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See Securities Exchange Act Release No. 15533 (January 29, 1979).) Finally, to the extent that ISE members rely on Rule 11a2-2(T) for a managed account transaction, they must comply with the limitations on compensation set forth in the rule. See id., at note 20.

<sup>40</sup> For example, in January 1986, in publishing for public comment two proposed rule changes relating to the operation of RAES, see supra note 30, the Commission raised the question of whether the proposals were inconsistent with the provision in Section 6(b)(5) of the Act relating to the protection of investors and the public interest. The Commission also asked whether RAES was inconsistent with Section 11A of the Act, which states that it is in the public interest and appropriate for the protection of investors to assure “economically efficient execution of securities transactions,” “the practicability of brokers executing investors’ orders in the best market,” and “an opportunity ... for investors’ orders to be executed without the participation of a dealer.” 15 U.S.C. 78k-1(a)(1)(C)(i), (iv) and (v). On August 1, 1986, the Commission approved the proposal to make the RAES pilot program in OEX options permanent and a modified version of the pilot proposal for RAES in equity options, concluding that the proposed rule changes were consistent with the requirements of the Act, and, in particular, with Sections 6 and 11A of the Act. See Securities Exchange Act Release No. 23490 (August 1, 1986), 51 FR 28788 (August 11, 1986). In its approval order, the Commission stated that it was “cognizant of the substantial benefits provided by RAES to public customers of OEX and firms using the system” and noted that RAES had increased the efficiencies of the OEX market and added to the confidence of public customers. The Commission indicated that it expected CBOE to modify RAES for OEX options in the future, although it stated that its approval of the rule change was not tied to this expectation. Noting the technical impediments to modifying the system for such options, the Commission expressed its belief that “on balance, the benefits of RAES for the market in OEX weigh in favor of permanent approval.”

The Commission does not believe that this provision of Section 6(b)(5) requires that ISE give priority to Public Customers whose orders would be considered Professional Orders under the proposal. The Commission has indicated in the past that it does not believe that priority for public customer orders is an essential attribute of an exchange. In particular, the Commission has approved options exchanges' trading rules that do not give priority to orders of public customers that are priced no better than the orders of other market participants.

For example, in approving proposed rules governing CBOEdirect, CBOE's electronic screen-based trading system ("SBT"), the Commission concluded that it was consistent with the Act for the CBOEdirect rules not to provide priority to public customer orders over market maker quotes and orders in all instances.<sup>41</sup> Significantly, the Commission noted in its approval order for the SBT rules that, in the rules governing trades on CBOE's floor, customer orders displayed on the limit order book are given priority over broker-dealer orders and market maker quotes, but distinguished the operation of CBOEdirect. On the floor, the Commission noted, the priority of booked customer limit orders was essential because (at the time) the DPM was the agent for orders resting in the limit order book and, therefore, consistent with general agency law principles, CBOE's rules accorded priority to those resting limit orders.<sup>42</sup> In contrast, an SBT market maker was not required to act as agent with respect to a limit order entered into CBOEdirect.

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<sup>41</sup> CBOE had proposed alternative priority methodologies for its SBT system including public customer priority, market turner priority, and trade participation rights for Designated Primary Market Makers ("DPMs") and Lead Market Makers. See Securities Exchange Act Release No. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (Commission order approving rules for CBOEdirect).

<sup>42</sup> In 2005, the Commission approved a proposal by the CBOE to eliminate the requirement that DPMs act as the agent in the options in which it is registered as the DPM on the Exchange. See Securities Exchange Act Release No. 52798 (November 18, 2005), 70 FR 71344 (November 28, 2005) (Commission order approving removing agency responsibilities of DPMs).

Furthermore, on the Boston Options Exchange (“BOX”), the options facility of the Boston Stock Exchange, Inc., orders generally are executed according to price-time priority, with no distinctions made with regard to account designation (Public Customer, Broker/Dealer or Market Maker).<sup>43</sup> On the options facility of NYSE Arca, Inc. (“NYSE Arca”), all non-marketable limit orders and quotes also are ranked in an electronic limit order file and matched for execution according to price-time priority.<sup>44</sup> On these exchanges, all options orders at the best price are executed based on the time the order was entered. In approving these exchanges’ rules, the Commission found them to be consistent with the Act.

The Commission believed that the BOX’s and NYSE Arca’s rules, which accord no priority to any public customer orders, are consistent with the Act’s requirement that exchange rules be designed to protect investors and the public interest.<sup>45</sup> Similarly, the Commission believes that the ISE’s proposal, which reasonably eliminates priority treatment of Professional Orders of Public Customers, is consistent with the statutory requirement.

### 3. Agency Obligations

In approving the proposed rule change, the Commission notes that, historically, exchange specialists have had substantial agency responsibilities in obtaining executions for customer limit orders. A specialist’s responsibility to a customer in his or her role as agent for the limit order book was based on common law notions of fiduciary duty and incorporated in the rules of some

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<sup>43</sup> The Commission stated that the “contention that all existing options exchanges provide strict customer priority is an overstatement.” The Commission noted that several options exchanges had rules to permit market makers to be on parity with customer orders in certain circumstances. See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004).

<sup>44</sup> See Securities Exchange Act Release No. 54238, (July 28, 2006), 71 FR 44758 (August 7, 2006) (Commission order approving NYSE Arca’s OX Trading Platform).

<sup>45</sup> Id.

exchanges. As exchanges increasingly have implemented automated trading systems, however, the specialist's role in handling limit orders has diminished.<sup>46</sup> On the ISE, market makers do not act as agent for incoming orders that are executable on the exchange. Orders submitted to the ISE are matched by an automated trading system and generally are not represented by a specialist acting as agent.<sup>47</sup>

The Commission's approval of ISE's proposal to no longer accord priority to Professional Orders is based solely on its determination that this proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange. The Commission is making no determination as to whether the failure of any market participant (e.g., a specialist managing an exchange's order book) to accord priority, as appropriate, to any order entrusted to that participant as an agent is consistent with the federal securities laws or any other applicable law. Accordingly, the Commission's approval of ISE's proposal does not affect fiduciary obligations under the federal securities laws or agency law principles.

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<sup>46</sup> On several options exchanges, including BOX and CBOE, the exchange market makers have no responsibility for executing book orders, do not receive any fees for execution of book orders, and, accordingly, have no agency responsibilities for book orders. See e.g., BOX Rules, Chapter V and CBOE Rules Chapter VIII.

<sup>47</sup> The Commission recognizes that ISE's rules mandate that a Public Customer Order be represented by an agent in a discrete situation. ISE Rule 803(c) requires Primary Market Makers ("PMMs"), as soon as practical, to address Public Customer Orders that are not automatically executed because there is a displayed bid or offer on another exchange trading the same option contract that is better than the best bid or offer on the Exchange. In such cases, PMMs are required to execute at a price that matches the best price displayed on another exchange and/or send a Linkage Order. However, ISE Rule 803(c), which pertains to Intermarket Linkage, would not be affected by the proposed rule change. As noted above, ISE rules relating to the Intermarket Linkage affecting Public Customers would continue to apply to all Public Customers – even those customers whose orders are identified as Professional Orders. See supra note 18 and accompanying text.

B. Issues Raised by Commenters

As noted above, the Commission has received ten comment letters regarding the proposed rule change.<sup>48</sup> Nine of these commenters opposed the proposal. One commenter endorsed the ultimate goal of the proposal, but expressed concerns regarding its implementation.<sup>49</sup> The Commission acknowledges the arguments and concerns that have been raised by the commenters, but believes that the arguments and concerns do not support the conclusion that the proposal is inconsistent with the Act.

The commenters raise essentially five main issues: (1) that the proposal is anti-competitive; (2) that it unfairly discriminates against certain Public Customers who no longer would have priority over Non-Customers; (3) that it raises technical and operational issues for firms; (4) that it is vague and therefore unenforceable; and (5) that the imposition of transaction fees for the execution of Professional Orders is unfair. In its review of the proposal, the Commission has carefully considered these issues and has evaluated them in light of the Act's provisions, as discussed below.

1. ISE's Proposal Does Not Impose an Unnecessary or Inappropriate Burden on Competition

Some commenters believed that the proposed rule change would thwart competition by treating the orders of certain Public Customers on a par with orders of broker-dealers, despite the inability of those customers to participate in the market on an equal footing with broker-dealers and market makers.<sup>50</sup> These commenters argued that broker-dealers and market makers have substantial marketplace advantages over Public Customers, including lower margin and

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<sup>48</sup> See supra note 4.

<sup>49</sup> See SIFMA Letter, supra note 4.

<sup>50</sup> See, e.g., Cox Letter I supra note 4 and Weisberg Letter supra note 4.



commission rates, better access to information, and superior technology,<sup>51</sup> and, in the case of market makers, the ability to stream quotes electronically on both sides of the market.<sup>52</sup>

As discussed above, the Act does not require that the order of a public customer or any other market participant be granted priority. The objective of promoting competition and the requirement that the rules of an exchange not impose an unnecessary or inappropriate burden upon competition do not necessarily mandate that a Professional Order be granted priority while the order of a broker-dealer should not be granted the same right.

As a general matter, in developing their trading and business models, exchanges have adopted rules, with Commission approval, that grant priority to certain participants over others, or to waive fees or provide discounts for certain kinds of transactions, in order to attract order flow or create more competitive markets.

The Act itself recognizes that the operation of a marketplace can warrant exceptions to general allocation principles, for example, by exempting specialists and market makers from the requirement that a member of an exchange yield to the order of a non-member.<sup>53</sup> “Specialist entitlements”<sup>54</sup> and facilitation and solicited order guarantees,<sup>55</sup> adopted by exchanges with

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<sup>51</sup> See, e.g., Carr Letter supra note 4, G. Schneider Letter supra note 4 and Rule Letter supra note 4.

<sup>52</sup> See, e.g., Carr Letter supra note 4, Cox Letter II supra note 4 and Rule Letter supra note 4.

<sup>53</sup> See Section 11(a) of the Act, 15 U.S.C. 78k(a), and the rules thereunder.

<sup>54</sup> A “specialist entitlement” as used here is an options exchange rule that under certain circumstances guarantees a specialist (or designated primary market maker) the right to trade ahead of other participants in the trading crowd with a certain percentage of every order – when the specialist is quoting at the best price – even when the specialist has not otherwise established priority. See, e.g., ISE Rule 713, Supplementary Material .01(b); Amex Rule 935-ANTE(a)(5); CBOE Rule 8.87; NYSE Arca Rule 6.82(d)(2); Phlx Rule 1014(g)(ii).

<sup>55</sup> A “facilitation guarantee” as used here is an options exchange rule that under certain circumstances guarantees an order entry firm that has submitted a public customer order

Commission approval, also are instances in which the need to attract order flow or provide incentives to one group of participants based on their role in the marketplace has been viewed as a valid reason to adjust the otherwise-established priority principles of an exchange. Other examples include options trading rules that adjust allocation principles under certain condition in the execution of larger orders<sup>56</sup> and the small order automatic execution systems created by options exchanges in the past.<sup>57</sup> Notably, in some prior proposals to waive or reduce customer fees, exchanges cited their need to remain competitive and attract order flow.<sup>58</sup>

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for execution on the exchange to trade with a certain percentage of that public customer order itself, ahead of other participants in the trading crowd that are prepared to trade at the same price. See, e.g., ISE Rule 716(d); Amex Rule 950-ANTE, Commentary .02; CBOE Rule 6.74(b); NYSE Arca Rule 6.47(b); A “solicited order guarantee” is an options exchange rule that entitles a broker or firm that has solicited an order from a third party to trade against its customer’s order to execute a certain percentage of the customer’s order against the solicited order ahead of other participants in the trading crowd that are prepared to trade at the same price. See, e.g., ISE Rule 716(e) (Solicited Order Mechanism).

<sup>56</sup> See, e.g., CBOE Rule 6.74(f) (Open Outcry SizeQuote Mechanism).

<sup>57</sup> In the past, options exchanges that generally operated on an open-outcry trading model adopted systems that automatically executed orders of public customers below a certain size without exposing them to the auction on the floor. These systems were designed to give investors speed, efficiency, and accuracy in the execution of their small orders, which were executed at the exchange’s disseminated quotation on a rotational basis against the accounts of participating market makers. Auto-ex orders were thus not executed according to auction principles and priority rules, but were allocated to market makers on the system by turn, regardless of who was first to bid or offer the disseminated price. For descriptions of such systems, see, e.g., Securities Exchange Act Release Nos. 48975 (December 23, 2003), 68 FR 75667 (December 31, 2003) (Amex); 44829 (September 21, 2001), 66 FR 49730 (September 28, 2001) (Phlx); 41823 (September 1, 1999), 64 FR 49265 (September 10, 1999) (Pacific Exchange); and 44104 (March 26, 2001), 66 FR 18127 (April 5, 2001) (CBOE).

<sup>58</sup> See, e.g., Securities Exchange Act Release Nos. 50469 (September 29, 2004), 69 FR 59628 (October 5, 2004) (CBOE reduction of public customer transaction fees on options on ETFs and HOLDRs); 49957 (July 1, 2004), 69 FR 41318 (July 8, 2004) (ISE waiver of surcharge on public customer transactions in certain licensed products); 44654 (August 3, 2001), 66 FR 42574 (August 13, 2001) (CBOE waiver of fees for public customer transactions in options on Standard & Poor's 100 European-style index). See also infra, note 101.

The Commission believes that ISE's proposal to grant priority only to Priority Customers and no longer to waive fees for transactions involving Professional Orders likewise does not necessarily place an inappropriate burden on competition and should most reasonably be viewed as within the discretion of the Exchange,<sup>59</sup> so long as these changes do not unfairly discriminate among participants.<sup>60</sup> In fact, the ISE's proposal simply restores the treatment of Professional Orders to a base line where no special priority benefits and fee waivers are granted.

Moreover, with respect to commenters' contention that broker-dealers have substantial marketplace advantages over Public Customers, it should be noted that broker-dealers, unlike Public Customers, pay significant sums for registration and membership in self-regulatory organizations ("SROs"), and incur significant costs to comply, and ensure that their associated persons comply, with the Act and the rules thereunder and SRO rules. Moreover, Public

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<sup>59</sup> The Commission previously has articulated its position regarding its application of Section 6 of the Act in evaluating distinctions among market participants proposed by exchanges and the leeway granted to an exchange to set an appropriate level of advantages and responsibilities of persons in its marketplace. See Securities Exchange Act Release No. 50484 (October 1, 2004), 69 FR 60440 (October 8, 2004), stating, inter alia:

[Section (b)(5)] sets forth the purposes or objectives that the rules of a national securities exchange should be designed to achieve. Those purposes or objectives, which take the form of positive goals, such as to protect investors and the public interest, or prohibitions, such as to not permit unfair discrimination among customers, issuers, brokers or dealers or to not permit any unnecessary or inappropriate burden on competition, are stated as broad and elastic concepts. They afford the Commission considerable discretion to use its judgment and knowledge in determining whether a proposed rule change complies with the requirements of the Act. Furthermore, the subsections of Section 6(b) of the Act must be read with reference to one another and to other applicable provisions of the Act and the rules thereunder. Within this framework, the Commission must weigh and balance the proposed rule change, assess the views and arguments of commenters, and make predictive judgments about the consequences of approving the proposed rule. (citations omitted)

<sup>60</sup> See infra Section III.B.2 for a discussion of whether ISE's proposal is unfairly discriminatory.

Customers who would not be Priority Customers on ISE because they place options orders on the scale contemplated by the proposal could choose to become registered broker-dealers and receive the same advantages.

With regard to commenters' contentions relating to market-maker advantages, the Commission notes that ISE market makers have obligations that customers who seek to compete with them do not have, including the responsibility to make continuous markets; to engage in a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market; and not to make bids or offers or enter into transactions that are inconsistent with such a course of dealings.<sup>61</sup> Generally, the advantages of market makers noted by commenters, such as the ability to stream quotes on two sides of the market, are granted by exchanges as the quid pro quo for the market makers' assumption of these obligations, in addition to the application of other rules and restrictions relating to their activities.<sup>62</sup>

In addition, the proposal could provide an advantage to Public Customers who would not be Priority Customers. Under the proposed rule change, Professional Orders would not be subject to cancellation fees,<sup>63</sup> which could result in partially reduced costs for those customers who place orders on an average of one order per minute and frequently cancel such orders.<sup>64</sup>

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<sup>61</sup> See ISE Rule 803.

<sup>62</sup> For example, pursuant to ISE Rule 803(b), a market maker on ISE has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for the market maker's own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular options contract, or a temporary distortion of the price relationships between options contracts of the same class. Public Customers, including customers who seek to compete with market makers, have no such obligations. Under ISE's proposal, Public Customers who submit Professional Orders would not be subject to market maker obligations.

<sup>63</sup> The Exchange charges a cancellation fee, currently \$2.00 per cancellation, on each clearing EAM that cancels at least 500 Public Customer orders in a month for itself or for an introducing broker, for each cancelled order in excess of the total number of orders

Several commenters stated that active traders provide valuable liquidity to the market and pose significant competition to market makers. According to some commenters, the proposed rule change would punish these customers who contribute liquidity,<sup>65</sup> and would force such traders from the market.<sup>66</sup>

The Commission acknowledges that Public Customers, including sophisticated algorithmic traders, provide valuable liquidity to the options markets and compete with market makers. In the Commission's view, however, the contribution of these participants to the market does not mean that their orders are entitled to favorable priority and fee treatment, even if – as commenters argue – they would not be able to supply this liquidity without being granted such priority and fee advantages. Market makers and broker-dealers also provide valuable liquidity to the marketplace and do not have priority. Thus, the Commission believes that it is consistent with the Act for the ISE to amend its rules so that Professional Orders, like the orders of broker-dealers and market makers, are not granted special priority.

Two commenters appeared to acknowledge that customers who enter orders on the scale that the proposed rule change would establish likely have information and technology that allows them to compete in a sophisticated manner.<sup>67</sup> However, they argued that the proposal's creation

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executed for itself or for such introducing broker that month. The cancellation fee does not apply to the cancellation of Public Customer Orders that improve ISE's disseminated quote at the time the orders were entered. There currently are no fees for the cancellation of Non-Customer Orders, and Professional Orders would not incur such fees under the proposed rule change.

<sup>64</sup> The Commission notes that, contrary to the apparent belief of some commenters, the proposal would not impose cancellation fees on Professional Orders. See Cox Letter II supra note 4 and Carr Letter supra note 4.

<sup>65</sup> See, e.g., A. Schneider Letter supra note 4 and Weisberg Letter supra note 4.

<sup>66</sup> See, e.g., Lampert Letter supra note 4.

<sup>67</sup> See, e.g., Carr Letter supra note 4 and Cox Letter II supra note 4.

of the category of Professional Orders suggests that “any person who wishes to consider themselves a retail customer [must] forego any type of trading technology, which of course is widely available in today’s market ....”<sup>68</sup>

The Commission disagrees with this contention. The proposed rule does not ask Public Customers to forego technology and does not limit the technology that Public Customers who would not be Priority Customers can use to access the ISE’s marketplace. Rather, it establishes that customers who place orders at the level proposed by the ISE – irrespective of their use of trading technology – are engaged in a course of active trading that need not be accorded the special deference paid to those customers who do not place orders as frequently.

In support of its proposal, the ISE contends that traders who place orders on the scale set forth in the proposal have the same technological and informational advantages over retail investors as broker-dealers trading for their own account – which enables them to compete effectively with broker-dealer orders and market maker quotes for execution opportunities in the ISE marketplace.<sup>69</sup> The Commission, however, does not believe that access to or use of sophisticated technology is the key issue in considering whether it is consistent with the Act for ISE to treat Professional Orders in the same manner as broker-dealer orders in specified circumstances. Instead, the Commission believes that the pivotal issue is whether, under the Act, the exchange can grant certain advantages, which it initially established for all public customers, to only those public customers who place no more than 390 orders per day.

The Commission notes that currently customers who are positioned to place orders in the number and frequency specified in the proposed rule change are treated on a par with customers

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<sup>68</sup> See Carr Letter supra note 4. The commenter believed that the proposal, as a result, would require retail customers who forego technology to “wander into the marketplace blind and helpless.”

<sup>69</sup> See Notice, supra note 3, at 73 FR 7346.

who may not have this ability, or even if they have this ability, do not place orders on the average of one order per minute per over the trading day. Under the Exchange's proposal, customers who place orders less frequently would be advantaged by the Exchange's grant of priority over Non-Customer Orders and market maker quotes at the same price, even if they have access to sophisticated options trading technology. Further, the Commission disagrees with the argument that customers would have to forego using trading technology under the Exchange's proposal. The ISE's proposal does not limit, prohibit, or proscribe the type of technology any customer uses. Customers could still use sophisticated technology to trade options and their orders would not be considered Professional Orders, as long as those customers placed fewer than one order per minute per day on average during a calendar month for their own beneficial account(s).

One commenter believed that the proposed rule change limited competition and was collusive because "it requires the cooperation of other competing exchanges. . . ." <sup>70</sup> The Commission notes, however, that the proposed rule change requires EAMs to conduct a quarterly review of customer activity only as reflected in the EAM's own records. The proposal does not require either EAMs or the Exchange to seek information from other broker-dealer firms or exchanges regarding a customer's activity. <sup>71</sup>

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<sup>70</sup> See Cox Letter III supra note 4. The commenter stated further: ". . . I fail to see how the ISE can request trading information from a person or entity trading from another exchange, particularly when other exchanges have business models that promote order entry: the exact behavior the ISE is attempting to punish with its rule."

<sup>71</sup> Confirmed in telephone conversation between Ira Brandriss, Special Counsel, Division, Commission, and Katherine Simmons, Deputy General Counsel, ISE, on April 29, 2008. See also supra note 17 and accompanying text. See also ISE Rules 401, 706, and 712.

## 2. ISE's Proposal Is Not Unfairly Discriminatory

Many of the commenters argued that the proposed rule change is unfairly discriminatory against those Public Customers who would not be Priority Customers by denying them priority rights and imposing transaction fees on their orders.<sup>72</sup> In the ISE's view, public customers today range from individuals who infrequently place options orders to sophisticated algorithmic traders that trade many options classes on a daily basis.<sup>73</sup> ISE proposes to continue to grant priority to, and waive transaction fees for, individuals who place orders below the threshold, as a means to encourage their participation. The Exchange believes, however, that priority rights and fee waivers are no longer warranted for market participants who place more than one order per minute on average during a calendar month, a level of activity that it believes is akin to that of broker-dealers. The Exchange therefore proposes to refrain from providing priority and fee incentives for such participants.

The Commission notes that the Act does not require that the Exchange's rules be designed to prohibit all discrimination, but rather they must not permit unfair discrimination.<sup>74</sup> With regard to public customer priority, the Commission has noted above ample precedent demonstrating that public customer orders are not entitled per se to priority treatment over the orders of other market participants. The Commission similarly believes that the ISE's proposal to grant such priority treatment only to Priority Customers is consistent with the Act and, in particular, is not unfairly discriminatory.

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<sup>72</sup> See, e.g., G. Schneider Letter supra note 4, Lampert Letter supra note 4, Rule Letter supra note 4, Cox Letter II supra note 4 and Cox Letter III supra note 4.

<sup>73</sup> See Notice, supra note 3, at 73 FR 7346.

<sup>74</sup> 15 U.S.C. 78f(b)(5). See also Securities Exchange Act Release No. 50484, supra note 59.



As discussed above, the Commission does not believe that the current rules of ISE and other exchanges that accord priority to all public customers over broker-dealers and market makers are unfairly discriminatory. Nor does the Commission believe that it is unfairly discriminatory to accord priority to only those customers who on average do not place more than one order per minute as ISE proposes.

Because, as discussed in Section III.A.1. above, the Commission believes that ISE's proposal is consistent with the Act in that it does not impose an undue burden on competition, the Commission believes that a grant of such priority is an exchange's prerogative and within the exchange's business judgment. As such, a decision to grant priority – which, after all, is a special benefit – to the orders of one type of customer (for example, a retail customer) and not to the orders of another (for example, an institutional investor) may be an economic decision that an exchange may make to provide some customers with incentives and fee waivers. In the Commission's view, nothing in the Act requires an exchange to provide the same incentives and discounts to all market participants equally, as long as the exchange does not unfairly discriminate among participants with regard to access to exchange systems.<sup>75</sup>

The Commission believes that the line that the ISE seeks to draw between Priority Customers and Public Customers whose orders would be treated as Professional Orders most simply reflects a belief – from the point of view of operating a marketplace – that the orders of a person who submits, on average, more than one order every minute of the trading day need not (or should not) be granted the same benefit or incentive that is granted to Public Customers who do not utilize the marketplace on such a scale.

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<sup>75</sup> In this regard, the Commission notes that ISE amended the proposal to remove the changes it had originally proposed to ISE Rules 715 and 723(c), which would have prevented access by all Public Customers to the Exchange's PIM. See Amendment No. 2, supra note 5.

The same can be said with regard to relief from transaction fees. Exchanges can and do have fee structures that vary depending on the market participant.<sup>76</sup> Various fee structures are permitted provided that they are consistent with the Act (including the requirement that the fees not be unfairly discriminatory). Such differing fee structures are based on the judgment of those responsible for the financial operation of the exchange, and are tied to exchange assumptions about market participant behavior, the impact of incentives and discounts, and other factors relating to the specific business model adopted by the exchange. A decision to waive or discount fees for orders of one kind of participant and not another, based on the extent of their participation in the market, is a reasonable decision for an exchange, provided it is otherwise consistent with the Act.<sup>77</sup>

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<sup>76</sup> For example, some exchanges impose different fees for different market participants, depending on whether the market participant adds liquidity by posting a quote or order, or takes liquidity by executing against a quote or order that is already posted on the exchange. Some exchanges' transaction fees, before additional charges are assessed, are identical for market makers and member firms, while on other exchanges market makers and member firms are charged at different rates. Some exchanges provide volume discounts; some place a cap on charges to particular participants. Some impose transaction fees upon certain participants for complex orders; others do not. As a result, the fees imposed upon various market participants can vary significantly from exchange to exchange. Each exchange's schedule of fees is available on the exchange's website. See e.g., the fee schedule of CBOE at <http://www.cboe.com/AboutCBOE/FeeSchedule.aspx>; the fee schedule of BOX at [http://www.bostonoptions.com/box\\_regulations/PDF/feeschedjan06.pdf](http://www.bostonoptions.com/box_regulations/PDF/feeschedjan06.pdf) ; and the fee schedule of NYSE Arca at <http://www.nyse.com/futuresoptions/nysearcaoptions/1147128317287.html>.

<sup>77</sup> Similar to other exchanges, ISE charges different fees depending on whether an individual is a Public Customer, Non-Member Broker-Dealer, EAM, ISE Market Maker or Non-ISE Market Maker. For example, ISE charges Public Customers a \$0.05 fee for Non-Premium Products and the \$0.03 Comparison Fee for the orders of Public Customers are currently waived while Non-Member Broker-Dealers and EAMs pay a \$0.15 fee for orders in Premium and Non-Premium Products (subject to volume discounts) and a \$0.03 Comparison Fee. Comparatively, ISE market makers are subject to a fee for transactions in Premium and Non-Premium Products between \$0.12-\$0.21 (subject to volume discounts). The amount of this fee is based on the average daily

### 3. The Proposal Can be Implemented on a Technical and Operational Level

One commenter, SIFMA, endorsed the underlying goal of the proposed rule change, but expressed concern about various aspects of the proposal. First, SIFMA was concerned that, under the proposed rule, EAMs would “have no ability to identify the end-user customer and count orders.”<sup>78</sup> SIFMA’s comment letter noted that EAMs would have to rely on the broker-dealers that route orders to them and have the customer relationship to identify the professional customer and code orders correctly. Moreover, SIFMA stated that, in general, firms do not count the number of orders directed by customers under the same beneficial owners and do not have the ability to break down, by beneficial owner, the number of orders placed. SIFMA further believed that EAMs would need to rely on the Options Clearing Corporation (“OCC”) member firm that ultimately clears the professional customer to identify such accounts. SIFMA stated, however, that such reliance would not be possible because OCC member clearing firms see only the number of cleared contracts at the end of the day, and not the number of executions. Moreover, SIFMA noted the lack of access by clearing firms to information regarding a customer’s cancellations, replacements, modifications, or corrections of orders, and the resulting inability of such firms to accurately determine the number of orders a customer has placed.<sup>79</sup>

In its response, ISE stated that these concerns were based on the erroneous assumption that compliance with the proposal would require analysis by an ISE member’s clearing firm of cleared data provided by the OCC to determine whether a customer had crossed the threshold of

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volume of transactions on the Exchange, and is currently \$0.13 per contract. See ISE Schedule of Fees. See also discussion infra note 105.

<sup>78</sup> See SIFMA Letter supra note 4.

<sup>79</sup> Id.

placing more than 390 orders per day, on average, over the course of a calendar month.<sup>80</sup> ISE clarified that only broker-dealers that received orders from the ultimate customers – not clearing firms – would be required under the proposal to monitor the number of orders they receive from each such customer and to mark the orders correctly. “These types of activities are routinely performed by broker-dealers who deal directly with customers,” the ISE maintained, adding that broker-dealers have a regulatory responsibility to know their customer, “and, in fact, do know if they have customers that conduct this high level of activity.”<sup>81</sup>

With regard to ISE members that submit customer orders to the Exchange when those orders were routed to them by other, non-ISE-member broker-dealers, SIFMA indicated its concern that such members “will be forced to rely on the good faith and effort of its broker-dealer client ... to identify the professional customer and code the order correctly.”<sup>82</sup> In response, the ISE noted that the Exchange and all other options exchanges currently have a variety of order marking requirements for which ISE members that route orders on behalf of other broker-dealers have regulatory responsibility. The ISE further noted that its EAMs would need to have reasonable procedures in place to confirm that their broker-dealer customers had implemented the appropriate procedures to monitor their customers’ trading activity in a way that would enable them to code orders properly to comply with the proposal.<sup>83</sup>

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<sup>80</sup> See ISE Response Letter supra note 6.

<sup>81</sup> Id. The ISE also stated that it consulted with a variety of firms that accept orders directly from customers, and that these firms did not believe it would be difficult for them to determine, on a quarterly look-back basis, whether a customer had on average entered more than 390 orders per day during any month. Id.

<sup>82</sup> See SIFMA Letter supra note 4.

<sup>83</sup> Id. According to the Exchange, an EAM would be required to have such procedures in place to comply with its obligation under ISE Rule 712(a) to properly mark orders. Telephone conversation between Katherine Simmons, Deputy General Counsel, ISE, and

The Commission believes that the ISE's response clarifies its proposal and addresses the concerns raised by SIFMA regarding the counting and marking of customer orders. The proposal would require any ISE member submitting a Public Customer Order to the ISE to identify such order as either a Priority Customer Order or a Professional Customer Order. Based on the ISE's representations, the Commission believes that ISE members that directly submit their Public Customers' orders to the Exchange for execution can readily determine the number of orders that their customers place and can mark those orders accordingly. The Commission notes that the Exchange has stated that EAMs would need to have reasonable procedures in place to confirm that their broker-dealer customers have instituted policies and procedures to enable them to monitor their customers' trading activity in a way that would allow them to mark their customer orders properly.<sup>84</sup>

The Commission believes that ISE members, as well as non-member broker-dealers who accept customer orders and route them to EAMs for execution on the Exchange, have the ability to ascertain for each customer account, by beneficial owner, the number of orders placed by a customer. As the ISE points out, the proposal requires the broker-dealer that has a relationship with, and knows, the ultimate customer to monitor the number of orders it is entering on the customer's behalf and to conduct a quarterly review to assure that the firm is marking the orders appropriately. This monitoring is accomplished by the ISE member directly in the case of its own customers or by the ISE member contractually requiring that its broker-dealer customers have reasonable procedures in place to ascertain whether their customers are submitting orders that should be marked as Professional Orders.

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Nancy J. Burke-Sanow, Assistant Director, Division, Commission, on December 15, 2008.

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Id.

Second, SIFMA expressed concern that professional customers could “‘game’ the system and inappropriately take advantage and avoid the purpose of the rule.” SIFMA noted the frequent use by Professional Customers of multiple firms for execution and clearing purposes, which would limit the review by any one EAM or OCC clearing member of a customer’s activity. SIFMA further noted that customers could electronically route orders to an exchange without a Professional Order designation and, due to linkage and best execution requirements, these orders could be sent to the ISE without the proper coding.<sup>85</sup> ISE acknowledged that customers could place orders at multiple firms, such that each individual broker-dealer would not know the full extent of its customer’s trading activity, making it impossible for a particular firm to measure the total number of orders entered by a particular customer through multiple firms. ISE stated, however, that it believed that “it might be impractical for a customer to conduct professional trading activities through multiple broker-dealer platforms.” The Exchange also stated that it would conduct surveillance designed to identify any such behavior, and that if it does detect such activity, it would alert the relevant ISE members. In addition, ISE agreed that, through the operation of the options linkage rules, an order for the account of a customer that ISE otherwise would consider a Professional Order might be routed to other exchanges that do not have the same order designation and ultimately receive the price available on the ISE indirectly.<sup>86</sup> The Commission believes that the rule change, as proposed, meets the Exchange’s aim with regard to those customers who do not employ such stratagems, and thus the potential for a customer to circumvent the proposed rule, does not, in this instance, make it inconsistent with the Act.

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<sup>85</sup> See SIFMA Letter supra note 4.

<sup>86</sup> See ISE Response Letter supra note 6.

Third, SIFMA believed that, for the proposed rule change to be properly implemented, customer trading information would need to be disseminated across desks within a single firm that typically are separated by information barriers. Regarding this issue, SIFMA requested specific guidance on how to implement the proposed requirements without violating applicable privacy regulations.<sup>87</sup> ISE responded that putting procedures in place to comply with its proposal would not result in disclosure of information about particular orders entered by a customer either pre- or post-trade, nor would it result in disclosures about any positions held by a customer. The Exchange stated that it is not aware of any information barrier rule or privacy regulations that would prevent a firm from marking an order as required under the proposal.<sup>88</sup> The Commission agrees with the ISE's position in this regard. The Commission believes that the determination of whether a Public Customer's orders are categorized as Priority Customer Orders or Professional Orders, which would be based on information compiled retrospectively each quarter, can be made at a level in the firm that is "above" the information barrier, and in any case does not require disclosure of any particular orders placed by a customer or any positions held by a customer.

Finally, one commenter expressed the concern that the proposal would be burdensome because it would require EAMs to purchase expensive technology to track the number of orders a person entered per day.<sup>89</sup> Another commenter, SIFMA, believed that the ISE's proposal would require broker-dealers to expend significant resources to comply with the rule and potentially

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<sup>87</sup> See SIFMA Letter supra note 4.

<sup>88</sup> See ISE Response Letter supra note 6.

<sup>89</sup> See Cox Letter III supra note 4.

would present large retail firms with difficulties in implementing a new order origin code within the proposal's timeframe.<sup>90</sup>

ISE acknowledged that systems changes to accommodate new coding of orders could be required for some broker-dealers, but did not believe that such systems changes would be particularly costly "relative to other rule changes routinely made by the ISE and other exchanges."<sup>91</sup> SIFMA also expressed a concern that the proposal could require significant revisions to the customer option account agreements used by firms, because customers could be designated as professional customers.<sup>92</sup> The Commission believes that it is within the business judgment of the Exchange to accept orders for execution in its marketplace contingent upon their submission with a particular order marking, even when that marking may require additional expense on the part of member firms. Exchanges routinely add new order types<sup>93</sup> and the ISE's proposal is no different in this regard. Thus, the Commission believes that the new order designations in the proposed rule change are consistent with the Act, even though they will require members to incur costs associated with systems changes and customer account agreements may need to be revised to reflect these new order designations. As a general matter, the Commission notes that membership in an exchange comes with the expectation that rule changes will be made by the exchange that could require member firms to make adjustments in their systems and procedures.

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<sup>90</sup> See SIFMA Letter, supra note 4.

<sup>91</sup> See ISE Response Letter supra note 6.

<sup>92</sup> See SIFMA Letter supra note 4.

<sup>93</sup> See, e.g., Securities Exchange Act Release Nos. 58546 (September 15, 2008), 73 FR 54440 (September 19, 2008); 57441 (March 6, 2008), 73 FR 13267 (March 20, 2008); and 56072 (July 13, 2007), 72 FR 39867 (July 20, 2007).



SIFMA further noted that the proposal would require additional systemic and procedural enhancements for firms to track the new fees that would be established under the proposal.<sup>94</sup> In response, the Exchange maintained that fees vary widely among exchanges and are changed frequently, and that firms routinely make changes in their systems to accommodate exchange fee changes.<sup>95</sup> The Commission notes that fee changes are commonly introduced by exchanges, and members can expect that they will need to adjust their tracking systems as needed when changes are made.

Finally, SIFMA further expressed a concern that the five-day timeframe allotted at the end of a quarter for firms to start coding for Priority Customer and Professional Orders is unrealistic.<sup>96</sup> In response, the ISE acknowledged that it may take more than five days for a broker-dealer to make the system changes necessary to accommodate the new order code, and stated that it would give members at least one full quarter, following Commission approval of the proposal to make these changes. The Exchange stated, however, that once the initial systems changes were implemented, five days would be sufficient to change the order code associated with a particular customer account.<sup>97</sup> The Commission notes that the Exchange has committed to working with its members to assure that there is adequate time to make the initial systems changes necessary to implement the new coding,<sup>98</sup> and believes that not less than one full quarter

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<sup>94</sup> See SIFMA Letter supra note 4.

<sup>95</sup> See ISE Response Letter supra note 6.

<sup>96</sup> See SIFMA Letter supra note 4.

<sup>97</sup> See ISE Response Letter supra note 6.

<sup>98</sup> The Exchange stated that it would work with its members to assure that there is adequate time to implement systems changes as necessary. ISE Response Letter, supra note 6, n.6. The Exchange further advised that it would issue a notice to its members informing them of the implementation date of the proposed rule change. Telephone conversation between Katherine Simmons, Deputy General Counsel, ISE, and Nancy J. Burke-Sanow, Assistant Director, Division, Commission, on December 15, 2008.

is a reasonable amount of time to achieve this aim. The Commission, however, will monitor whether any issues may arise that would require the ISE to postpone the proposal's implementation timeframe.

#### 4. ISE's Proposal Is Not Vague

One commenter contended that the proposal was vague and unenforceable.<sup>99</sup> The Commission believes that the ISE's proposed rule change is amply clear regarding the kind of order that would not receive priority at the same price and would incur transaction fees as a result of the proposal. The proposal sets forth specific and objective numeric thresholds in its provisions, defining "Priority Customer" as "a person or entity that (i) is not a broker or dealer in securities, and (ii) does not place more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s)." It further defines the term "Professional Order" as "an order that is for the account of a person or entity that is not a Priority Customer." The Commission believes that these definitions are clear and provide notice of the parameters of the rule.

#### 5. Transaction Fees for Professional Orders Are Not Inequitable

As noted above, Section 6(b)(4) of the Act requires that the rules of an exchange must provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities. In evaluating whether a proposed fee can be considered an equitable allocation of a reasonable fee, the Commission considers all of the relevant factors including, among others, the amount of the fee and whether the fee is an increase or decrease, the classes of persons subject to the fee, the basis for any distinctions in

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<sup>99</sup> See Cox Letter III, supra note 4.

classes of persons subject to the fee, the potential impact on competition, and the impact of any disparate treatment on the goals of the Act.<sup>100</sup>

Under the proposed rule change, transaction fees would be charged for the execution of certain Public Customer Orders that currently are not subject to such fees. The Commission notes, however, that options exchanges have charged transaction fees for the execution of public customer orders in the past,<sup>101</sup> and in many cases continue do so when necessary to defray the costs of maintaining a market and associated expenses for a particular product or category of products.<sup>102</sup> The ISE itself currently imposes fees on certain Public Customer Orders.<sup>103</sup>

Moreover, Public Customer Orders that today incur no transaction fees on the ISE are not indefinitely excepted from such fees. The Exchange's Fee Schedule specifically sets forth transaction fees for customer orders, while indicating that these fees (other than fees for "Premium Products") currently are waived.<sup>104</sup> The Commission notes that different market

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<sup>100</sup> See, e.g., Securities Exchange Act Release No. 50484 (October 1, 2004), 69 FR 60440 (October 8, 2004).

<sup>101</sup> Subsequently, however, some exchanges have rescinded transaction fees for manually executed equity options orders for public customers. See, e.g., Securities Exchange Act Release Nos. 42798 (May 18, 2000), 65 FR 34239 (May 26, 2000); and 43343 (September 26, 2000), 65 FR 59243 (October 4, 2000).

<sup>102</sup> For example, the exchanges generally charge transaction fees for executions of public customer orders in index options. See, e.g., Securities Exchange Act Release No. 52983 (December 20, 2005), 70 FR 76475 (December 27, 2005) (Commission notice of filing and immediate effectiveness of a proposed rule change adopting a flat execution fee for Public Customer Orders in premium products).

<sup>103</sup> As noted at *supra* note 9, Public Customer Orders incur fees for certain transactions in Premium Products and Complex Orders, orders entered in response to special order broadcasts, and orders entered in PIM. Public Customer Orders also are subject to fees for cancellation.

<sup>104</sup> See Securities Exchange Act Release Nos. 42370 (April 28, 2000), 65 FR 26256 (May 5, 2000) (Commission order adopting original ISE Fee Schedule), in which the Commission found that the fee schedule was "not unreasonable" and "should not discriminate unfairly among market participants." See also the current ISE Fee Schedule, dated August 12, 2008 and Securities Exchange Act Release No. 58139 (July 10, 2008), 73 FR 41142 (July

participants pay fees based on their status on the Exchange (e.g., Public Customer, non-member broker-dealer, EAM, non-ISE market maker and ISE market maker).<sup>105</sup> Under the proposal, customers whose orders are identified as Professional Orders would pay the same fees as non-member broker-dealers.

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17, 2008) (customer fees, except those for “Premium Products,” currently waived until June 30, 2009).

<sup>105</sup> Public Customers - The \$0.05 fee for Non-Premium Products and the \$0.03 Comparison Fee for the orders of Public Customers are currently waived. Public Customers currently pay a fee of \$0.15 for certain orders in Premium Products and Complex Orders, orders entered in response to special order broadcasts and orders entered in PIM. Public Customers are also subject to an order cancellation fee of \$1.75 per order. See supra notes 9 and 64.

Non-member Broker-Dealers - Non-member broker-dealers pay a \$0.15 fee for orders in Premium and Non-Premium Products (subject to volume discounts) and a \$0.03 Comparison Fee. Customers whose orders are identified as Professional Orders would incur these fees under the proposal.

EAMs - EAMs pay the same fees for orders as non-member broker-dealers. In addition to non-member broker-dealer fees, EAMs also pay a one time application fee of \$3500, a regulatory fee of \$5000 per year and a monthly access fee of \$500.

ISE Market Makers - ISE market makers are subject to a fee for transactions in Premium and Non-Premium Products between \$0.12-\$0.21 (subject to volume discounts). The amount of this fee is based on the average daily volume of transactions on the Exchange, and is currently \$0.13 per contract. See Fee Notice to ISE Members dated March 3, 2008, available at <http://www.iseoptions.com>. In addition, ISE market makers pay a \$0.03 Comparison Fee, a fee for payment for order flow (only for customer orders) of \$0.65 per contract and \$0.10 per contract for options on issues that are participating in the Penny Pilot (subject to available rebates).

In addition to these market maker fees, PMMs and Competitive Market Makers (“CMMs”) pay additional fees including, but not limited to, the fees described below. PMMs have a minimum monthly transaction fee of \$50,000, a one time application fee of \$7500, a regulatory fee of \$7500 per year, a monthly access fee of \$4000 and an inactivity fee of \$100,000 per month. CMMs have a one time application fee of \$5500, a regulatory fee of \$5000 per year, a monthly access fee of \$2000 and an inactivity fee of \$5,000 per month.

Non-ISE Market Makers - Non-ISE market makers pay a \$0.37 fee for transactions in Premium and Non-Premium Products (subject to volume discounts) except for a \$0.16 fee for orders entered in the Facilitation and Solicitation Mechanisms and a \$0.03 Comparison Fee.

The Commission notes that the customers who enter more than 390 orders per day on average during a calendar month are using the Exchange's facilities to place approximately 8000 orders, on average one order for every minute of every trading day, over the course of the month and nearly 100,000 orders per year. The Commission believes that it is consistent with the Act for ISE to allocate to customers who participate in the market at this level of activity – which enables them to compete with Non-Customers who are registered broker-dealers – the same transaction fees that it charges to such Non-Customers.

C. Accelerated Approval of Proposed Rule Change, As Modified by Amendment Nos. 1 and 2

Pursuant to Section 19(b)(2) of the Act,<sup>106</sup> the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30<sup>th</sup> day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission hereby finds good cause for approving the proposed rule change, as modified by Amendment Nos. 1 and 2, before the 30<sup>th</sup> day after the date of publication of notice of filing thereof in the Federal Register.<sup>107</sup> The Commission notes that the proposal, as modified by Amendment No. 1, was published for comment in the Federal Register on February 7, 2008. The revisions made to the proposal in Amendment No. 2 deleted proposed changes to ISE Rules 715 and ISE Rule 723 (d)(2). These revisions appropriately clarify that the proposed rule change would not limit a Public Customer's access to the Exchange's PIM. Accordingly, pursuant to Section 19(b)(2) of the Act,<sup>108</sup> the Commission finds good cause to approve the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

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<sup>106</sup> 15 U.S.C. 78s(b)(2).

<sup>107</sup> See supra note 3.

<sup>108</sup> 15 U.S.C. 78s(b)(2).

#### 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 modified by Amendment Nos. 1 and 2, 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-2006-26 on the subject line.

##### Paper comments:

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

All submissions should refer to File Number SR-ISE-2006-26. 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 such filing also will be available for inspection and copying at the principal office of the Exchange. 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-2006-26 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>109</sup> that the proposed rule change (SR-ISE-2006-26), as modified by Amendment Nos. 1 and 2, be, and it hereby is, approved on an accelerated basis.

By the Commission.

Florence E. Harmon  
Deputy Secretary

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<sup>109</sup> 15 U.S.C. 78s(b)(2).