INTERNATIONAL SECURITIES EXCHANGE

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September 23, 1999

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: International Securities Exchange; File No. 10-127, Amendment No. 1

Dear Mr. Katz:

The International Securities Exchange LLC ("ISE") hereby amends its Form 1 application for registration as a national securities exchange filed with the Commission on February 2, 1999 (the "Filing").[1] These amendments are technical in nature and cover the following points:

- Amendment to Form 1. The name of the applicant is officially changed from ISE LLC to International Securities Exchange LLC. The address of the applicant is now 60 Broad Street, New York, New York 10004, and the phone number is (212) 943-2400.

- Amendment to Exhibit A(1). Attachment 1 contains the amended Articles of Organization and operating agreement reflecting the applicant's name change. In addition, the changes listed below are being made to the ISE Constitution and Rules. A revised table of contents for the ISE Rules and the text of the provisions being amended marked to show changes are contained in Attachment 2.

  (1) Constitution, Article II, Section 8 and Rule 306 regarding nominees are being deleted. Rule 801, entitled "Designated Trading Representatives," requires that persons entering orders or quotations on behalf of a market maker be registered with the ISE, thus negating the need to use the term "nominee." Other various provisions are being amended to remove reference to this term.

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[1] Notice of the filing of this application appeared in the *Federal Register* on June 1, 1999, and the comment period expired on July 16, 1999. *See* Securities Exchange Act Release No. 34-41439 (May 24, 1999); 64 FR 29367 (June 1, 1999).

(2) Constitution, Article II, Section 2 is being amended to permit the approval of all 100 Competitive Market Maker Memberships without restriction. Previously, the ISE was restricted from approving more than 50 of the 100 memberships without seeking Board approval. While we imposed this limitation purely for systems capacity reasons, we now have confirmed that the trading system will be able to support all 100 memberships. In connection with this change, Rules 303(g) and 317(a) are also being amended to maintain a 10 percent limit. Previously, a member firm could not own nor be approved to operate more than five of the 50 available competitive market maker memberships without good cause shown. Now that there are 100 available competitive market maker memberships, a member firm may be approved to own and operate competitive market maker memberships in the 10 groups of options traded on the ISE.

(3) Rule 309 is being amended to clarify that the ISE Rules intended to provide a system to facilitate the transfer of Memberships will not be established until after the ISE commences operations. This system is designed to (i) provide members of an active exchange assurances that they will be able to recover outstanding claims against departing members by requiring that the proceeds of sales be transferred by the Exchange, which is not applicable prior to the initiation of trading, and (ii) disseminate information regarding the value of memberships in the context of a ready secondary market for Memberships, which also is not applicable in the initial sales of Memberships by the Founders. Accordingly, Rule 309 will provide that the rules governing this system for selling Memberships will not apply to sales made by Founders under agreements entered into prior to the initiation of trading on the Exchange.

(4) Rule 406 regarding gratuities is being added.

(5) Rule 706 is being amended. The Rule previously implied that a violation of the Rule was subject to treatment under a minor rule violation provision. While several of the activities that would violate paragraph (b) already are included in the minor rule violation provision, Rule 1614, violation of Rule 706 itself is not included within that provision.

(6) Rule 716 regarding block trades is being amended to clarify the language describing the operation of Block Order and Facilitation Mechanisms. In addition, the rule is being amended to specify that a member using the Facilitation Mechanism will execute at least fifty percent of the original size of the order being facilitated, not fifty percent

of the size remaining after the execution of Public Customer Orders and superior-priced trading interest. However, such Public Customer Orders and superior-priced trading interest still must be satisfied at the facilitation price before the facilitating firm can trade with the order.

(7) Rule 717(a), regarding limitations on orders, is being amended to permit the entry of limit orders that cross the market by more than two trading increments provided such orders can be executed within two trading increments below the ISE best bid or above the ISE best offer. Previously, such orders were cancelled by the System.

(8) Rule 804 is being amended to clarify that when Primary Market Makers and Competitive Market Makers enter continuous quotes in options classes as required by the Rule, they must do so in all of the series that are traded on the Exchange within such classes.

(9) New Rule 1407 is being added to permit ISE market makers to avail themselves of the market maker hedge exemption contained in the National Association of Securities Dealers, Inc. ("NASD") short sale rule. This rule is the substantive equivalent of the rules of the current options exchanges, and is required under the NASD's rules to provide ISE market makers with a limited exemption from the NASD's short sale rule.

(10) Rules 1601 through 1603 are amended to give the ISE's staff the authority to institute enforcement proceedings. Currently, these rules grant the Business Conduct Committee the sole authority to institute such actions. Providing the staff with this authority gives the ISE greater flexibility in dealing with enforcement matters and is in keeping with the rules and procedures of the other self-regulatory organizations.

(11) Various technical changes are being made, typographical errors are being corrected, and cross references are being changed in the ISE Rules.

- Amendment to Exhibit E. The ISE submits audited financial statements reflecting the ISE's most recent full fiscal year (1998). The new audited financial statements are contained in Attachment 3.

- Amendment to Exhibit F. The ISE submits audited financial statements reflecting the most recent full fiscal year (1998) for Adirondack Trading Partners, LLC. The new audited financial statements are contained in Attachment 4.

- Amendment to Exhibit G. The ISE has added seven officers since the time of our initial filing. An updated list of the officers and their titles is contained in Attachment 5. In addition, Attachment 5 also includes a copy of the biographies for each of the ISE officers that are available on the ISE's web site at www.iseoptions.com.

In addition to these amendments, we have prepared a response to certain comments that the Commission has received regarding our application. This response is contained in Attachment 6. We currently are developing our fee schedule and intend to file it under Section 19(b)(2) for full Commission review and approval after the ISE's application is approved.

* * *

We believe that with the submission of this amendment our application for registration is complete. We respectfully request that the Commission approve our application as soon as practical. As I am sure the Commission can appreciate, prompt approval of our application is a critical step necessary for us to commence operations early next year. Once we begin operations, we will add competition to the options markets and will benefit public investors and all participants in this market. The ISE thanks the Commission and its staff for all the efforts made to date in processing this application and we look forward to a speedy approval process.

Very truly yours,

David Krell

David Krell
President and Chief Executive Officer

cc: Annette Nazareth, Esq.
Robert Colby, Esq.
Michael Walinskas, Esq.

Attachments:

1 Amendment to Exhibit A(1) regarding name change.
2 Amendment to Exhibit A(1) regarding changes to rules.
3 Amendment to Exhibit E regarding ISE audited financial statements.
4 Amendment to Exhibit F regarding ATP audited financial statements.
5 Amendment to Exhibit G regarding ISE officers.
6 Response to comment letters.

N. Y. S. DEPARTMENT OF STATE
DIVISION OF CORPORATIONS AND STATE RECORDS ALBANY, NY 12231-0001

FILING RECEIPT

ENTITY NAME: INTERNATIONAL SECURITIES EXCHANGE LLC

DOCUMENT TYPE: AMENDMENT (DOM LLC) NAME COUNTY: NEWY

SERVICE COMPANY: DELANEY CORPORATE SERVICES LTD. SERVICE CODE: 30

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ADDRESS FOR PROCESS

REGISTERED AGENT

STATE OF NEW YORK * DEPARTMENT OF STATE *

FILER

ORRICK HERRINGTON & SUTCLIFFE LLP
666 FIFTH AVENUE
18TH FLOOR
NEW YORK, NY 10103

FEES	70.00	PAYMENTS	70.00
FILING	60.00	CASH	0.00
TAX	0.00	CHECK	0.00
CERT	0.00	CHARGE	0.00
COPIES	10.00	DRAWDOWN	70.00
HANDLING	0.00	BILLED	0.00
		REFUND	0.00

DOS-1025 (11/89)

CERTIFICATE OF AMENDMENT OF THE ARTICLES OF ORGANIZATION OF

ISE LLC

UNDER SECTION TWO HUNDRED ELEVEN OF THE

LIMITED LIABILITY COMPANY LAW

The undersigned, as the manager of ISE LLC, hereby amends the initial Articles of Organization of ISE, LLC (the "Company"), pursuant to Section 211 of the New York Limited Liability Company Law.

WHEREAS, the name of the limited liability company is ISE LLC.

WHEREAS, the date of the initial filing of the Articles of Organization of the Company was September 29, 1997.

WHEREAS, the manager of the Company wishes to amend the Articles of Organization to change the name of the Company.

WHEREAS, as required by Section 204(h) of the New York Limited Liability Company Law, the attorney general approved the use of the word "exchange" in the name of the Company pursuant to a letter dated July 14, 1999, a copy of which is attached hereto.

NOW, THEREFORE, ARTICLE I of the of Articles of Organization of the Company is hereby amended and restated to read in its entirety as follows:

ARTICLE I. The name of the limited liability company is: International Securities Exchange LLC (the "Company").

IN WITNESS WHEREOF, this Certificate of Amendment of the Articles of Organization has been executed this 29 day of July, 1999, by the undersigned who affirms that the statements made herein are true under the penalties of perjury.

By: W A Porter
WILLIAM A. PORTER, Manager

WRITTEN CONSENT OF MANAGERS IN LIEU OF MEETING

OF

ISE LLC

The undersigned, being the sole managers (the "Managers") of ISE LLC, a New York limited liability company (the "Company"), pursuant to the authority vested in them by the provisions of Exhibit A of the Company's Second Amended and Restated Operating Agreement, dated as of January 1, 1999, hereby adopt the following recitals and resolutions with the same force and effect as if adopted at a duly convened meeting of the Board of Directors:

Certificate of Amendment re: Name Change

WHEREAS, the filing of that certain Certificate of Amendment of the Articles of Organization of the Company adopted by resolution of the Managers on October 16, 1998 has been postponed due to a delay in obtaining the consent of the New York Attorney General's office to the use of the word "exchange" in the name of the Company, and

WHEREAS, the New York Attorney General's office approved the use of the word "exchange" in the name of the Company in its letter of July 14, 1999;

NOW THEREFORE, BE IT RESOLVED, that the Certificate of Amendment of the Articles of Organization of ISE LLC under section two hundred eleven of the Limited Liability Company Law, in the form attached as EXHIBIT A hereto, changing the name of the Company to INTERNATIONAL SECURITIES EXCHANGE LLC, be, and it hereby is, adopted and approved by the Managers of ISE LLC; and

FURTHER RESOLVED, that each of the Managers be, and each hereby is, authorized and directed to execute and file with the appropriate state authorities said Certificate of Amendment of the Articles of Organization of ISE LLC, together with such changes as such Manager deems necessary or appropriate in its sole discretion, the authority of such Manager and the exercise of such discretion to be conclusively evidenced by his execution and filing of such Certificate of Amendment; and

FURTHER RESOLVED, that any and all action heretofore taken by the officers of the Company for and on behalf of the Company in the execution and filing of the Certificate of Amendment and any related transactions are hereby ratified, approved and confirmed.

IN WITNESS WHEREOF, the undersigned, being the Managers of ISE LLC, have executed this Written Consent of Managers in Lieu of Meeting as of this 29 day of July, 1999.

By: W A Porter
WILLIAM A. PORTER, Manager

By: David Krell
DAVID KRELL, Manager

INTERNATIONAL SECURITIES EXCHANGE

RULES

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Form 1 -- Exhibit A(1)
Amendments to ISE Constitution and Rules

Deletions are in brackets and additions are underlined.

CONSTITUTION, ARTICLE I, SECTION 1 – DEFINITION OF TERMS

(Paragraphs (a) through (m) unchanged)

(n) The term "Member" means a Class A, Class B or Class C Member and, unless the context indicates otherwise, shall include an individual Member or a Member Organization of the Exchange [(or a registered nominee of a Member Organization)] that is a Member in good standing.

* * *

CONSTITUTION, ARTICLE II, SECTION 2 – COMPETITIVE MARKET MAKER MEMBERS

(a) There shall be one hundred (100) Competitive Market Maker Memberships. [However, the Exchange only may approve up to fifty (50) Competitive Market Maker Members to effect Exchange Transactions until authorized by the Board to approve additional Competitive Market Maker Members to effect Exchange Transactions. The Board may authorize the approval of additional Members at such time and in such numbers as it may determine].

* * *

[CONSTITUTION, ARTICLE II, SECTION 8 – NOMINEES OF MEMBER ORGANIZATIONS]

(All text deleted. Article II, Sections 9 through 11 renumbered to Sections 8 through 10.)

ISE CONSTITUTION, ARTICLE IV, SECTION 1(A) – BOARD OF DIRECTORS; NUMBER, ELECTION AND TENURE

* * *

(4) Eight (8) Directors shall be non-industry representatives ("non-Industry Directors"), at least two (2) of whom shall be representatives of the public ("Public Directors") who are elected as provided in paragraph [(c)] <u>(d)</u> below.

* * *

Rule 300. Public Securities Business

(a) Every owner of a Membership shall have as the principal purpose of its ownership the conduct of a public securities business. Such a purpose shall be deemed to exist if and so long as:

* * *

(4) the owner is a general partner or executive officer [or nominee] of a Member Organization with such a purpose and the Membership is registered for that organization; or

* * *

Rule 301. Ownership of Memberships

(Paragraphs (a) and (b) unchanged)

[(c) With respect to each Membership owned or leased by a corporation, partnership or limited liability company ("LLC"), the organization must designate an individual nominee in accordance with Rule 306, and Article II, Section 8 of the Constitution. With respect to each Membership registered for a corporation, partnership or LLC pursuant to Article II, Section 9 of the Constitution, the Member Organization shall be represented by the individual Member who registered the Membership for the organization.]

[(d)] (c) The Exchange may determine not to permit a Member or person associated with a Member to continue as a Member or associated therewith, if the member or associated person:

* * *

Rule 303. Denial of and Conditions to Membership

(Paragraphs (a) through (f) unchanged)

(g) An applicant will be denied Membership if, together with any person who directly or indirectly controls, is controlled by, or is under common control with, approval would result in the applicant owning and/or leasing more than one (1) Primary Market Maker Membership or more than [five (5)] ten (10) Competitive Market Maker Memberships, unless this requirement is waived by the Board for good cause shown.

Rule 306. [Nominees] (Reserved)

(All text deleted)

Rule 309. Purchase of Memberships

(a) *Founders*. The Exchange's Class A and Class B [m]Memberships shall be purchased by the Founders from the Exchange at a price determined by the Exchange. The procedures of paragraph (b) below and Rule 310 shall not govern sales of Memberships involving Founders made pursuant to agreements entered into prior to the date on which the Exchange commences operation. Until the date the Exchange commences operations, the Founders may sell Memberships according to such terms and conditions that shall be agreed upon with purchasers. When a Founder sells a Membership prior to the date on which the Exchange commences operation, the purchaser shall submit an application for Membership in accordance with Rule 307 within two (2) weeks following the later of such sale or the date on which the Exchange is registered with the SEC.

Rule 310. Sale and Transfer of Memberships

(a) *Sale by Owner.* The owner of a transferable Membership who desires to sell [his] a Membership shall submit a written offer of sale to the Exchange.

* * *

(5) A Member who has filed an offer of sale shall, so long as [he] it remains in good standing and until the purchase price has been paid, continue to have all of the rights and privileges, and shall remain subject to all of the duties and obligations, of Membership.

(b) *Sale by Exchange.* Whenever one or more of the following conditions exist with respect to a Membership, the Exchange may offer the Membership for sale in accordance with paragraph (a) of this Rule:

* * *

(5) A Founder that owns a number of Memberships that exceeds the concentration limits contained in Article II, Section [11] 10 of the Constitution fails to lease or sell at least forty percent (40%) of the Memberships that exceed those limitations by [insert date six (6) years after initiation of trading on the Exchange], provided, however, that if there is more than one (1) Membership subject to sale by the Exchange under this subparagraph (5), the Exchange shall hold one or more auctions for the sale of such Memberships pursuant to the following procedures:

* * *

(Brackets in paragraph (b)(5), above, are contained in the text of the Rule and do not indicate a deletion)

Rule 311. Proceeds From Sale of Memberships

(Text of Rule unchanged)

Rule 313. Death, Retirement, Withdrawal and Resignation

Upon the death, retirement, withdrawal or resignation from a Member Organization of an individual Member whose Membership is registered for the organization[, of a nominee, or of the general partner—leaving] which leaves the organization without a Membership, [or without a nominee, or without a general partner--] the Exchange may permit the organization to continue to act as a Member in good standing for such period as the Exchange deems reasonably necessary to enable the organization to acquire a Membership[, to obtain approval of a substitute nominee, or to admit a new general partner, as applicable].

Rule 316. Transfer of Individual Membership in Trust

(Paragraph (a) unchanged)

(b) The terms of the trust shall provide the following:

* * *

(3) The trust shall provide that the Exchange shall bear no liability for any actions taken or omitted by the trust Member or any successor trustee in respect of the administration of the trust [of]or the management of trust assets.

* * *

Rule 317. Limitations on Number of Memberships

(a) *General Rule*. The Exchange generally will approve a Member to effect Exchange Transactions pursuant to only one (1) Primary Market Maker Membership [and up to five (5) Competitive Market Maker Memberships]. However, upon good cause shown, the Exchange may approve a Member to effect Exchange Transactions with respect to two (2) Primary Market Maker Memberships [and up to ten (10) Competitive Market Maker Memberships].

* * *

Rule 404. False Statements

No Member, person associated with a Member or applicant for Membership shall make any false statements or misrepresentations in any application, report or other communication to the Exchange, and no Member or person associated with a Member shall make any false statement or misrepresentation to the Clearing Corporation with respect to the reporting or clearance of any Exchange Transaction or adjust any position at the Clearing Corporation in any class of options traded on the Exchange except for the purpose of correcting a bona fide error in recording or transferring the position to another account.

Rule 406. Gratuities

No Member shall give any compensation or gratuity in any one year in excess of $50.00 to any employee of the Exchange or in excess of $100.00 to any employee of any other Member or of any non-member broker, dealer, bank or institution, without the prior consent of the employer and of the Exchange.

(Rules 406 through 417 are renumbered to Rules 407 through 418, and cross references changed where appropriate.)

Rule [411] 412. Significant Business Transactions

(Paragraphs (a) through (d) unchanged)

(e) Transactions that come within paragraph (c) of this Rule shall be reviewed according to the following procedures:

* * *

(6) The Exchange shall file notice with the SEC in accordance with the provisions of Section 19(d)(1) of the Exchange Act of all final decisions to disapprove or condition a proposed [a] SBT.

* * *

Rule [412] 413. Exemptions from Position Limits

(Paragraphs (a) and (b) unchanged)

(c) *Firm Facilitation Exemption*. To the extent that the following procedures and criteria are satisfied, a Member Organization may receive and maintain for its proprietary account an exemption ("facilitation exemption") from the applicable standard position limit in non-multiply-listed options traded on the Exchange for the purpose of facilitating, pursuant to the provisions of Rule 716[(c)](d), (i) orders for its own Public Customer (one that will have the resulting position carried with the firm) or (ii) orders received from or on behalf of a Public Customer for execution only against the [m]Member firm's proprietary account.

* * *

(6) The facilitation firm shall comply with the following provisions regarding the execution of its Public Customer Order and its own facilitating order:

(i) neither order may be contingent on a "fill-or-kill" instructions; and

(ii) the orders must be executed pursuant to Rule 716[(c)](d).

* * *

Rule 706. [Admission] Access to and Conduct on the Exchange

(a) *[Admission to Enter Orders]* *Access to Exchange.* Unless otherwise provided in the Rules, no one but a Member or a person associated with a member shall effect any Exchange Transactions.

(b) *Exchange Conduct.* Members and persons employed by or associated with any Member, while using the facilities of the Exchange, shall not engage in conduct (i) inconsistent with the maintenance of a fair and orderly market; (ii) apt to impair public confidence in the operations of the Exchange; or (iii) inconsistent with the ordinary and efficient conduct of business. [Any action taken by the Exchange hereunder shall not preclude further disciplinary action under Chapter 16 (Discipline).] Activities that may violate the provisions of this paragraph (b) include, but are not limited to, the following:

* * *

[(c) Non member joint venture participants are subject to the provisions of paragraphs (a) and (b) above.]

Rule 713. Priority of Quotes and Orders

(Paragraphs (a) through (e) unchanged)

(f) *Priority on Split Price Transactions.* If a Member purchases (sells) one (1) or more options contracts of a particular series at a particular price, [he] it shall at the next lower (higher) price at which a Non-Customer is bidding (offering), have priority over such Non-Customers in purchasing (selling) up to the equivalent number of options contracts of the same series that [he] it purchased (sold) at the higher (lower) price, but only if the purchase (sale) so effected represents the opposite side of a transaction with the same offer (bid) as the earlier purchase (sale).

Rule 716. Block Trades

(a) *Block-Size Orders.* Block-size orders are orders for fifty (50) contracts or more.

(b) For purposes of this Rule, the term "Crowd Participants" means the market makers appointed to an options class under Rule 803, as well as other Members with proprietary orders at the inside bid or offer for a particular series.

[(b)] (c) *Block Order Mechanism*. The Block Order Mechanism is a process by which an Electronic Access Member can obtain liquidity for the execution of block-size orders. [solicit indications of the prices and sizes at which market makers quoting in the options series and other Members with proprietary orders at the inside bid or offer would be willing to trade with block-size orders.]

(1) Upon the entry of an order into the Block Order Mechanism, a broadcast message will be sent to the Crowd Participants, which will be given an opportunity to respond to the broadcast message (a "Response") with indications

of the prices and sizes at which they would be willing to trade with a block-size order.

(2) At the conclusion of the time given Crowd Participants to enter Responses, either an execution will occur automatically, or the order will be cancelled.

[(1)] (i) Bids (offers) on the Exchange at the time the block order is executed that are priced higher (lower) than the block execution price, as well as [market maker bids (offers) in response the solicitation of interest] Responses that are priced higher (lower) than the block execution price, will be executed at the block execution price.

(ii) Responses, quotes and Non-Customer orders at the block execution price will participate in the execution of the block-size order according to Rule 713(e).

[(2)] (iii) Notwithstanding Rule 714(a), Public Customer block-size orders executed through [this] the Block Order [m]Mechanism will be executed without consideration of any prices that might be available on other exchanges trading the same options contract.

[(c)] (d) *Facilitation Mechanism.* The Facilitation Mechanism is a process by which [A]an Electronic Access Member can facilitate block-size Public Customer Orders. [will be assured of executing as principal a minimum portion of block-size Public Customer limit orders, after Public Customer Orders on the Exchange have been satisfied, through the Exchange's Facilitation Mechanism.] Electronic Access Members must be willing to facilitate the entire size of orders entered into the Facilitation Mechanism.

(1) [An Electronic Access Member can solicit indications of the prices and sizes at which market makers quoting in the options series and other Members with proprietary orders at the inside bid or offer would be willing to trade with block size orders.] Upon the entry of an order into the Facilitation Mechanism, a broadcast message will be sent to the Crowd Participants, which will be given an opportunity to indicate whether they want to participate in the facilitation of the Public Customer order at the facilitation price (an "Indication").

(2) [Responses to the solicitation] Indications must be priced at the price of the order to be facilitated and must not exceed the size of the order to be facilitated.

(3) [Members] Crowd Participants may indicate a willingness to facilitate an order at an improved price by entering [that receive a request for indications may enter] orders or changing[e] their quotes, as applicable, [in a manner that would improve upon the facilitation price,] but must do so [as] at least ten (10) seconds prior to the expiration of the request for indications.

[(4) After executable Public Customer Orders and superior-priced Non-Customer Orders and quotes in the System are satisfied, precedence of Non-Customer Orders and quotes, as well as any Indications will be determined

according to a procedure whereby the facilitating Electronic Access Member executes at least fifty percent (50%) of the remaining size of the order.]

(4) At the end of the period given for the entry of Indications, the facilitation order will be automatically executed in full.

(i) Bids[/offers] (offers) on the Exchange at the time the [block] facilitation order is executed that are priced [better] higher (lower) than the facilitation price will be executed at the facilitation price.

(ii) The facilitating Electronic Access Member will execute at least fifty percent (50%) of the original size of the facilitation order, but only after better-priced orders, quotes and Indications, as well as Public Customer Orders at the facilitation price are executed. Indications, quotes and Non-Customer Orders at the facilitation price will participate in the execution of the facilitation order according to Rule 713(e).

Rule 717. Limitations on Orders

(a) *Market Orders and Marketable Limit Orders.*

Electronic Access Members shall not enter into the System, as principal or agent, Non-Customer market orders. [An Electronic Access Member may not enter into the System, as principal or agent, Non-Customer limit orders that cross the market by more than two (2) minimum variations unless there is sufficient size at the best offer (bid) to satisfy the entire order.] Non-Customer limit orders that cross the market and that cannot be executed within two (2) minimum variations below the best bid or above the best offer can not be executed on the Exchange. Such limit orders will be canceled by the System.

* * *

(d) *Principal Transactions.*

Electronic Access Members may not execute as principal orders they represent as agent unless (i) agency orders are first exposed on the Exchange for at least two (2) minutes, (ii) the Electronic Access Member has been bidding or offering on the Exchange for at least two (2) minutes prior to receiving an agency order that is executable against such bid or offer, or [(ii)] (iii) the Member utilizes the Facilitation Mechanism pursuant to Rule 716[(c)](d).

* * *

Rule 803. Obligations of Market Makers

(Paragraphs (a) and (b) unchanged)

(c) *Primary Market Makers.* In addition to the obligations contained in this Rule for market makers generally, for options classes to which a market maker is the appointed Primary Market Maker, [he] it shall have the responsibility to:

(1) Assure that each disseminated market quotation in each series of options is for a minimum of ten (10) contracts, or such other minimum number as the Exchange shall set from time to time. When the best bid (offer) on the Exchange represents one or more Public Customer Orders for less than a total of ten (10) contracts at that price, the Primary Market Maker is obligated to buy (sell) at that price the number of contracts needed to make the disseminated quote firm for ten (10) contracts.

* * *

(d) *Classes of Options To Which Not Appointed*. With respect to classes of options to which a market maker is not appointed, [he] it should not engage in transactions for an account in which [he] it has an interest that are disproportionate in relation to, or in derogation of, the performance of his obligations as specified in paragraph (b) above with respect to those classes of options to which [he] it is appointed. Market makers should not:

* * *

Rule 804. Market Maker Quotations

(Paragraphs (a) through (d) unchanged)

(e) *Continuous Quotes*. A market maker must enter continuous quotations for the options classes to which [he] it is appointed pursuant to the following:

(1) Primary Market Makers. A Primary Market Maker[s] must enter continuous quotations and enter into any resulting transactions in all of the series listed on the Exchange of the options classes to which he is appointed on a daily basis.

(2) Competitive Market Makers. (i) On any given day, a Competitive Market Maker must participate in the opening rotation and make markets and enter into any resulting transactions on a continuous basis in at least sixty percent (60%) of the options classes [and all of the series of such options classes] for the Group to which the Competitive Market Maker is appointed and all the series of such options classes listed on the Exchange.

(ii) Whenever a Competitive Market Maker enters a quote or order in an options class to which [he] it is appointed, [he] it must maintain continuous quotations for all series within the same expiration month until the close of trading that day; provided, however, if such quote or order is entered in an options series during the month in which such series expires, the Competitive Market Maker must participate in the opening rotation and maintain continuous quotations for all series in that month each day through their expiration.

* * *

Rule 807. Securities Accounts and Orders of Market Makers

(a) *Identification of Accounts.* In a manner prescribed by the Exchange, each market maker shall file with the Exchange and keep current a list identifying all accounts for stock, options and related securities trading in which the market maker may, directly or indirectly, engage in trading activities or over which [he] it exercises investment direction. No market maker shall engage in stock, options or related securities trading in an account which has not been reported pursuant to this Rule.

* * *

Rule 1203. Meeting Margin Calls by Liquidation Prohibited

(Paragraph (a) unchanged)

(b) The provisions of this Rule shall not apply to any account maintained for another broker or dealer in which are carried only the commitments of customers of such other broker or dealer, exclusive of the partners, officers and directors of such other broker or dealer, provided such other broker or dealer is a Member Organization of the Exchange or has agreed in good faith with the Member Organization carrying the account that [he] it will maintain a record equivalent to that referred to in Rule 1205.

Rule 1403. Audits

(Paragraph (a) unchanged)

(b) A Member may file, in lieu of the report required in paragraph (a) of this Rule, a copy of any financial statement which [he] it is or has been required to file with any other national securities exchange or national securities association of which he is a member, or with any agency of any State as a condition of doing business in securities therein, and which is acceptable to the Exchange as containing substantially the same information as Form X-17A-5.

* * *

Rule 1406. Regulatory Cooperation

(Paragraph (a) unchanged)

(b) No Member, partner, officer, director or other person associated with a Member or other person or entity subject to the jurisdiction of the Exchange shall refuse to appear and testify before another exchange or self-regulatory organization in connection with a regulatory investigation, examination or disciplinary proceeding or refuse to furnish documentary materials or other information or otherwise impede or delay such investigation, examination or disciplinary proceeding if the Exchange requests such information or testimony in connection with an inquiry resulting from an agreement entered into by the Exchange pursuant to paragraph (a) of this Rule, including but not limited to members and affiliates of the Intermarket Surveillance

Group. The requirements of this paragraph (b) shall apply regardless whether the Exchange has itself initiated a formal investigation or disciplinary proceeding.

(c) Whenever information is requested by the Exchange pursuant to this Rule, the Member or person associated with a Member from whom the information is requested shall have the same rights and procedural protections in responding to such requests as such Member or person would have in the case of any other request for information initiated by the Exchange pursuant to Rule 1601[(d)](b).

* * *

Rule 1407. Short Sales in Nasdaq National Market Securities

This Rule provides that market maker transactions in designated Nasdaq National Market securities underlying options classes to which market makers are appointed are exempt from the NASD's restriction on short sales contained in NASD Rule 3350 (the "bid test"). NASD Rule 3350, however, only is approved on a temporary basis. Accordingly, this Rule will continue in effect only so long as the options market maker exemption from the NASD bid test remains in effect.

(a) No Member shall initiate, accept or transmit for execution, or execute a sale of a designated Nasdaq National Market security for its own account or for the account of another Member unless the sale is clearly identified as a long sale, short sale or bid test exempt sale.

(b) For purposes of this Rule, a short sale shall have the same meaning as set forth in SEC Rule 3b-3 under the Exchange Act.

(c) A short sale may be designated as a bid test exempt sale if:

(1) The sale qualifies for an exemption from the short sale bid test established in NASD rule 3350; or

(2) The short sale is by or for the account of a Primary or Competitive Market Maker and is an exempt hedge transaction in a designated Nasdaq National Market security underlying a class of stock options to which a registered ISE market maker is appointed under Rule 803.

(d) *Definitions.* For purposes of paragraph (c) of this Rule:

(1) An "exempt hedge transaction" shall mean a short sale in a designated Nasdaq National Market security that was effected to hedge, and in fact serves to hedge, an existing offsetting options position or an offsetting options position that was created in one or more transactions contemporaneous with the short sale, provided that, in the case of a stock option, when establishing the short position the market maker receives or is eligible to receive good faith margin pursuant to Section 220.12 of Regulation T of the Federal Reserve Board for that transaction.

(2) Transactions will be considered to be "contemporaneous" if they occur simultaneously or within the same brief period of time. A transaction unrelated to normal options market making activity that is independent of a

market maker's market making functions will not be considered an "exempt hedge transaction."

(3) A "designated Nasdaq National Market security" shall mean a Nasdaq National Market security which qualifies for the exemption provided in this Rule.

(e) The Exchange may withdraw, suspend or modify a market maker's eligibility for an exemption from the NASD's bid test as the result of a disciplinary action.

(f) Short sales of a security of a company involved in a publicly announced merger or acquisition by or for the account of a market maker will be deemed to be an exempt hedge transaction qualifying for designation as bid test exempt if the short sale was made to hedge existing or prospective positions (based on communicated indications of interest) in options on a security of another company involved in the merger or acquisition, where the options positions are or will be in a class of options to which the market maker is appointed under Rule 803, and were or will be established in the course of bona fide market making activity.

(g) It will not be deemed a violation of this Rule when a Member designates a sale for an account in which the Member has no interest as a long sale where the Member does not know or have reason to know that the beneficial owner of the account has, or as a result of such sale would have, a short position in the security, or where a Member designates such a sale as a bid test exempt sale where the Member does not know or have reason to know that the criteria for designating such sale as bid test exempt are not satisfied.

(h) If a Member initiates, accepts, transmits for execution or executes a short sale of a designated Nasdaq National Market security without clearly and properly identifying it as required by paragraph (a) above, or if a Member designates a short sale as a bid test exempt sale under paragraph (c) but fails to satisfy all of the conditions to such designation, or even if all such conditions are satisfied, if the sale is made for the purpose of disrupting or manipulating the market in the security that is the subject of the sale or a related option, such sale may constitution a violation of Rules 400 (Just and Equitable Principles of Trade), 405 (Manipulation) and 804(a) (Obligations of Market Makers), as well as this Rule.

RULE 1600. DISCIPLINARY JURISDICTION

(Paragraph (a) unchanged)

(b) An individual Member[, nominee] or other person associated with a Member Organization may be charged with any violation committed by employees under his supervision or by the Member Organization with which he is associated, as though such violation were his own. A Member Organization may be charged with any violation committed by its employees or by a Member or other person who is associated with such Member Organization, as though such violation were its own.

* * *

RULE 1601. [COMPLAINT AND] INVESTIGATION

(Paragraphs (a) and (b) unchanged)

[(c) *Report.* In every instance where an investigation results in a finding that there are reasonable grounds to believe that a violation has been committed, the Exchange staff shall submit a written report of its investigation to the Business Conduct Committee.]

[(d) *Notice, Statement and Access.* Prior to submitting its report, the staff shall notify the person(s) who is the subject of the report (the "Subject") of the general nature of the allegations and of the specific provisions of the Exchange Act, rules and regulations promulgated thereunder, or provisions of the Constitution or Rules of the Exchange or any interpretation thereof or any resolution of the Board regulating the conduct of business on the Exchange, that appear to have been violated. Except when the Committee determines that expeditious action is required, a Subject shall have fifteen (15) days from the date of the notification described above to submit a written statement to the Committee concerning why no disciplinary action should be taken. To assist a Subject in preparing such a written statement, he shall have access to any documents and other materials in the investigative file of the Exchange that were furnished by him or his agents.]

RULE 1602. EXPEDITED PROCEEDING

[Upon receipt of the notification required by Rule 1601(d), a Subject may seek to dispose of a matter] In lieu of the procedures set forth in Rules 1603 through 1605 (Charges, Answer and Hearing), a matter may be disposed of through a letter of consent [signed by the Subject].

[(a) If a Subject desires to attempt to dispose of the matter through a letter of consent, the Subject must submit a written notice electing to proceed in an expedited manner pursuant to this Rule within fifteen (15) days from the date of the notification required by Rule 1601(d).]

[(b) The Subject must then endeavor to reach agreement with the staff upon a letter of consent that is acceptable to the staff and which sets forth a stipulation of facts and findings concerning the Subject's conduct, the violation(s) committed by the Subject and the sanction(s) therefor.]

[(c) The] (a) A matter can only be disposed of through a letter of consent if the Regulatory Division staff and the person(s) who is the subject of the investigation (the "Subject") are able to agree upon terms of a letter of consent that are acceptable to the staff and the letter is signed by the Subject. Such letter shall set forth a stipulation of facts and findings concerning the Member's conduct, the violation(s) committed by the Member and the sanction(s) therefor.

[(d) At any point in the negotiations regarding a letter of consent, the staff may deliver to the Subject or the Subject may deliver to the staff a written declaration of an end to the negotiations. On delivery of such a declaration the Subject will then have

fifteen (15) days to submit a written statement pursuant to Rule 1601(d) and thereafter the staff may bring the matter to the Business Conduct Committee for appropriate action.]

[(e)] (b) In the event that the Subject and the Regulatory Division staff are able to agree upon a letter of consent, the staff shall submit the letter to the Business Conduct Committee. If the letter of consent is accepted by the Business Conduct Committee, it may adopt the letter as its decision and shall take no further action against the Subject respecting the matters that are the subject of the letter. If the letter of consent is rejected by the Business Conduct Committee, the matter shall proceed as though the letter had not been submitted. The Business Conduct Committee's decision to accept or reject a letter of consent shall be final, and a Subject may not seek review thereof.

(c) In the event that the Subject and the Regulatory Division staff are unable to agree upon a letter of consent, the staff may institute an action according to the procedures contained in Rule 1603.

Rule 1603. Charges

[(a) *Determination Not to Initiate Charges.* Whenever it shall appear to the Business Conduct Committee from the report of the staff of the Exchange that no probable cause exists for finding a violation within the disciplinary jurisdiction of the Exchange, or whenever the Committee otherwise determines that no further action is warranted, it shall issue a written statement to that effect setting forth its reasons for such finding, which shall be sent to the Subject and the Complainant, if any.]

[(b)*Initial*] *(a) Initiation of Charges.* Whenever it shall appear [to the Business Conduct Committee from the report of the staff of the Exchange] that there is probable cause for finding a violation within the disciplinary jurisdiction of the Exchange and that further proceedings are warranted, the [Business Conduct Committee shall direct the staff of the Exchange] Regulatory Division shall prepare a statement of charges against the [person or organization] Member or associated person alleged to have committed a violation (the "Respondent") specifying the acts in which the Respondent is charged to have engaged and setting forth the specific provisions of the Exchange Act, rules and regulations promulgated thereunder, provisions of the Constitution or Rules of the Exchange, or interpretations or resolutions of which such acts are in violation. A copy of the charges shall be served upon the Respondent in accordance with Rule 1611. The Complainant, if any, shall be notified if further proceedings are warranted.

[(c)] (b) *Access to Documents.* Provided that a Respondent has made a written request for access to documents described hereunder with sixty (60) calendar days after a statement of charges has been served upon the Respondent in accordance with Rule 1611, the Respondent shall have access to all documents concerning the case that are in the investigative file of the Exchange except for staff investigation and examination reports and materials prepared by the staff in connection with such reports or in anticipation of a disciplinary hearing. In providing such documents, the staff may protect the identity of a Complainant.

[(d) *Ex Parte Communication.* No Member or person associated with a Member shall make or knowingly cause to be made an ex parte communication with any member of the Business Conduct Committee concerning the merits of any matter pending under this Chapter. No member of the Business Conduct Committee shall make or knowingly cause to be made an ex parte communication with any Member or any person associated with a Member concerning the merits of any matter pending under this Chapter.

(1) "Ex parte communication" means an oral or written communication made without notice to all parties, that is, regulatory staff and Subjects of investigations or Respondents in proceedings.

(2) A written communication is ex parte unless a copy has been previously or simultaneously delivered to all interested parties. An oral communication is ex parte unless it is made in the presence of all interested parties except those who, on adequate prior notice, declined to be present.]

(Paragraph (d), above, moved to Rule 1605(e).)

Rule 1605. Hearing

(a) *Participants*. Subject to Rule 1606 of this Chapter concerning summary proceedings, a hearing on the charges shall be held before one or more members of the Business Conduct Committee [(the "Panel")] or other persons designated by the Exchange (the "Panel"). The Exchange and the Respondent shall be the parties to the hearing. Where a Member Organization is a party, it shall be represented by one of its Members [(including nominees)] at the hearing.

* * *

(e) *Ex Parte Communication.* No Member or person associated with a Member shall make or knowingly cause to be made an ex parte communication with any member of the Business Conduct Committee concerning the merits of any matter pending under this Chapter. No member of the Business Conduct Committee shall make or knowingly cause to be made an ex parte communication with any Member or any person associated with a Member concerning the merits of any matter pending under this Chapter.

(1) "Ex parte communication" means an oral or written communication made without notice to all parties, that is, regulatory staff and Subjects of investigations or Respondents in proceedings.

(2) A written communication is ex parte unless a copy has been previously or simultaneously delivered to all interested parties. An oral communication is ex parte unless it is made in the presence of all interested parties except those who, on adequate prior notice, declined to be present.

Rule 1606. Summary Proceedings

Notwithstanding the provision of Rule 1605 of this Chapter, [the Business Conduct Committee] a Panel may make a determination without a hearing and may impose a penalty as to violations that the Respondent has admitted or has failed to answer or that otherwise do not appear to be in dispute.

(a) Notice of such summary determination, specifying the violations and penalty, shall be served upon the Respondent, who shall have ten (10) days from the date of service to notify the [Business Conduct Committee] Panel that he desires a hearing upon all or a portion of any charges not previously admitted or upon the penalty. Failure to so notify the [Business Conduct Committee] Panel shall constitute admission of the violations and acceptance of the penalty as determined by the [Business Conduct Committee] Panel and a waiver of all rights of review.

(b) If the Respondent requests a hearing, the matters that are the subject of the hearing shall be handled as if the summary determination had not been made.

Rule 1607. Offers of Settlement

(a) *Submission of Offer.* At any time during a period not to exceed 120 calendar days immediately following the date of service of a statement of charges upon the Respondent in accordance with Rule 1611, the Respondent may submit to [the Business Conduct Committee] a Panel a written offer of settlement, signed by him, which shall contain a proposed stipulation of facts and shall consent to a specified sanction.

(1) Where the [Business Conduct Committee] Panel accepts an offer of settlement, it shall issue a decision, including findings and conclusions and imposing a sanction, consistent with the terms of such offer.

(2) Where the [Business Conduct Committee] Panel rejects an offer of settlement, it shall notify the Respondent and the matter shall proceed as if such offer had not been made, and the offer and all documents relating thereto shall not become a part of the record.

(3) A decision of the [Business Conduct Committee] Panel issued upon acceptance of an offer of settlement, as well as the determination of the [Committee] Panel whether to accept or reject such an offer, shall be final, and the Respondent may not seek review thereof.

(4) A Respondent shall be entitled to submit to the [Business Conduct Committee] Panel a maximum of two (2) written offers of settlement in connection with the statement of charges issued to that Respondent pursuant to Rule 1603(b), unless the [Business Conduct Committee] Panel, in its discretion, permits a Respondent to submit additional offers of settlement.

(5) The 120-day period specified in section (a) shall be tolled during the number of days in excess of seven (7) calendar days that it takes staff of the Exchange to provide access in response to a Respondent's request for access to documents provided that the request for access is made pursuant to the provisions and within the time frame provided in Rule 1603(c).

(6) Subject to Rule 1606, following the end of the 120-day period or after the [Business Conduct Committee] Panel's rejection of a Respondent's second offer of settlement, a hearing will be scheduled and the hearing will proceed in accordance with the provisions of Rule 1605.

(b) *Submission of Statement.* A Respondent may submit with an offer of settlement a written statement in support of the offer. In addition, if the staff will not recommend acceptance of an offer of settlement before the [Business Conduct Committee] Panel a Respondent shall be notified and may appear before the Committee to make an oral statement in support of his offer. Finally, if the [Business Conduct Committee] Panel rejects an offer that the staff supports, a Respondent may appear before that [Committee] Panel to make an oral statement concerning why he believes the [Committee] Panel should change its decision and accept his offer. A Respondent must make a request for such an appearance within five (5) days of his being notified that his offer was rejected or that staff will not recommend acceptance.

Rule 1609. Review

(Paragraphs (a) through (d) unchanged)

[(e) Review of Decision Not to Initiate Charges. Upon application made by the President within thirty (30) days of a decision made pursuant to Rule 1603(a), the Board may order review of such decision.]

RULE 1614. IMPOSITION OF FINES FOR MINOR RULE VIOLATIONS

(a) *General*. In lieu of commencing a disciplinary proceeding pursuant to Exchange Rule 1601, the Exchange may, subject to the requirements set forth herein, impose a fine, not to exceed $5,000, on any Member, Member Organization, or person associated with or employed by a Member or Member Organization, with respect to any Rule violation listed in section (g) of this Rule. Any fine imposed pursuant to this Rule that (i) does not exceed $2,500 and (ii) is not contested, shall be reported on a periodic basis, except as may otherwise be required by Rule 19d-1 under the Exchange Act or by any other regulatory authority. The Exchange is not required to impose a fine pursuant to this Rule with respect to the violation of any Rule included [in] herein, and the Exchange may, whenever it determines that any violation is not minor in nature, proceed under Exchange Rule 1601, rather than under this Rule.

* * *

RULE 1615. CONTRACTING [RESPONSIBILITIES] DISCIPLINARY FUNCTIONS

(Text of Rule unchanged)

RULE 1706. CONTRACTING [RESPONSIBILITIES] HEARING AND REVIEW FUNCTIONS

(Text of Rule unchanged)

RULE 1835. CONTRACTING [RESPONSIBILITIES] ARBITRATION FUNCTIONS

(Text of Rule unchanged)

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INDEPENDENT AUDITORS' REPORT

To the Members of ISE LLC:

We have audited the accompanying balance sheets of ISE LLC (the "Company") (a development stage company) as of December 31, 1998 and 1997, and the related statements of operations and cash flows for the year ended December 31, 1998, the period from September 29, 1997 (inception date) to December 31, 1997, and the period from September 29, 1997 (inception date) to December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 1998 and 1997, and the results of its operations and its cash flows for the year ended December 31, 1998, the period from September 29, 1997 (inception date) to December 31, 1997, and the period from September 29, 1997 (inception date) to December 31, 1998, in conformity with generally accepted accounting principles.

The Company is in the development stage as of December 31, 1998. As discussed in Note 1 to the financial statements, successful completion of the Company's development program and, ultimately, the attainment of profitable operations is dependent upon future events, including maintaining adequate financing to fulfill its development activities, obtaining regulatory approval, and achieving a level of revenues adequate to support the Company's cost structure.

Deloitte + Touche LLP

January 22, 1999

Deloitte Touche Tohmatsu

ISE LLC
(A Development Stage Company)

BALANCE SHEETS
DECEMBER 31, 1998 AND 1997

	1998	1997
ASSETS		
CASH AND CASH EQUIVALENTS	$ 8,519,836	$ 76,000
PREPAID EXPENSES	7,823	
FURNITURE AND EQUIPMENT (net of accumulated depreciation of $21,979 in 1998 and $5,321 in 1997)	61,518	30,243
TOTAL ASSETS	$ 8,589,177	$ 106,243
LIABILITIES AND MEMBERS' CAPITAL		
LIABILITIES:		
Accrued liabilities	$ 157,005	
Amount due to member	33,906	$ 507,775
Total liabilities	190,911	507,775
MEMBERS' CAPITAL:		
10 Class A memberships, 50 Class B memberships and an unlimited number of Class C memberships authorized; 10 Class A memberships and 50 Class B memberships outstanding on December 31, 1998 and 13 Class B memberships outstanding on December 31, 1997		
Balance at beginning of period	(401,532)	
Net loss for the period	(2,200,202)	(726,532)
Sale of memberships	30,450,000	325,000
Membership subscription receivable	(19,450,000)	
Balance at end of period	8,398,266	(401,532)
TOTAL LIABILITIES AND MEMBERS' CAPITAL	$ 8,589,177	$ 106,243

See notes to financial statements.

ISE LLC
(A Development Stage Company)

STATEMENTS OF OPERATIONS
YEAR ENDED DECEMBER 31, 1998 AND PERIOD FROM SEPTEMBER 29, 1997 (INCEPTION DATE) TO DECEMBER 31, 1997

	1998	1997	September 29, 1997 (Inception) through December 31, 1998
REVENUE:			
Interest income	$ 197,390	$ -	$ 197,390
EXPENSES:			
System development costs	690,343		690,343
Salaries, benefits and taxes	584,589	316,908	901,497
Legal fees	338,192	247,282	585,474
Travel and entertainment	263,272	86,967	350,239
Rent and office expense	202,286	28,644	230,930
Professional services	238,401	27,250	265,651
Depreciation	16,658	5,321	21,979
Interest expense	31,148	12,660	43,808
Other	32,703	1,500	34,203
Total expenses	2,397,592	726,532	3,124,124
NET LOSS	$(2,200,202)	$(726,532)	$(2,926,734)

See notes to financial statements.

ISE LLC
(A Development Stage Company)

STATEMENTS OF CASH FLOWS
YEAR ENDED DECEMBER 31, 1998 AND PERIOD FROM SEPTEMBER 29, 1997 (INCEPTION DATE) TO DECEMBER 31, 1997

	1998	1997	September 29, 1997 (Inception) through December 31, 1998
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	$ (2,200,202)	$ (726,532)	$ (2,926,734)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	16,658	5,321	21,979
Changes in assets and liabilities:			
Prepaid expenses	(7,823)		(7,823)
Amount due to member	(473,869)	507,775	33,906
Accrued liabilities	157,005		157,005
Net cash used in operating activities	(2,508,231)	(213,436)	(2,721,667)
CASH FLOWS FROM INVESTING ACTIVITY - Purchase of furniture and equipment	(47,933)	(35,564)	(83,497)
CASH FLOWS FROM FINANCING ACTIVITY - Proceeds from sale of memberships	11,000,000	325,000	11,325,000
NET INCREASE IN CASH AND CASH EQUIVALENTS	8,443,836	76,000	8,519,836
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	76,000	-	-
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 8,519,836	$ 76,000	$ 8,519,836
SUPPLEMENTAL CASH FLOW INFORMATION:			
Interest paid	$ 31,148	$ 12,660	$ 43,808
Memberships issued for membership subscription receivable	$19,450,000		$19,450,000

See notes to financial statements.

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

General - ISE LLC (the "Company"), a development stage company, was organized on September 29, 1997 under New York Limited Liability Company Law. The Company was formed to develop and ultimately conduct the operations of the International Securities Exchange, a fully electronic options exchange. Since inception, substantially all of the resources of the Company have been devoted to the development of the exchange and to establish the infrastructure that would permit the operation of the exchange.

Basis of Presentation - The financial statements of the Company have been prepared in conformity with Statement of Financial Accounting Standards No. 7, *Accounting and Reporting by Development Stage Enterprises*. As a development stage company with no commercial operating history, the Company is subject to all of the risks and expenses inherent in the establishment of a new business enterprise. To address these risks and expenses, the Company must, among other things, respond to competitive developments, attract, retain and motivate qualified personnel and support the expense of marketing new services based upon innovative technology. In addition, the Company must receive regulatory approval. To date, the Company has not recognized any operating revenues and does not expect to recognize any revenues until the first half of 2000. As a result of incurring expenses in these development activities without generating revenues, the Company has incurred significant losses and negative cash flow from operating activities, and as of December 31, 1998, the Company had accumulated net losses of $2,926,734. The Company expects to incur substantial losses and substantial negative cash flow from operating activities in the foreseeable future. There can be no assurance, however, that the Company will be able to achieve revenues in excess of such expenses.

Cash Equivalents - The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

Furniture and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the asset.

Income Taxes - The Company is not subject to federal and state income tax as the net income (loss) is passed through to the members. Each member's share of net income (loss) is included on his/her tax returns in accordance with the Internal Revenue Code.

Use of Estimates - The preparation of the Company's financial statements in conformity with generally accepted accounting principles necessarily requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the balance sheet dates and the reported amounts of revenues and expenses for the periods presented. Actual results could differ from those estimates.

2. OPERATING AGREEMENT

The amended and restated Operating Agreement (the "Agreement") dated August 1, 1998 sets forth the respective rights and obligations of members of the Company and provides for terms of its management and conduct of its affairs as summarized below:

Term - The Company's stated termination date is December 31, 2098.

Capital Contributions - Initially, the Company is authorized to accept capital contributions for 10 Class A Membership Units for Primary Market Makers, 50 Class B Membership Units for Market Makers and an unlimited number of Class C Membership Units for broker/dealers who will be Electronic Access Members.

Capital Accounts - The Company must establish capital accounts for each Class A and each Class B Member. No capital account may be established for Class C Members. The Board may, in its discretion, adjust the capital accounts to reflect a revaluation of the Company's assets in accordance with the Agreement.

Allocation of Net Income (Loss) - In accordance with the Agreement, net income and losses are allocated among the Class A Members and Class B Members in proportion to their respective capital interests. Class C Members may not be allocated any portion of net income and losses.

Distributions - Each Class A Member and Class B Member is entitled to receive distributions in proportion to their respective capital interests provided that mandatory distributions are made, to the extent of cash available, to each Class A Member and Class B Member sufficient to allow them to pay federal, state and local income taxes on the income of the Company deemed to be taxable to the members.

3. MEMBERSHIP SUBSCRIPTION RECEIVABLE

On August 1, 1998, Adirondack Trading Partners, LLC ("ATP") entered into an agreement with the Company to purchase 10 Class A Membership Units and 37 Class B Membership Units for $30,450,000. The purchase price is payable in two installments. As of December 31, 1998, ATP made payments of $11,000,000. The remaining amount payable of $19,450,000 is due on August 1, 1999.

4. RELATED PARTY TRANSACTIONS

During the period September 29, 1997 (inception date) to December 31, 1997, a member advanced the Company $507,775. During the year ended December 31, 1998, $473,869 was repaid.

Additionally, the Company entered into an agreement with a member of ATP, whereby the member will provide technology in the development of the Company's systems. In exchange for such technology, the Company will pay the member a fee based on the volume of future contracts transacted per day for a minimum period of eight years.

5. COMMITMENTS

Operating Leases - The Company leases office space under a noncancelable operating lease which extends to 2009. Minimum annual rental for such lease is as follows:

1999	$ 229,884
2000	689,655
2001	689,655
2002	689,655
2003	689,655
Thereafter	4,207,896
Total	$7,196,400

6. SUBSEQUENT EVENT

On January 1, 1999, the Company approved the Second Amended and Restated Operating Agreement whereby the Class B Membership Units were split 2 for 1.

* * * * * *

Deloitte & Touche

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INDEPENDENT AUDITORS' REPORT

To the Members of Adirondack Trading Partners LLC:

We have audited the accompanying consolidated balance sheet of Adirondack Trading Partners LLC (the "Company") as of December 31, 1998, and the related consolidated statements of operations, changes in members' capital and cash flows for the period January 27, 1998 (inception date) to December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 1998, and the results of its operations and its cash flows for the period January 27, 1998 (inception date) to December 31, 1998, in conformity with generally accepted accounting principles.

Deloitte & Touche LLP

January 22, 1999

Deloitte Touche

ADIRONDACK TRADING PARTNERS LLC

CONSOLIDATED BALANCE SHEET
DECEMBER 31, 1998

ASSETS	
Cash and cash equivalents	$23,973,786
Prepaid expense	65,292
Total current assets	24,039,078
FURNITURE AND EQUIPMENT (net of accumulated depreciation of $27,795)	103,686
OTHER ASSETS (net of accumulated amortization of $73,614)	327,918
TOTAL ASSETS	$24,470,682
LIABILITIES AND MEMBERS' CAPITAL	
LIABILITIES:	
Accounts payable and accrued liabilities	$ 208,960
Amount due to member	33,906
Total liabilities	242,866
MEMBERS' CAPITAL	24,227,816
TOTAL LIABILITIES AND MEMBERS' CAPITAL	$24,470,682

See notes to consolidated financial statements.

ADIRONDACK TRADING PARTNERS LLC

CONSOLIDATED STATEMENT OF OPERATIONS
PERIOD JANUARY 27, 1998 (INCEPTION DATE) TO DECEMBER 31, 1998

REVENUE:	
Interest income	$ 357,016
EXPENSES:	
Salaries, benefits and taxes	1,060,008
System development	690,343
Legal fees	503,859
Travel and entertainment	451,556
Consultants fees	345,502
Rent and office	247,922
Interest	36,611
Depreciation and amortization	96,088
Other	46,281
Total expenses	3,478,170
NET LOSS	$(3,121,154)

See notes to consolidated financial statements.

ADIRONDACK TRADING PARTNERS LLC

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' CAPITAL
PERIOD JANUARY 27, 1998 (INCEPTION DATE) TO DECEMBER 31, 1998

BALANCE, JANUARY 27, 1998 (INCEPTION DATE)	$ -
ISSUANCE OF PREFERRED CAPITAL	27,250,000
ISSUANCE OF COMMON CAPITAL	98,970
NET LOSS	(3,121,154)
BALANCE, DECEMBER 31, 1998	$24,227,816

See notes to consolidated financial statements.

ADIRONDACK TRADING PARTNERS LLC

CONSOLIDATED STATEMENT OF CASH FLOWS
PERIOD JANUARY 27, 1998 (INCEPTION DATE) TO DECEMBER 31, 1998

CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	$ (3,121,154)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	96,088
Change in liabilities:	
Accounts payable and accrued liabilities	208,960
Prepaid expense	(65,292)
Other assets	(401,532)
Net cash used in operating activities	(3,282,930)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchase of furniture and equipment	(90,596)
Other	(1,658)
Net cash used in investing activities	(92,254)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from issuance of preferred capital	27,250,000
Proceeds from issuance of common capital	98,970
Net cash provided by financing activities	27,348,970
NET INCREASE IN CASH AND CASH EQUIVALENTS	23,973,786
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	-
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$23,973,786
SUPPLEMENTAL CASH FLOW INFORMATION:	
Interest paid	$ 36,611

See notes to consolidated financial statements.

ADIRONDACK TRADING PARTNERS LLC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
PERIOD JANUARY 27, 1998 (INCEPTION DATE) TO DECEMBER 31, 1998

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Adirondack Trading Partners LLC ("ATP") was organized on January 27, 1998 under New York Limited Liability Company Law. ATP was organized to finance the development of the International Securities Exchange LLC ("ISE"), an electronics options exchange, and became an options market maker on this new exchange.

Principles of Consolidation - The consolidated financial statements include the accounts of ATP and its majority owned limited liability company, ISE (collectively, the "Company"). All intercompany balances and transactions have been eliminated.

ISE is a development stage company with no commercial operating history. Accordingly, ISE is subject to all of the risks and expenses inherent in the establishment of a new business enterprise. To address these risks and expenses, ISE must, among other things, respond to competitive developments, attract, retain and motivate qualified personnel and support the expense of marketing new services based upon innovative technology. In addition, ISE must receive regulatory approval. To date, ISE has not recognized any operating revenues and does not expect to recognize any revenues until the first half of 2000. As a result of incurring expenses in these development activities without generating revenues, ISE has incurred significant losses and negative cash flow from operating activities. ISE expects to incur substantial losses and substantial negative cash flow from operating activities in the foreseeable future. There can be no assurance, however, that ISE will be able to achieve revenues in excess of such expenses.

Cash Equivalents - The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

Furniture and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets.

Income Taxes - The Company is not subject to federal and state income tax as the net income (loss) is passed through to the members. Each member's share of net income (loss) is included on his/her tax returns in accordance with the Internal Revenue Code.

Use of Estimates - The preparation of the Company's financial statements in conformity with generally accepted accounting principles necessarily requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the balance sheet dates and the reported amounts of income and expenses for the periods presented. Actual results could differ from those estimates.

2. OPERATING AGREEMENT

The amended and restated Operating Agreement dated October 1, 1998 sets forth the respective rights and obligations of members of the Company and provides for terms of its management and conduct of its affairs as summarized below:

Term - The Company's stated termination date is December 31, 2098.

Preferred A Units - The Company is authorized to issue 5 Preferred A Units for $1,000,000 per unit. As of December 31, 1998, 5 Preferred A Units were issued and outstanding.

Preferred B Units - The Company is authorized to issue 25 Preferred B Units. As of December 31, 1998, 22.25 Preferred B Units were issued and outstanding.

Preferred C Units - The Company is authorized to issue 35 Preferred C Units provided that the aggregate number of outstanding Preferred B and C units do not exceed 50 units. As of December 31, 1998, there were no Preferred C Units issued and outstanding.

Common Units - The Company is authorized to issue 1,390,000 Common Units. As of December 31, 1998, 989,700 Common Units were issued and outstanding.

Capital Accounts - The Company must establish capital accounts for each member holding Preferred A, B and C Units. The Board may, in its discretion, adjust the capital accounts to reflect a revaluation of the Company's assets in accordance with the Agreement.

Allocation of Net Income (Loss) - In accordance with the Agreement, net income and losses are allocated among the holders of Preferred A Units, Preferred B Units and Common Units in proportion to their respective capital interests.

Distributions - Members are entitled to receive distributions in proportion to their ownership of units, to the extent of cash available, to allow them to pay federal, state and local income taxes on the income of the Company deemed to be taxable to the members.

3. INVESTMENT IN ISE LLC

On August 1, 1998, ATP entered into an agreement with ISE to purchase 10 Class A Membership Units and 37 Class B Membership Units in ISE for $30,450,000. The purchase price is payable in two installments. As of December 31, 1998, ATP made payments of $11,000,000. The remaining amount payable of $19,450,000 is due on August 1, 1999. On January 1, 1999, ISE approved a 2 for 1 split of the Class B Membership Units.

4. RELATED PARTY TRANSACTION

ISE entered into an agreement with a member of ATP, whereby the member will provide technology in the development of ISE's systems. In exchange for such technology, ISE will pay the member a fee based on the volume of future contracts transacted per day for a minimum period of eight years.

5. COMMITMENTS

Operating Lease - ISE leases office space under a noncancelable operating lease which extends to 2009. Minimum annual rentals for such lease is as follows:

1999	$ 229,884
2000	689,655
2001	689,655
2002	689,655
2003	689,655
Thereafter	4,207,896
Total	$7,196,400

Amendment to Exhibit G

ADDITIONAL ISE OFFICERS

Daniel P. Friel:	Senior Vice President, Chief Information Officer beginning February 1999.
Bruce Cooperman:	Senior Vice President, Chief Financial Officer beginning February 1999.
Katherine Simmons:	Vice President and Associate General Counsel beginning February 1999.
Paul J. Bennett:	Vice President, Project Director, Technology beginning April 1999.
Gregory J. Maynard:	Vice President Member Services, Technology beginning April 1999.
Lawrence P. Campbell:	Vice President Technical Services beginning May 1999.
Jerome Mangano:	Vice President Computer/Market Operations beginning May 1999.

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Officers & Management

- William A. Porter, Chairman
- David Krell, President & CEO
- Gary Katz, Senior Vice President, Marketing & Business Development
- Michael J. Simon, Senior Vice President, Chief Regulatory Officer and General Counsel
- Daniel P. Friel, Senior Vice President, Chief Information Officer
- Bruce Cooperman, Senior Vice President, Chief Financial Officer
- Paul J. Bennett, Vice President Project Director, Technology
- Lawrence P. Campbell, Vice President Technical Services
- Jerome Mangano, Vice President Computer/Market Operations
- Gregory J. Maynard, Vice President Member Services, Technology
- Richard T. Pombonyo, Vice President, Marketing
- Katherine Simmons, Vice President & Associate General Counsel

William A. Porter, Chairman

Bill Porter is a founder and the first Chairman of ISE. His career is marked by significant innovation, having conceived and developed several new technology based businesses. Mr. Porter is chairman emeritus of E*TRADE, the very first real-time on-line electronic brokerage service, which he established in 1992 and has since led the industry in bringing unmatched efficiencies and cost-savings to the investing public. Beginning in 1980, Mr. Porter conceived and implemented several new financial services, including the first on-line financial management service bureau. Mr. Porter has held numerous senior management positions, including Chairman of Trelleborg Rubber Company; President of Tretorn Shoes; President of Commercial Electronics Incorporated as well as several senior level positions in the science and technology arena. Mr. Porter holds 14 patents, having developed a number of electronic devices and processes. These include the first shoulder mounted back pack broadcast color TV camera; the first electronic diesel-electric locomotive check-out system; the first infrared horizon sensor for satellite stabilization and several other breakthroughs still in use today in a variety of fields. Mr. Porter

has an M.S. in Management from MIT, where he was a Sloan Fellow, an M.S. in Physics from Kansas State College and a B.A. in Mathematics from Adams State College.

David Krell, President & CEO
David Krell is a founder and President & CEO of ISE. From 1997 to 1998, he was Chairman and co-founder of K-Squared Research, LLC, a financial services consulting firm. From 1984 to 1997, Mr. Krell was Vice President, Options and Index Products, of the New York Stock Exchange where he managed marketing, systems and new product introductions for the division. From 1981 to 1984, Mr. Krell was First Vice President at the Chicago Board Options Exchange, responsible for the management and operation of the Marketing and Sales Division. Mr. Krell was also a Vice President of Merrill Lynch from 1978 to 1981 and founded its Managed Options Service. Active in numerous industry groups, Mr. Krell is a Director on the Board of the International Federation of Technical Analysts, a former president of the Market Technicians Association and a past Director on the Board of The Options Clearing Corporation. As well, Mr. Krell is an Adjunct Professor at Rutgers University Graduate School of Management and at the Graduate School of Baruch College. He has also taught, coordinated and directed numerous seminars and workshops at the New York Institute of Finance. Mr. Krell holds an M.B.A. from Bernard Baruch College and a B.A. from Queens College.

Gary Katz, Senior Vice President,
Marketing & Business Development
Gary Katz is a founder and SVP, Marketing and Business Development of ISE. From 1997 to 1998, he was President and co-founder of K-Squared Research, LLC, a financial services consulting firm. From 1986 to 1997, Mr. Katz was Managing Director, Options and Index Products, at the New York Stock Exchange. There he managed the research and development of new options products and spearheaded a major marketing program for the promotion of NYSE options products. Mr. Katz is a co-founder of The Options Industry Council, a trade group dedicated to promoting the equity options sector through the education of the investing public. Prior to 1986, Mr. Katz was an actuary with the Equitable Life Assurance Company and is an Associate of the Society of Actuaries. Mr. Katz is an Adjunct Professor of Statistics at the Stern School of Business, New York University, where he conducts classes in business mathematics applications and also teaches classes in options strategies and pricing at the New York Institute of Finance. Mr. Katz has an M.S. in Statistics with Distinction from New York University and a B.A. from Queens College.

Michael J. Simon, Senior Vice President,

Chief Regulatory Officer and General Counsel
Michael Simon is SVP, Chief Regulatory Officer and General Counsel of ISE. From 1993 to 1998, Mr. Simon has been "Of Counsel" to Milbank, Tweed, Hadley & McCloy. He had previously been Senior Attorney and an Associate with the firm since 1988. Mr. Simon has practiced in the firm's Corporate and Banking Department where for the last six years he had primary responsibility for representation of the New York Stock Exchange, focusing on corporate listings, market structure and regulation. From 1986 to 1988, Mr. Simon was Vice President and Associate General Counsel of the National Securities Clearing Corporation, where he handled general corporate and regulatory matters. There, he also worked on international clearance and settlement and on the development of the first clearance and settlement facility for government securities. From 1978 to 1986, Mr. Simon was with the U.S. Securities and Exchange Commission where he was Assistant Director for Over-the-Counter Market Regulation and Structure. Mr. Simon is a graduate of the University of Pittsburgh School of Law and the University of Rochester, and is a member of the American Bar Association.

Daniel P. Friel, Senior Vice President,
Chief Information Officer
Daniel Friel is Senior Vice President, Chief Information Officer of ISE. From 1977 to 1999, he was with Securities Industry Automation Corporation (SIAC), a jointly owned subsidiary of the New York Stock Exchange (NYSE) and American Stock Exchange (Amex). From 1994 to 1999, he was vice president of Amex Computer Operations, managing a 24 hour dual-site operation. His responsibilities included quality assurance testing, communications, trading floor support and systems programming related to SIAC's work for Amex. Prior to 1994, Mr. Friel held several management positions at SIAC, implementing numerous innovations that remain an integral part of SIAC's services to the equities and options markets. A graduate of Cathedral College of the Immaculate Conception, Mr. Friel holds a B.A. degree in psychology.

Bruce Cooperman, Senior Vice President
Chief Financial Officer
Bruce Cooperman is Senior Vice President, Chief Financial Officer of ISE. From 1997 to 1999, he was Senior Vice President at the Board of Trade of the City of New York (NYBOT). During his tenure, he was Chief Financial Officer of the New York Cotton Exchange (subsidiary of NYBOT) and played a lead role in developing the first electronic marketplace for trading U.S. Treasury futures contracts. From 1993 to 1997, Mr. Cooperman was Director of Finance and Information Technology at Fischer, Francis, Trees and Watts where he directed the global

operations of the finance and technology divisions. From 1992 to 1993, he was a Vice President in the Finance Division of CS First Boston, where he supervised the management reporting and budgeting effort. Mr. Cooperman is a graduate of Ohio State University, where he received B.S. degrees in accounting and computer science.

Paul J. Bennett, Vice President
Project Director, Technology
Paul Bennett is Vice President, Project Director, Technology of ISE. From 1988 to 1999, he was with the Australian Stock Exchange (ASX), most recently as the project director heading up the transition of trading from a floor-based system to a fully automated market. In previous positions at ASX, Mr. Bennett was responsible for all aspects of information systems management for the derivatives business unit and customer account management to the users of information systems services. From 1986 to 1988, he was manager of information systems at East-West Airlines and before then was systems development manager with Joint Exchange Computers. Prior to moving to Australia, Mr. Bennett held developmental and operational positions in the information technology industry in Great Britain.

Lawrence P. Campbell, Vice President
Technical Services
Larry Campbell is Vice President, Technical Services of ISE. From July 1998 to 1999, he was project management consultant for PriceWaterhouseCoopers working on the integration testing of the NASDAQ/AMEX project. His responsibilities included the management of the project plan for the testing and operational integration, design and implementation of multiple testing configurations, business requirement development, and hardware and software procurement for testing environments. Prior to July 1998, Mr. Campbell was with Prudential Investments as project management/quality assurance where he applied an effective project management strategy to a critical People Soft upgrade project. Previously, he was with Securities Industry Automation Corporation (SIAC), a jointly owned subsidiary of the New York Stock Exchange (NYSE) and American Stock Exchange (Amex) where he held several management positions providing technical direction.

Jerome Mangano, Vice President
Computer/Market Operations
Jerry Mangano is Vice President, Computer/Market Operations of ISE. From 1979 to 1999, he was with the Securities Industry Automation Corporation (SIAC), a jointly owned subsidiary of the New York Stock Exchange (NYSE) and American Stock Exchange (Amex). Mr. Mangano was managing director of

computer operations and quality assurance for the American Stock Exchange market data systems. His responsibilities included managing a 5 x 24 hour dual site operation in support of Amex trading, ensuring that all systems performed at optimal levels of reliability. In these capacities, Mr. Mangano worked with OPRA, CTS and CQS. A graduate of St. Francis College in Brooklyn, NY, Mr. Mangano holds a B.S. degree in business administration.

Gregory J. Maynard, Vice President
Member Services, Technology
Greg Maynard is Vice President, Member Services, Technology of ISE. From 1983 to 1999, he was with the Australian Stock Exchange (ASX), most recently as a business analyst responsible for member firms' connectivity to the trading system, acting as the primary facilitator between the members, system developers and ASX management. ASX was one of the first options markets to shift from floor to screen trading. In previous positions at ASX, Greg was responsible for the functionality and maintenance of the OM CLICK trading system. From 1980 to 1983, he was with Telecom Australia, where he was responsible for support and maintenance of mainframe-based operating system software. A graduate of Monash University in Melbourne, Mr. Maynard holds a B.S. degree in computer science.

Richard T. Pombonyo, Vice President, Marketing
Richard Pombonyo is Vice President, Marketing of ISE. From 1997 to 1998, he was President of RTP Associates, a financial services consulting firm. From 1990 to 1997, Mr. Pombonyo was Managing Director, Marketing, at the New York Futures Exchange (NYFE), a subsidiary of the New York Stock Exchange (until 1994) and later the New York Cotton Exchange. At NYFE he developed and managed the marketing program, including institutional and retail sales and promotion. From 1985 to 1990, he was Managing Director of Product Development at NYFE, where he was instrumental in the design and launch of several unique trading vehicles, and from 1980 to 1985 was Director of Financial Surveillance at the New York Futures Clearing Corporation, a subsidiary of NYFE. From 1977 to 1980, Mr. Pombonyo was Assistant Vice President responsible for managing the compliance department at the Coffee, Sugar & Cocoa Exchange. Prior to 1977, he was with the National Association of Securities Dealers. Mr. Pombonyo has an M.B.A. in Corporate Finance from Hofstra University and a B.A. in Economics from C.W. Post College of Long Island University.

Katherine Simmons, Vice President &
Associate General Counsel
Katherine Simmons is Vice President & Associate General

Counsel of ISE. From 1996 to 1999, Ms. Simmons was with the law firm of Orrick, Herrington & Sutcliffe LLP, which has been outside counsel to the ISE project since its inception. While at Orrick, she advised broker-dealers and exchanges with respect to a wide variety of regulatory issues, including market structure, best execution and compliance-related matters. From 1993 to 1996, Ms. Simmons was with the Office of Market Supervision in the U.S. Securities and Exchange Commission's Division of Market Regulation, where she was involved with market regulation and trading issues. She is a graduate of the University of Maryland School of Law and a member of the American Bar Association.

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RESPONSE TO COMMENT LETTERS

The Commission received 21 comment letters regarding our Filing. Twelve letters supported the Filing and urged the Commission to approve our application, while nine letters were either mixed or critical of our application. The comment letters supporting our application were submitted by potential broker and dealer members of the International Securities Exchange ("ISE" or "Exchange"), as well as investors in equity options and a representative from the academic community. Of the comment letters that were not fully supportive of our Filing, three were from existing options exchanges, three were from options market makers (including an association of such market makers) currently trading on those exchanges, one was from a former options trader, one was from a law firm on behalf of an unidentified client and one was from an electronic communications network.[1]

I. INTRODUCTION

We believe the comments that raise concerns with specific aspects of our Filing are without merit, as discussed in detail in this response. However, we agree with several underlying principles contained in these comment letters. Specifically, a registered exchange must have: (1) the ability to perform all of its self-regulatory responsibilities under the Securities Exchange Act of 1934 (the "Act"), including appropriate surveillance, investigative and enforcement programs; (2) a market structure that embodies the principals of self-regulation and fair representation of members, as well as investor protection; (3) rules governing trading that are designed to assure that it has a fair, orderly and liquid market on a continuous basis, and that market participants are treated fairly in the execution of their orders; and (4) adequate systems, both in terms of their functionality and their capacity. As we discuss below, the ISE fully complies with these requirements. Indeed, the ISE meets or exceeds the current standards in the options market in all of these areas.

A number of letters seek to use our application as a vehicle to address certain structural inefficiencies that exist in the options market. We sympathize with these comments and we believe that the entry of the ISE will be a great step forward for the options markets. However, we enter the options market with realistic expectations, and it will not be possible for us to compete with the existing exchanges if our application is used as a means to address all the structural issues current in the options market. Indeed, doing so

[1] Two commentators raising objections to our Filing – the American Stock Exchange LLC ("Amex") and the Amex Option Market Makers Association – submitted their letters a month after the close of the comment deadline. It appears that these late submissions are intended to delay Commission action on our application, which would help these commentators maintain their current competitive positions in the market.

would create an insurmountable barrier for us to overcome. Our competitors are well aware of the current problems in the options market, so it is not surprising that they have raised these "structural" issues. Indeed, our competitors even criticize our proposal in areas where we have improved upon their current practices.

In particular, the Chicago Board Option Exchange's ("CBOE") letter illustrates how entrenched market participants seek to use the regulatory process to prevent or delay potential competition. That letter takes a "shotgun" approach of raising a host of issues, often multiple times. However, as this response will make apparent, the CBOE does not raise a single substantive issue of merit. Rather, the CBOE seeks to "muddy the waters," hoping to delay our registration and to maintain the current options market structure as long as possible, a structure in which the CBOE derives the most benefit. In addition, any delay in our registration further benefits our competitors by providing them with additional time in which to establish their own automated exchange systems to compete against us. We respectfully request that the Commission reject this blatant anticompetitive action and move quickly to approve our application.

As a final introductory point, some commentators seem to believe that the ISE either is seeking to register an "alternative trading system" ("ATS")[2] or will function like an ATS, and that we are seeking changes to the current regulatory system in order to accommodate our registration as an exchange. This is incorrect. The ISE is applying for registration as an exchange and will comply with all the currently-applicable requirements that govern exchanges. Indeed, the ISE's application does not raise any new or unique issues regarding the manner in which the Commission should regulate exchanges.

In the ATS Release, the Commission implemented a new regulatory scheme for what previously were considered "broker-dealer trading systems." While the Commission determined that ATSs would fall within the definition of an "exchange," it acknowledged that an ATS seeking exchange registration would present novel issues. Thus, the Commission adopted Regulation ATS as an exemption from exchange registration.

For example, ATSs generally are for-profit businesses that have contractual relationships with "customers." Thus, ATSs may have to alter their ownership and governance structures to meet the statutory requirement that an exchange provides for the "fair representation" of its members in the selection of directors and administration of its business. The registration of a "for-profit" business also could raise issues regarding an ATS's regulatory authority over its "customers." While the Commission expressed a willingness to address these issues if an ATS sought to register as an exchange, the ATS Release made clear that the Commission was not prepared to exempt new exchanges from the statutory requirements generally applicable to exchanges.

We understand and share the concerns expressed by some commentators that the registration of ATSs as exchanges without requiring them to comply fully with the Act

[2] *See* Securities Exchange Act Release No. 40760 (December 8, 1998) (the "ATS Release"), which, among other things, adopted Regulation ATS.

could give such systems a considerable competitive advantage, while bestowing on them all of the benefits of being a registered exchange. However, these concerns do not apply to the ISE since we will comply with all the statutory requirements applicable to exchanges. Unlike ATSs, the ISE is a membership organization just like the existing registered exchanges: The Exchange will be owned and governed by its members and will perform fully its self-regulatory obligations under the Act. We are not seeking any exemptions from the requirements of the Act and we expect to be held to the same standards as the existing exchanges.

II. PROCEDURAL ISSUES

Various commentators criticized: our filing of the "old" version of Form 1; the level of detail provided in the application and in the ISE rules; our lack of "regulatory circulars"; and the fact that our Filing does not contain a detailed discussion of our surveillance system. The CBOE argues that these perceived "procedural deficiencies" provide us with a competitive advantage.

Form 1 is the application that an entity files with the Commission to register as a national securities exchange. On February 2, 1999, the ISE filed with the Commission the version of Form 1 then in effect. At the same time, we were aware that the Commission had adopted a new version of Form 1 that would become effective on April 21, 1999. Recognizing this, we asked the Commission staff for guidance as to which version of Form 1 to file. The staff instructed us to file the then-current version of the form, which we did. The staff further requested that we include in our filing a description of our trading system, which we included as Exhibit N to our filing. Thus, not only did we file all the information required for registration as a national securities exchange, we actually filed additional information to help potential commentators better understand our trading system.

Regarding the specificity of the ISE rules, our rules are drafted in the same style as the rules of every other self-regulatory organization ("SRO"). As such, certain rules give the Exchange discretion to set specific parameters. For example, ISE Rule 803(c)(1) gives the Exchange the ability to set the minimum size of the disseminated ISE best bid or offer. As with all SROs, and as required under Section 19(b) of the Act and Rule 19b-4 thereunder, to the extent that the ISE adopts or changes stated policies, practices or interpretations regarding these rules by establishing more specific criteria, such action may well be ISE "rule changes." In that case, the Exchange will file such proposed rule changes with the Commission on Form 19b-4 prior to implementing the rule change. The public will receive notice of, and have an opportunity to comment on, such proposals.

Following our registration as an exchange, we will be filing rule changes with the Commission establishing the specific parameters under certain of our rules. In addition, we will file a rule change joining the Joint-Exchange Options Plan, which contains universal industry procedures for the listing of new options. Adopting generic rules and implementing such rules through specific rule filings is how all SROs implement their rules, and in no way will the ISE have a "competitive advantage" over any existing exchange with respect to the adoption of new rules or policies.

As to "regulatory circulars," exchanges issue such circulars to address interpretive issues that arise in implementing their rules. Since we have yet to implement any of our rules, we do not yet have any interpretive issues that we must address. As such issues do arise, the Exchange will consider and adopt circulars unique to our market, whether prior to or after the commencement of trading on the Exchange. We will provide such circulars to our members, and we will post all circulars on our web site. These circulars will be subject to Commission review, and, to the extent any circular establishes an ISE "rule," we will make any necessary filings with the Commission.

Finally, as to the lack of a substantive description of our surveillance system, we believe that, by their very nature, surveillance systems are confidential; a public filing describing such a system would seriously undermine such a system's integrity, and we are not aware of any SRO that has made a public filing describing its surveillance system. Rather, we believe that this is an area that all SROs should handle confidentially with the Commission and its staff. However, as discussed below, we would be pleased to discuss our surveillance system with our fellow SROs if such discussions would facilitate intermarket coordination and foster more effective regulation of the securities markets.

III. ISE REGULATORY PROGRAM

Certain commentators questioned whether the ISE would have an adequate regulatory program. In particular, the CBOE is concerned that the ISE is attempting to "turn over its entire regulatory functions to another SRO," will "delegate wholesale its regulatory responsibilities," and has a "lack of regulatory vigor." Supposedly in support of these claims, the CBOE notes that the ISE will have agreements regarding regulatory responsibility with other SROs pursuant to Section 17(d) of the Act, that the Filing contains provisions allowing us to contract with other SROs to provide certain regulatory services, and that the Filing does not contain specific employee ethics rules. The CBOE further argues that the ISE inappropriately is relying on a member's designated examining authority ("DEA") to handle certain regulatory functions. Similarly, while the Amex recognizes that we will discuss our regulatory program with the Commission on a confidential basis, that exchange believes we should be required to "explain and justify" our program to the public, the industry and "the other SROs."

The ISE takes its regulatory responsibilities extremely seriously. We recognize that we will be successful only if we provide our members and the investing public with assurances of our market integrity. Our trading rules must be fair, and we must be able to enforce compliance with those rules by our members. The broker-dealer community and the investing public will be unforgiving if our market is misused by our members or otherwise perceived as unfair. Simply put, we will not be successful unless we have a first class regulatory program in which the Commission and the investing community have full confidence.

In establishing our regulatory program, we first recognized that our trading system is unique, with no existing model for conducting surveillance of this type of electronic auction market. At the same time, there are certain aspects of our regulatory program that are essentially similar, if not identical, to the regulatory programs that other SROs

operate. If we can provide for a higher level of regulation to our member community, at a competitive cost, by contracting with another SRO to provide certain services, we have an obligation to our members to explore such alternatives.

Based on these principles, we determined that we must develop and operate our own surveillance system. As the Commission is aware, we are well along in this process. We are custom-building a surveillance system that will aide us in policing our market for compliance with both ISE and Commission rules. We are using the most advanced computer hardware and software tools currently available. ISE staff will operate this system and will have responsibility for conducting all aspects of the daily surveillance of our market activities. We believe that we will have a state-of-the-art surveillance system that will be a model for other SROs to follow.

In addition to the daily surveillance of our market, the ISE will have significant regulatory responsibilities that are common to all SROs. In discharging these responsibilities, we seek to operate our regulatory program in as efficient a manner as possible, avoiding duplicative regulation for our members. Thus, we are mindful of the flexibility that Section 17(d) of the Act and Rules 17d-1 and 17d-2 thereunder provide to SROs, and our regulatory program reflects these provisions in two ways.

First, our rules recognize that, under Commission Rule 17d-1, all broker-dealers, including ISE members, will have only a single DEA that will be responsible for certain aspects of the members' regulatory oversight. At least in our initial stages of operation, other SROs likely will be the DEA for our members. Our rules properly note that the DEA will have the primary regulatory authority over many aspects of a joint member's activities, and we believe it would result in regulatory duplication for us to assume primary jurisdiction in these areas. Nevertheless, our rules provide us with the ability to take disciplinary action against our members for failure to comply with these rules if such actions call into question the integrity of our market.

Second, we will enter into regulatory agreements pursuant to Commission Rule 17d-2 to help avoid duplicative regulation. Under Rule 17d-2, SROs may agree that one SRO will have regulatory responsibility for joint members in specified areas. SROs that agree to allow another SRO to handle an area of regulation under Rule 17d-2 are relieved of regulatory responsibility under the Act for that area. These agreements generally cover such common areas of regulation as personnel registration, branch office examinations and sales practices. All currently-registered exchanges have entered into such agreements. Of course, any Rule 17d-2 agreement into which we enter must be filed with the Commission for approval.

Outside of Section 17(d), we have reached a preliminary agreement with another SRO to perform specific regulatory functions for us on a contract basis. These will be areas in which this SRO has significant experience and expertise. This SRO, as our agent, will process membership applications, will conduct certain "upstairs" investigations for us and will prosecute ISE enforcement actions. Similarly, we will use the hearing panel infrastructure of this SRO for the actual conduct of enforcement hearings. The Commission obviously must find this arrangement acceptable prior to approving our

application.

As opposed to Rule 17d-2 agreements, this contractual arrangement will not result in the ISE being relieved of any regulatory responsibility. Indeed, this agreement effectively will result in the ISE "hiring" experienced and capable regulatory personnel to perform specified functions on our behalf, with the ISE retaining ultimate control over these areas. For example, while the personnel in another SRO's membership department will process membership applications to ensure their completeness, the ISE itself will make all determinations regarding approval or denial of membership on the Exchange. Similarly, the ISE will determine when to bring enforcement actions, including who to charge in such actions and the specific sanctions to be sought. Any hearing will be before an ISE hearing panel, populated by a hearing officer (likely on hire from the other SRO) and representatives of ISE members, providing the necessary expertise in administering our unique trading rules. Any appeals of ISE disciplinary actions will be heard by the ISE board.[3]

We believe that the contractual relationship we propose with another SRO demonstrates the seriousness with which we are approaching our responsibilities as a national securities exchange. At least at the time of our initial operations, we will be a relatively small exchange. While we could hire staff to develop an upstairs regulatory program and enforcement capability, contracting with a major SRO provides us with a first-class regulatory program subject to the jurisdiction and control of the ISE on the first day of trading, while allowing us to focus our resources on our surveillance system, which is unique to our market. Over time, we may bring such services in-house if this would be appropriate from a regulatory and business perspective. Of course, our investigative and prosecutorial efforts must fulfill all of our regulatory obligations to the satisfaction of the Commission, which routinely conducts examinations of each SRO in this area. This is a far cry from the "wholesale" delegation of regulatory responsibilities that our competitors fear.[4]

We appreciate that the commentators do not have a full understanding of our regulatory program since, as discussed above, it is not practical for us to make a public filing detailing such a program. However, we believe that it is important for SROs to work together to coordinate their regulatory efforts. Thus, one of the first steps we took in designing our regulatory program was to ask both the Amex and the CBOE to meet with

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[3] We have amended our disciplinary rules to make them consistent with the procedures utilized by the SRO with which we have reached a preliminary agreement. In particular, the authority to bring enforcement actions is changed from the Business Conduct Committee to the Exchange's staff.

[4] Despite its criticism of our approach to regulation, the CBOE specifically recognizes that the Commission already has stated its support for this type of regulatory program. *See* ATS Release, *supra* note 2. In the context of discussing exchange regulation, the Commission noted that it "may be possible for an exchange to contract with another SRO to perform its day-to-day enforcement and disciplinary actions," provided that the contracting exchange "would retain ultimate responsibility for this function." The Commission stated that this form of arrangement would be "consistent with the public interest." This is precisely the arrangement into which we are entering.

us. We sought to discuss our regulatory program, to learn about their regulatory programs and to develop a coordinated approach to regulation. We did so on the belief that SRO regulatory staffs should work together, notwithstanding the fact that the SROs themselves actively compete in the market. Both the Amex and CBOE declined our invitation and told us that they would not meet with us until we received Commission approval of our application.

Although we respect the Amex's and CBOE's decision to deal only with registered SROs on surveillance matters, we find it disingenuous for both of these markets to decline our invitation to learn about our regulatory program while at the same time arguing that the Commission should not approve our application because we have not provided sufficient detail on this issue.

In another effort to work with our fellow SROs as we develop our surveillance and regulatory systems, we have applied to join the Intermarket Surveillance Group ("ISG"). Specifically, in a letter dated March 23, 1999, we provided the ISG with all the material they requested in order to process our membership application. We also offered to make a presentation describing our regulatory program to the ISG at its June, 1999, meeting. By letter dated May 17, 1999, the ISG requested certain additional information from us, while stating that Commission registration was a prerequisite to our joining the ISG. By letter dated May 20, 1999, we provided the additional information the ISG requested and we again raised the possibility of attending the June meeting. In a conference call on June 15, 1999, the ISG told us it would be premature for us to attend their meeting. Thus, we have not yet been able to discuss our regulatory program with our fellow SROs.[5]

Finally, with respect to the ISE's ethics policies, we are fully aware of the standards the Commission's Office of Compliance Inspections and Examinations ("OCIE") has recommended that all SROs adopt. While the CBOE is correct in noting that we have not included certain ethics policies in our rules in the same manner as the CBOE, this is simply because the ISE is centralizing all its ethics policies in certain internal handbooks and policy statements that will be made available, as appropriate, to directors, officers and employees. Our ethics policies will comply in all respects with OCIE's recommendations. However, to ensure that our members are subject to appropriate discipline for actions that raise ethical concerns regarding ISE employees, we have added Rule 403 specifying that members may not give ISE employees gifts with more than a nominal value.

As this discussion indicates, the ISE is developing a regulatory program that will rival the programs of any currently-registered SRO. We will have a state-of-the-art proprietary surveillance system monitoring all activity in our market. We also will discharge all our other regulatory functions using proven industry resources in a manner the Commission

[5] We also understand that the ISG is considering implementing a consolidated options audit trail. Since we are in the midst of developing a surveillance system, we believe that we have much to offer in the development of such an audit trail, and we have offered the ISG our help and participation. We have not yet received a response to that offer, other than to be informed that a response will be forthcoming.

specifically has found to be consistent with the public interest. It is unfortunate that our competitors have chosen to criticize our regulatory program without taking the time to meet with us and learn about our capabilities. We renew our invitation to the Amex and CBOE, as well as the other SROs, to meet with us to pursue ways in which to enhance the regulation and integrity of the options markets.

IV. MARKET STRUCTURE ISSUES

Two of our competitor markets, the CBOE and the Philadelphia Stock Exchange ("Phlx"), argue that the Commission should delay action on the ISE's application because the options industry is currently facing capacity issues. Similarly, the Amex cites its "understanding," without any support or attribution, regarding the projected volume of ISE message traffic, arguing that we should be required to "explain" how this level of message traffic will impact industry utilities, such as the Options Price Reporting Authority ("OPRA"), and how the costs of any enhancements to these systems will be allocated.

Commentators also note that the Commission must determine that the ISE has the internal capacity to process its internal quotation and transaction traffic prior to approving its registration. Also thrown into the mix are other technical concerns, such as the Year 2000 computer problem, as additional issues the Commission must consider in reviewing our application. Finally, the Phlx states that trading on the ISE could result in increased market "fragmentation," requiring at least a review of a possible intermarket linkage before approving the ISE's application. These arguments simply are more "noise" intended to delay our registration.

A. ISE Internal Capacity

We appreciate the concerns of our competitors that we may not have sufficient capacity to handle a substantial amount of market volume. They can rest assured that we take our capacity planning extremely seriously. We are working closely with the Commission staff in this area and we would not expect the Commission to permit us to initiate trading unless it is comfortable that we have the capacity to handle the anticipated volume of quote, trade and message traffic on our system. Indeed, we will phase-in our operations slowly, starting our trading with only a limited number of options. We will increase the number of options traded in our system only when we are comfortable that both the Exchange and our members can handle additional volume. In addition, once we are registered, we will be subject to, and we will fully participate in, the Commission staff's Automation Review Policy. As a general matter, we believe that the internal capacity capability of the individual exchanges is a competitive issue that should be left to the oversight of the Commission and not our competitors.

B. OPRA

It is hardly surprising that our competitors also raise issues regarding our potential effect on OPRA's capacity. This is fully consistent with their general approach of raising every issue possible to delay our entry into a market they have controlled for more than two

decades. Despite the obvious self-interest in these comments, we take seriously the capacity constraints facing the options markets. These constraints have many causes, but are due primarily to the impending move of the industry to decimal pricing and the changes to minimum trading increments that are likely to flow from that move. To address these concerns, we are participating in the joint industry study of options capacity issues being conducted with the Commission's support and approval. Indeed, we are participating on the steering committee of this study and are funding a portion of the study, even though our application for registration has not yet been approved by the Commission.

As to the level of ISE message traffic, the Amex cites its "understanding that the ISE expects, in the near future, to be generating approximately 16,000 messages per second," and compares that to OPRA's current capacity of 1,900 messages per second. This comment either reflects a gross misunderstanding of the ISE and the way we will operate or is yet another attempt to raise non-existent issues to delay the Commission's approval of our application.

As part of our application to join OPRA, the OPRA participants asked us to prepare estimates of our message traffic. However, due to potential antitrust concerns, the participants instructed us not to provide these estimates directly to them. Rather, they asked us to provide these estimates to OPRA's processor, the Securities Industry Automation Corporation ("SIAC"), which we did. Our estimates were a very small fraction of the 16,000 messages per second the Amex cites, and we do not know the basis for the Amex's number.

It is possible that the Amex is confusing the volume of messages we send to OPRA with the internal message traffic our system will generate. Due to competitive quotations and other unique aspects of our system, we will be generating internally significantly more message traffic than the best bids, best offers and transaction information we send to OPRA. This volume is internal to the ISE, for which we will have adequate capacity, and will have no effect on OPRA.

As to the "burdens" our message traffic will impose on OPRA and the funding of any enhancements that may be necessary to OPRA's systems, this is an issue that is being addressed as part of our application to join OPRA. The Commission has full jurisdiction over any amendments to the plan governing OPRA that may be necessary to address our membership and the allocation of any costs regarding that membership. This issue is not relevant in the consideration of our Filing.

As to capacity issues generally, we support industry efforts to address capacity concerns at OPRA and elsewhere in the industry. However, we strongly object to any suggestion that capacity concerns should result in delaying our entry into the market. OPRA capacity concerns arise, in large part, because the existing markets are using the current system capacity so inefficiently. As of June, 1999, the current four options exchanges traded options on 2,704 underlying securities. However, over three-quarters of the trading volume – 77.7 percent – was concentrated in options on just 233 securities. Indeed, only options on 397 underlying securities traded at least 500 contracts a day and

nearly half – options on 1255 securities – traded less than 50 contracts a day. Well over half the options – 60.7 percent – had average daily volume of less than 100 contracts a day.[6] The options exchanges disseminate continuous quotes on all these options series. Indeed, an exchange may even disseminate the identical quotation multiple times. Because OPRA traffic volume mainly consists of quote messages, current capacity is being used inefficiently to provide a tremendous volume of quotation information on these options, for which there is virtually no trading interest nor volume.

In citing these statistics, we appreciate that each options market is free to exercise its own business judgment as to which options it will trade. However, the current markets are not free to flood OPRA's limited capacity with quotation information on options for which there is no investor interest, and then use that as a basis to argue that the ISE should not be permitted to enter the market to provide competition in the most actively-traded options. The current options market structure is a model of inefficient use of limited resources and lack of competition. The way to address this problem is to encourage the entry of the ISE, not use the inefficiency of the current system to bar our entry. While we look forward to working with our fellow exchanges to find practical solutions to the capacity issues in the industry, our competitors must recognize that barring our entry into the market is not a solution to the current problems.

C. Year 2000

We specifically have delayed our proposed start of trading until the first quarter of 2000 to avoid interfering with any "Y2K" preparations. Moreover, all our systems, as well as our vendors' systems, are Y2K compliant.

D. Market Fragmentation

The Phlx argues that our entry into the market could result in increased market fragmentation, requiring consideration of a possible intermarket linkage before approving the ISE's application. The ISE fully supports an intermarket linkage and we voiced that support in our letter responding to Chairman Levitt's concerns regarding the existing options market structure.[7] However, the fear of fragmentation and the call for an intermarket linkage long have been misused by the existing options exchanges as a basis to impede enhanced competition in the market. The Commission has rejected this argument before and it should reject the argument now.

Specifically, in adopting Rule 19c-5, regarding multiple trading of options, the Commission addressed this issue in detail.[8] After recognizing the possibility of some fragmentation following multiple trading, the Commission stated that "improvements in market making quality should be the most significant in those classes for which there are competitive markets." Moreover, while the Commission endorsed the concept of an

[6] It was indicated at a recent options industry meeting that of the 216,000 series currently being quoted, 70,000 series (or over 32 percent) had no open interest.
[7] Letter dated March 12, 1999, from David Krell, President and Chief Executive Officer, ISE, to The Honorable Arthur Levitt, Chairman, Commission (the "ISE Response Letter").
[8] Securities Exchange Act Release No. 26870 (May 26, 1989).

intermarket linkage to help coordinate trading among markets and address potential trade-through situations, the Commission also stated that it did not believe that "meaningful progress on [a linkage] will occur so long as some of the existing options markets who oppose multiple trading believe that failure to develop such facilities will further delay multiple trading." The same is true for the ISE's entry into the market. Indeed, the best way to ensure lack of progress on an intermarket linkage is to make our entry into the market conditioned on the development of such a linkage.

V. GOVERNANCE AND OWNERSHIP ISSUES

Commentators raised various concerns regarding the ISE's governance and ownership structures. These issues include the manner in which the ISE raised the initial funds necessary to develop the Exchange, its membership structure, and even its organization as a limited liability company ("LLC"). Specifically, commentators asserted that because the initial ownership of ISE memberships is concentrated in Adirondack Trading Partners, LLC ("ATP"), the ISE would not be able to fulfill its regulatory responsibilities and would be at risk if ATP experienced financial difficulties. In making these assertions, the commentators mischaracterized our market structure and ignored the numerous provisions in our rules that directly address the issues they raised.

A. Background

The ISE is a start-up venture creating a new national securities exchange. As the Commission is aware, there are significant barriers to entry in this market: There has not been a newly-registered securities exchange in the United States in over a quarter century, and the only new exchange to be formed since the Act was adopted in 1934 was the CBOE. The CBOE was started by the Chicago Board of Trade, an organization with existing capital and an established infrastructure and membership body. Moreover, there were no competitive pressures at the time the CBOE was registered, since exchange-trading of options did not yet exist. In contrast, we started with no existing financing or infrastructure and we are attempting to enter a segment of the securities market with significant entrenched interests.

We are engaged in an ambitious undertaking, requiring that we simultaneously design and implement our electronic market, establish our infrastructure, recruit members, and register with the Commission as a national securities exchange, all under enormous competitive pressure. In facing this task, the ISE's founders recognized that we would need substantial and secure financing. To assure that we could proceed with our development without incurring large debts and without being dependent upon the potential value of memberships, our founders provided the necessary funding by organizing a consortium of broker-dealers that supported the development of a new competitor to the existing exchanges.

ATP, as this pooled consortium, has provided the majority of our funding through the purchase of ISE memberships. Investors in ATP faced substantial risk due to the extraordinary barriers to entry that exist in the options market, as well as the uncertainty regarding the eventual value, if any, of the ISE memberships. However, this structure

allowed our founders to bifurcate capital raising efforts from the development of the Exchange itself: ATP has focused on the capital raising effort, while ISE management has been able to focus on the development of the Exchange. Accordingly, while the ISE must approve members under its rules, a firm interested in becoming a market maker on the Exchange must acquire a membership from ATP.[9]

B. Membership Structure

The ISE is an agency-auction market with three classes of memberships: (1) ten Class A memberships ("primary market maker" or "PMM" memberships); (2) 100 Class B memberships ("competitive market maker" or "CMM" memberships); and (3) an unlimited number of Class C memberships ("electronic access members" or "EAMs").[10] PMM and CMM memberships are similar to "seats" on other exchanges in that, in addition to providing trading privileges, they represent an equity interest in the Exchange and may be leased[11] or sold[12] to approved persons or entities[13] by the owner. Class C memberships are akin to licenses since an approved EAM does not need to purchase a "seat."[14] Class C memberships have no equity interest in the Exchange and are not transferable.

Our rules require PMMs and CMMs (collectively, "market makers") to maintain substantial net capital,[15] and they have obligations with respect to providing fair, orderly and liquid options markets.[16] Market makers may only trade for their own account and they are not permitted to represent agency orders.[17] EAMs, in contrast, only may place agency and proprietary orders on the Exchange. EAMs have no obligations with respect to providing liquidity to the market place, and thus are not permitted to quote or otherwise make markets on the ISE. A firm can be both an EAM and a market maker on the ISE only if the EAM function is performed separately from the market maker function.[18] These rules are integral to our agency-auction market.

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[9] We understand that ATP has been in negotiations with several firms for the purchase of market maker memberships. In this respect, we note that until the Exchange is registered, certain of the ISE Rules cannot be implemented. In particular, the ISE has informed potential member firms that while they can negotiate with ATP for the purchase or lease of memberships and enter into purchase or lease agreements, the ISE cannot accept or consider applications for membership until after we are registered as an exchange and have implemented the necessary infrastructure. We will process these membership applications once our registration is effective. Thereafter, any subsequent transfers of memberships will be subject to ISE Rules 309 and 310. We have amended Rule 309 to clarify this.

[10] ISE Constitution, Art. II, Secs. 1, 2 & 3.

[11] ISE Constitution, Art. II, Sec. 4; and ISE Rule 312.

[12] ISE Rules 309 – 311.

[13] ISE Constitution, Art. II, Secs. 5 & 6; and ISE Rules 300 – 308.

[14] ISE Constitution, Art. II, Sec. 3.

[15] ISE Rule 805.

[16] ISE Rules 803 and 804.

[17] ISE Rule 800.

[18] ISE Rule 810 requires a firm to implement a “Chinese Wall” between its ISE market making operation and other brokerage activities.

Certain commentators misconstrue our market structure as one that will foster "internalization," or the ability of a firm to trade against its own order flow, either as a market maker or an EAM. In contrast, another commentator recognized that our rules limit internalization by EAMs, but argued that the limitations were inappropriate and that we should not impose any restrictions on how EAMs may trade. To clear up any confusion that the commentators may have, we specifically drafted our rules to prevent internalization that would conflict with our auction market structure. First, a market maker cannot internalize order flow: Only an EAM can enter customer orders into our market, and there must be a separation between a firm's market making and EAM functions. Second, various trading rules limit the ability of EAMs to internalize their order flow. These rules are described below in our discussion of ISE trading rules.

We strongly believe that encouraging competition between market makers by requiring them to post quotations to attract order flow, rather than allowing them to execute against their own captured order flow, will result in more liquid markets with narrower spreads. Moreover, allowing EAMs to execute against their order flow without first exposing orders to other trading interest on the Exchange would be inconsistent with our agency-auction market, in which market makers and EAMs are encouraged to narrow the best bid and offer on the Exchange. There would be no incentive to provide competitive quotes, or enter orders that improve the market, if members simply could by-pass other trading interest and trade with their own order flow. Indeed, there would be little incentive for any participants to undertake the responsibilities associated with being a market maker on the ISE.[19]

We believe that our membership structure provides the right mix of market making benefits and responsibilities that will attract order flow to, and encourage liquidity on, the ISE. While our competitors are free to disagree with our judgment, the marketplace will be the judge of who is right. The mix of benefits and responsibilities we have chosen fully complies with all the requirements of the Act and is designed to assure fair and orderly options markets on the ISE.

C. ISE Market Makers

Most of the arguments criticizing ISE market makers are based on the assumption that a market maker on an electronic market such as the ISE should operate in the same manner as a floor-based market maker. These arguments are wrong because their assumption is wrong. Indeed, our market maker structure is carefully crafted to reflect the unique nature of our electronic auction market.

[19] It is essential to our market to prevent EAMs from enjoying the potential benefits of market making (by acting as dealer for their own order flow) without purchasing a market maker membership and without undertaking the obligation to provide liquidity to the public in unfavorable as well as favorable market conditions. We firmly believe that an exchange structure that does not provide public investors with liquidity in unfavorable market conditions is undesirable to anyone other than the professional traders that would benefit from being relieved of market making responsibilities. In addition, creating an exchange that lacked participants with market maker responsibilities would serve as a disincentive for market makers on other exchanges, as they would receive an influx of orders in unfavorable market conditions when customers were unable to find liquidity on our market.

On the existing options exchanges, market makers are individuals who trade, in person, on a trading floor, and who often are appointed to options classes within specific "zones" on that floor. This structure effectively imposes physical limitations on the number of options a market maker can trade. Indeed, a floor-based market maker only can stand at one post at a time, regardless of the size of the "zone." Thus, such individual market makers are able to provide liquidity to only a small number of options classes simultaneously. On the other hand, the lack of independent quoting on a continuous basis on the existing exchanges permits an individual to participate in market making without the need to monitor his or her quotes on a continuous basis.

In contrast, the ISE will not have a physical trading floor. Instead, options classes will be arranged into 10 "Groups" of securities.[20] Each Class A membership represents the right to be the PMM in one options Group,[21] while each Class B membership similarly represents the right to be a CMM in one options Group.[22] Subject to the concentration limits discussed below, a firm may be a market maker in more than one Group by purchasing multiple market maker memberships. Since we intend to eventually trade the 600 most active options classes divided into 10 Groups, the purchase of a single membership will permit the member to make markets in approximately 60 options classes.

Our rules require ISE market makers to make continuous markets in all or a portion of the market maker's appointed options every trading day, all day long. Specifically, PMMs must provide quotations in their assigned options 100 percent of the time. Similarly, CMMs must meet their obligations to provide quotations in 60 percent of their options every day. These rules are in marked contrast to those of the floor-based exchanges, discussed above, where market makers compete only when they physically are on the floor, without any requirements as to when they must be present. [23]

Similar to the rules of the other options markets, ISE market makers also are permitted to enter orders to trade outside their appointed options, providing additional liquidity to our market. Specifically, PMMs can trade up to 10 percent of their volume, and CMMs can trade up to 25 percent of their volume, outside of their assigned Groups. In so trading,

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[20] ISE Rule 803(b).
[21] ISE Constitution, Art. II, Sec. 1(c).
[22] ISE Constitution, Art. II, Sec. 2(c).
[23] The Amex inquired whether the ISE will trade every series of every options class it lists. We note that there is no requirement in the Amex's rules, nor any other options exchange's rules, that requires it to trade all of the series of every options class it lists. However, the existing options exchanges generally have traded all of the series of each class for competitive reasons and it is our current plan to do the same. As a general matter, we will make this determination in the same competitive environment as the other options exchanges. With respect to quoting in all the series we trade, ISE Rule 804(e)(2)(i) clearly provides that competitive market maker's must quote in all of the series of at least 60 percent of the options classes in their appointed group. With respect to primary market makers, ISE Rule 804(e)(1) requires a market maker to enter continuous quotations in all of the options classes to which it is appointed. We have amended this Rule to clarify that a primary market maker is required to quote in all of the series of each of the options classes to which it is appointed that are traded on the Exchange.

market makers are subject to specified obligations, including the ISE's quotation spread parameters.[24]

The result of our structure is that, while an individual may own a membership, it will not be possible for one person to fulfill the market making responsibilities associated with an ISE market maker membership. Rather, market makers will need to employ numerous traders to make markets and hedge positions in their assigned options classes. The ISE rules require that these traders be registered with the ISE as "designated trading representatives" ("DTRs").[25] A market maker must demonstrate to the ISE that its DTRs are qualified, which includes a requirement that all DTRs pass an ISE examination.[26]

Certain commentators questioned whether this structure would provide sufficient market making depth on the ISE. These commentators need not worry. Our rules provide that there must be at least two CMMs appointed to each class, resulting in a minimum of three market makers (that is, the PMM and two CMMs) to provide a liquid market in the limited number of options we will begin trading. We will initiate trading in as few as three Groups of a small number of options classes (for example, 10 options classes each), with one PMM and at least two CMMs appointed to each Group.[27] Eventually we will have 10 Groups of approximately 60 options classes each. Because we have 100 CMM memberships, we expect eventually to appoint 10 CMMs to each Group of options.[28]

Overall, we believe that our rules are well-tailored to the needs of an electronic auction market. Our electronic trading system and competitive market maker structure – highlighted by our stringent independent quotation requirements – will provide a market with depth and liquidity that rivals or exceeds today's markets.

Finally, several commentators questioned why we adopted a limited number of market maker memberships. In fact, every exchange has a limited number of memberships (for example, there are 1366 New York Stock Exchange memberships). Indeed, Section 6(c)(4) of the Act specifically permits an exchange to limit the number of its memberships. Our limits are justified – and actually are necessary – to support the type of market that we are building.

There are various constraints on the number of memberships an exchange can support, ranging from limited physical space on the trading floor to economic considerations. In the ISE's case, we are building the first electronic auction market for listed options, and

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[24] *See infra* note 61.

[25] Each DTR will have a unique password that is verified by the Exchange each time the DTR logs into the system.

[26] In yet another example of the CBOE raising a pointless comment simply to muddy the waters and delay our registration, they imply that the DTR examination somehow will be immune from Commission review. Indeed, the DTR examination, like every other rule, policy or practice of the Exchange, will be fully subject to Commission review.

[27] ISE Rule 803(c).

[28] ISE Rule 804(e)(2)(ii) provides that the Exchange may call upon a CMM to submit a single quote or maintain continuous quotes in one or more of the series of an options class to which the CMM is appointed.

the structural requirements of such a market have led to a complex system architecture, with considerable capacity requirements. Based on our current conservative estimates, existing technology simply does not permit us to operate an electronic auction market, based on independent and competitive quotations, with a greater number of market maker participants.[29]

At first, we contemplated having only 50 CMM memberships. However, as we reviewed the capacity of the system, we became comfortable that we eventually could have 100 CMMs, so we split that class of membership, but proposed that only 50 memberships be made immediately available for trading. Since the time we filed our Form 1 in February, we have worked closely with OM Technology to build sufficient capacity for all 100 CMMs for day one of trading.[30] As we gain experience in the market, we may well consider adding to the number of memberships if this is technologically feasible and makes business sense. In the interim, we strongly believe that an electronic market with 110 market maker memberships, with each market maker employing numerous individuals to quote independently in the market, fully complies with the Act.

D. Exchange Governance

Our voting and governance structure is designed to provide for the proper governance of our Exchange and to fulfill the statutory requirement that members of our Exchange engage in self-governance. At the same time, we sought to balance the interests of the different classes of members and to provide substantial controls with respect to potential conflicts of interest. We also were cognizant of the Commission's strong view that exchanges should have non-industry representatives on their boards. To address unique issues presented by a start-up exchange without pre-existing capital or members, many of the provisions contained in our Constitution and Rules are unique to the ISE, and in some cases, more restrictive than those of the currently registered exchanges.

Various commentators misconstrue the ISE's governance structure, arguing that one or more members or classes of members have inappropriate control over the Exchange. In fact, we have provided all members and classes of members with a voice in exchange

[29] The single largest cause of message traffic in the options markets comes from quotations for the thousands of options series traded. The systems operated by the floor-based options exchanges, which generally rely on a "crowd quote," need to handle quotation traffic from only one source in each options series. In contrast, because our market makers will quote independently, the ISE system must handle quotation traffic from each market maker in each options series. Thus, internal ISE capacity constraints are directly related to the number of market maker participants.

[30] We have amended ISE Constitution, Article II, Section 2, to remove the limitation on the number of memberships with respect to which the Exchange may approve CMMs to trade. In a corresponding amendment, we have deleted the provision in Rules 303 and 317 limiting a member to five CMM memberships. This is necessary to maintain a 10 percent standard: while there previously was a limit of five CMM memberships out of a total of 50, there now will be a limit of 10 CMM memberships out of a total of 100. As a practical matter, however, a firm that is a PMM on the ISE could be approved to operate a maximum of 9 memberships, since a firm can not be a PMM and a CMM in the same options group.

governance, while ensuring that no one member or class of members has dominance over our operations. In particular, we have taken care to ensure that ATP, as our founding member, has a much more limited voice in our governance structure than its ownership of memberships would normally provide.

1. Voting Structure

Our voting structure is carefully tailored to recognize the economic differences between market makers, who are equity owners of the Exchange, and EAMs, who purchase annual licenses to trade on the ISE. Market makers vote on corporate actions such as: mergers, consolidations or dissolution of the Exchange; changes to the structure of the Exchange (for example, creating additional classes of members or increasing the number of memberships in a class); and amendments to the Constitution. EAMs do not have such voting rights, except in the case where an amendment to the Constitution would (1) affect their economic status, such as requiring EAMs to purchase memberships; (2) alter EAM voting rights; or (3) change the composition of the board of directors.[31] Despite these significant differences, each class of members elects two representatives to the board of directors and participates equally in the election of the non-industry directors.[32]

Our voting structure also limits potential conflicts between trading and non-trading members of the ISE. These conflicts arise on other exchanges when members lease their "seats" to persons who actually conduct the trading on the exchange. The terms of a lease must specify which of the parties will exercise the full voting rights associated with the membership. In contrast, we specifically divided the voting rights associated with each ISE market maker membership into "Ownership Voting Rights" and "Membership Voting Rights." Ownership Voting Rights are the right of an owner of a membership to vote on (1) any merger, consolidation or dissolution of the Exchange or any sale of all or substantially all of the assets of the Exchange, and (2) the creation of any additional classes of memberships or any increase in the number of memberships in any class.[33] ISE Ownership Voting Rights are not transferable to a lessee.[34]

In contrast, Membership Voting Rights include the right of a member to vote on all matters requiring approval by the members that are not included in Ownership Voting Rights.[35] Thus, Membership Voting Rights include voting for representatives on the board of directors and most changes to the Constitution. Membership Voting Rights may be passed to a lessee of a membership under a lease agreement or they may be retained by the owner of the membership.[36] This bifurcation of voting rights will provide lessors

[31] ISE Constitution, Art. III, Secs. 7 and 11.
[32] ISE Constitution, Art. IV, Sec. 1. One commentator questioned why we do not have a representative of issuers on our board. However, the only issuer of ISE-listed securities will be The Options Clearing Corporation ("OCC"). We are unaware of any options exchange that has a representative of OCC on its board, and do not believe that requiring us to have an OCC representative on our board would enhance the governance of our Exchange.
[33] ISE Constitution, Art. I, Sec. 1(q).
[34] ISE Constitution, Art. II, Sec. 4(d).
[35] ISE Constitution, Art. I, Sec. 1(n).
[36] ISE Constitution, Art. II, Sec. 4(c).

and lessees with the ability to allocate voting rights between themselves reflecting their membership interests.

2. Board of Directors

Our Board will have 15 directors. In addition to the six representatives of member firms (two from each class of members), eight are non-industry directors (at least two of whom must be public directors).[37] The chief executive officer of the Exchange also will be a director.[38] Thus, more than half of the ISE board will be unaffiliated with a member or the management of the Exchange, a model of governance not required by the Act, but nevertheless a governing structure strongly advocated by the Commission. While the CBOE strongly criticizes our structure, the CBOE has been perhaps the most adamant in its opposition to the Commission's outside governance standards. Indeed, the CBOE's constitution currently requires that its 21-member board have 15 members or representatives of member organizations, and only four representatives of the public.[39]

Only two out of the 15 board members will be representative of PMMs and only two will be representative of CMMs, and together, only four out of the 15 board members will be representative of market makers generally. As the Amex notes, board approval of our rule changes requires the affirmative vote of at least one CMM and one PMM board members. While both of these classes of members are market makers, the primary and competitive market makers may have conflicting interests. To assure fair representation, we believe it is necessary to require that at least one representative from each class vote in favor of rule changes.

Because the profitability of market making is dependent on customer order flow from EAM members and because there are eight non-industry directors, we do not believe the same type of requirement is necessary to protect the interest of EAMs. In addition, we note that any rule changes will require a majority vote of the board, so that EAM and non-industry representatives, which together represent 10 out of the 15 board members, potentially have far greater power over proposed changes to the ISE's rules. Overall, we

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[37] The definitions of "non-industry," "industry" and "public" director contained in the ISE Constitution, Art. I, Sec. 1(l) and (r) and (v), are the same as those adopted by the National Association of Securities Dealers, Inc ("NASD"), the parent company of the Amex. See NASD By-Laws, Art. I, Section (o), (cc) and (ff). Thus, we fail to understand what "assurance" the Amex would suggest is necessary with respect to whether the non-industry directors will, in fact, represent the public. Whether non-industry directors are elected by the members or appointed by an exchange official, they must satisfy the definition contained in the ISE rules. Moreover, we believe that it is preferable for non-industry directors to be elected by the ISE membership rather than appointed by an exchange official, which is the practice at some of the existing exchanges. *E.g.*, CBOE Constitution, Art. VI, Sec. 6.1 (providing that the four non-industry directors are appointed by the chairman of the board and approved by the board).

[38] ISE Constitution, Art. IV, Sec. 1(a).

[39] CBOE Constitution, Art. VI, Sec. 6.1. The CBOE recently has proposed amendments to this provision, which would provide for eight of 23 board members being representatives of the public, still well less than the eight of 15 on the ISE board. *See* Securities Exchange Act Release No. 41791 (August 25, 1999).

believe that our board composition and voting structure appropriately and fairly balance the interest of the three classes of ISE members, while providing substantial non-industry participation in the governance of the Exchange.

In addition to the composition of our board, the ISE has proposed quorum requirements for the board and its most important committees that include at least one non-industry director.[40] This is in marked contrast to the rules of some of our competitors, which have no such requirement. In another provision unique to the ISE, only one representative from each member firm may serve on the ISE board, regardless of how many memberships the firm might own or operate, and regardless whether the firm is both an EAM and market maker on the Exchange.[41] On this note, the ISE also included concentration limits both on the number of memberships that may be owned by a single entity[42] and the number of memberships for which a single firm may be approved for market making on the Exchange.[43]

3. Founders

The commentators correctly note that our founders play a unique role in the creation of our Exchange, requiring us to be especially vigilant in dealing with these members in our governance structure. We have done so.

To allow for an orderly sale or lease of memberships by our founders, we included various rules that, while giving the founders time to sell or lease their memberships, also removed their control over the operation of the Exchange as a result of their ownership of numerous memberships. Similarly, we limited the time in which they have to sell or lease memberships that exceeds the concentration limits contained in the ISE Constitution and rules. At the same time, any person who buys or leases a membership from our founders must meet the rigorous membership criteria that we have established and that we will administer in conjunction with the SRO handling the processing of our membership applications.

The commentators ignore or misrepresent significant limitations that we have placed on founders' ownership of memberships: (1) founders may not exercise the Membership Voting Rights associated with their memberships except with respect to those memberships for which they have been approved to make markets on the ISE;[44] (2) when memberships are leased by founders, the founder *must* pass the Membership Voting Rights to the lessees;[45] and (3) we do not consider "outstanding," either for voting or quorum purposes, Membership Voting Rights with respect to memberships for which a founder has not been approved to operate on the Exchange or which have not been leased.[46] Thus, founders will not have the ability to control the election of directors or

[40] ISE Constitution, Art. VI.
[41] ISE Constitution, Art. IV, Sec. 1(c).
[42] ISE Constitution, Art. II, Sec. 11.
[43] ISE Rule 317.
[44] ISE Constitution, Art. V, Sec. 12.
[45] ISE Constitution, Art. II, Sec. 4.
[46] ISE Constitution, Art. V, Sec. 12.

the operation of the Exchange by owning a number of memberships that exceeds the concentration limit for either Class A or Class B memberships.

Similarly, contrary to the implications of the commentators, there is no exemption for founders with respect to how many memberships they may operate.[47] Specifically, ATP will operate, at most, two PMMs and will not dominate market making on the ISE merely because it owns a significant number of memberships. If ATP were to incur financial difficulties, it would not have a disproportionately adverse effect on the Exchange. Indeed, to provide extra assurance of this, the ISE concentration rule even contains a phase-in for the approval of multiple memberships for a single firm based upon the number of operating memberships.[48] These rules directly address the specter of systematic risk raised by the CBOE. Accordingly, there is no additional potential risk to the ISE, or to "the entire industry," resulting from any temporary concentration of memberships in the founders.

Notwithstanding the numerous safeguards described above, the ISE also included a provision that permits the Exchange essentially to reclaim, at no cost to the ISE, memberships purchased by the founders if the founders do not divest themselves of memberships in a timely fashion. Specifically, a founder that owns a number of memberships that exceeds the concentration limit must reduce its access by at least 40 percent through the lease or sale of memberships within six years of the start of the ISE.[49] As an outside limit, founders will not be permitted to exceed the concentration limits for more than ten years.[50]

In evaluating these provisions, the ISE was mindful that there is no economic incentive for a founder to hold memberships without selling or leasing them because, as discussed below, our organizational structure will not provide for classic "dividends" to owners of memberships, nor is there a control advantage due to the restrictions noted above. We view this phased divestiture schedule as a "fail-safe," since if the founders were unable to sell or lease their memberships within this time frame it would mean that ISE memberships were virtually worthless, and therefore the ISE had not been successful. Although we believe such an outcome is highly unlikely, requiring the founders to relinquish ownership of memberships would provide the Exchange an opportunity to distribute the memberships directly.

4. Role of the Chairman

The CBOE misconstrues the role of our Chairman in order to create the illusion of conflicts of interest. First, the CBOE fails to note that, unlike many other exchanges, our

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[47] ISE Rule 317.
[48] ISE Constitution, Art. II, Sec. 11(b); and ISE Rule 312(b).
[49] ISE Rule 310(b)(5).
[50] ISE Rule 300(a)(5) contains a ten-year exemption for founders from the rule requiring members to have as the principal purpose of their membership the conduct of a public securities business. This exemption permits founders temporarily to own memberships without using them to trade on the Exchange or leasing them to a member that trades on the Exchange.

Chairman is not an officer of the Exchange.[51] The Chairman of the ISE will have very limited functions beyond those of any other director, such as calling special meetings and receiving notices when a board member or an officer resigns. Thus, the title of Chairman reflects more of a "chief of state" status, rather than a management position. Moreover, the Chairman is elected by the board. Given that more than half of our board members are non-industry directors, we believe the board should be permitted to elect whomever they believe would best represent the Exchange.

We have adopted this structure in contemplation that Mr. William Porter, the Chairman Emeritus of E*TRADE and one of our founders, will be our initial Chairman. Mr. Porter has played a leading role in publicizing the ISE and giving us credibility in the market. Thus, it is important to us that Mr. Porter be our Chairman through our start-up phase. Nevertheless, we recognize that Mr. Porter's stature and role in organizing the Exchange is unique, and following Mr. Porter's tenure, there could be at least an appearance of a conflict when the Chairman is affiliated with a member. Thus, our Constitution provides that the longest Mr. Porter can serve as Chairman is two years, the length of one term on our board. After this initial two-year term, the Chairman will be chosen from among the non-industry directors.[52]

5. Delegation of Authority

Perhaps the most nonsensical of the comments on our governance structure regards the manner in which the ISE will delegate authority to make decisions within the Exchange. The CBOE raises concern about our discretion in this area and questions what it perceives to be a lack of committee structure in the decision-making process. Similarly, the Amex argues that we should specify exactly how the ISE will make a decision that is within the purview of "the Exchange." We believe that it is of no concern to the Amex, CBOE or any of our competitors how the ISE makes its internal decisions. We will use committees or other governance structures as we see fit as a business entity and an SRO. Any decisions we do make will be subject to the full protection of the ISE's governance structure described above, and also will be subject to oversight and review by the Commission.

E. Limited Liability Company Organization

A number of commentators assumed that the ISE adopted the LLC structure to operate as a for-profit entity. That is not correct. Rather, we adopted this structure to provide certain tax benefits to our members. In keeping with our goal of working within the current exchange regulatory structure, the ISE form of organization presents no unique legal issues for the Commission.

All existing registered exchanges except the American Stock Exchange LLC are organized under state law as "not-for-profit" corporations.[53] This does not mean,

[51] ISE Constitution, Art. IV, Sec. 2.
[52] *Id.*
[53] The Amex is organized as an LLC and is owned by the NASD.

however, that the exchanges do not have net income. In fact, exchanges generally create budgets and set fees based upon an expectation that a certain amount of net income will result. This net income is necessary, among other things, to finance capital improvements and to provide for financial reserves. Exchanges generally control the amount of annual net income by adjusting their fees. For instance, some exchanges rebate fees collected, or reduce or eliminate fees temporarily when they exceed earnings projections.[54]

With one exception, our LLC structure provides the same financial model as the existing exchanges. The exception involves taxation: Instead of the ISE paying state and federal taxes on its net income, the income is "allocated" to Class A and Class B memberships, and the owner of each membership pays taxes on the income. This allocation is an accounting procedure whereby an LLC assigns to each membership a portion of its net income. This is a book entry, not a "distribution" where the Exchange actually pays out money.[55] We intend to make distributions to each owner of a membership solely to cover the tax liability on its allocated portion of the Exchange's net income.[56] Therefore, the overall financial effect on the Exchange is the same as if it were a corporation: Through distributions to its members, the ISE pays an amount equal to what it would have paid in taxes on its net income if it were a corporation.

We adopted the LLC structure because it has advantages to the owners of memberships when the Exchange has net losses, as is common during the development stages of any new company. Net losses are allocated to memberships just like net income, allowing the owners of memberships to offset their net income with the losses allocated from the Exchange. If the Exchange were a corporation, there would be no opportunity for members to receive any tax benefits for the developmental years in which the Exchange has net losses. Thus, as the first exchange to begin operation from scratch, this new form of organization provides unique benefits. In fact, the only major industry restructuring to occur since the advent of LLC laws resulted in the Amex becoming an LLC.

We emphasize that, despite our organization as an LLC, the ISE it is not structured to provide owners of memberships a "profit" from Exchange-generated revenue. Like seats on existing exchanges, the primary value of owning a membership will be the opportunity to trade on a low-cost, efficient electronic exchange (or to lease the membership to someone who trades on the Exchange). Because the profitability of trading is dependent on having sufficiently liquid markets, it will be important to attract transaction volume by providing a quality, low-cost alternative for brokers seeking execution of their customers' orders. Thus, it will be in the interest of our members to keep fees on the Exchange as low as possible to generate that order flow. For these reasons, the ISE's financial model mirrors those of the existing exchanges: keep fees low; do not distribute profits; but build reserves for regulatory programs, systems enhancements and other improvements.

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[54] *See, e.g.,* Securities Exchange Act Release No. 39462 (Dec. 17, 1997).
[55] *Compare* ISE Operating Agreement, Art. IV, Sec. 4.1 (distributions), *with* Art. IV, Sec. 4.3 (allocations).
[56] ISE Operating Agreement, Art. IV, Sec. 4.1.

Entities purchasing our memberships are well informed of this model.[57]

Accordingly, we will not be operating on a "for-profit" basis. The concerns commentators raised regarding our ability to fulfill our self-regulatory duties based on this erroneous assumption are without merit. The ISE's LLC structure raises no unique issues.

[57] We are aware of the trend towards "demutualization" of exchanges in other countries and reports that certain U.S. markets are considering ways to "demutualize." Indeed, the Commission's ATS Release discusses issues raised under the Act by for-profit exchange structures, and potential ways in which such issues could be resolved. However, the founders of the ISE did not create the ISE in a demutualized structure recognizing that we already face considerable barriers to entry. We decided not to forge new ground that could raise complex issues under the Act. However, as the securities markets continue to evolve, demutualization is a possibility we may consider at some point in the future.

VI. TRADING RULES

The negative comments on our trading rules largely reflect a misunderstanding of our market structure and trading system. As with every other exchange, the ISE will have the obligation to operate its market in a manner that is consistent with its rules and the Act, and of course, will be subject to Commission examination. As with the rules of every other exchange, the text of our rules do not, and cannot, explain all aspects of our trading. As discussed above, to the extent we develop stated practices, policies or interpretation of our rules, we will file any necessary rule changes with the Commission to implement such rule changes. The following description of our system and in-depth discussion of our rules clearly show we are in full compliance with all the requirements of the Act.

A. Exchange System Architecture

The ISE electronic system is not a simple electronic limit orderbook similar to those typically operated by the existing options exchanges and ATSs. Rather, our system is a complex electronic auction market that incorporates many different functions and processes, only one of which is a central orderbook. The ISE auction market system architecture includes five primary subsystems: (1) a common data base containing basic information needed for trading and clearing, covering such areas a members and options series; (2) a system to distribute information to members, to provide security, and to conduct validations; (3) the market place itself, which receives and executes quotes and orders according to the trading rules; (4) a data capture system, which processes and stores information regarding executed trades; and (5) an information subsystem that receives and sends market data.

Our entire system architecture is replicated in two different locations, both of which are used to conduct trading, and is overlaid by a complex communications network that links the various subsystems and will connect the ISE to its members. The market normally is operated using both sites simultaneously, with the continuous communication of information between the two sites. However, either site is capable of operating the entire market. This system architecture has been implemented at the Stockholm and Australian stock exchanges, among several other electronic markets, by OM Technology, the Swedish company that has developed ISE's system and software.[58]

We recognize that a simple "first-in, first-out" limit orderbook system would be much easier to develop and operate. However, our more complex system design is necessary to implement a true auction market system in an electronic environment. We do not believe it is possible to provide fair, orderly and liquid markets for listed options through a "first-in, first-out" orderbook, since such systems neither provide priority for customer orders nor support multiple market makers that have affirmative market making obligations. Indeed, we believe that fundamental principles governing the registration and operation of an exchange include: providing customers with priority; encouraging liquidity through a market making system comprised of multiple, independent market makers competing for order flow by providing quotations in size; and maintaining active surveillance of the

[58] *See* www.omgroup.com for further information regarding OM Technology.

market, complete with self-regulation by members.

Both market makers and EAMs can use ISE-supplied terminals to send quotes and orders to the ISE, or they can design their own systems to connect through our API. In either case, both market makers and EAMs can connect to our system though the use of one or more T-1 communication lines.[59] Thus, the Amex's unsupported "understanding" that our system will handle 40 to 60 messages per second for market makers, but only two messages per second for EAMs, is incorrect. Because we will have multiple market makers independently quoting, and because those market makers need to update multiple series of an options class upon a change in the underlying security, capacity needs are far greater for market makers than for customers placing or canceling individual orders. Accordingly, market makers may communicate quotation changes in multiple series within a single message. However, the speed at which market maker quotations and customer orders are communicated to the ISE is the same. This is in contrast to the floor-based options exchanges, where there is an inherent time advantage for market makers, since quotations are updated on the floors immediately, while customer orders must be communicated to the exchanges.

B. ISE Trading System Overview

The ISE will operate a central system where quotes and orders come together in an auction market, resulting in a true price discovery mechanism. ISE members will have terminals into which they can enter quotes and orders. Quotes and orders are entered into the central orderbook, where they will either be executed or stored in price priority.[60] Customer orders at the same price are stored in time priority, and all customer orders have priority over market maker quotes and professional orders at the same price. Our best bid and offer ("BBO") is determined by the highest priced order or quote to buy and the lowest priced order or quote to sell in the orderbook. The size associated with the ISE BBO will be updated upon the receipt of an order or quote that joins the ISE BBO. The ISE BBO is communicated to OPRA and ISE members. By definition, limit orders or quotes that improve upon the ISE BBO will become the best bid or offer and will be displayed. As a result of various rules, which are discussed in detail below, the size of the ISE BBO cannot be less than ten contracts.[61]

Subject to the discussion below on intermarket price protection, market orders will be

[59] EAMs will have more flexibility as to how they connect. For example, if an EAM believes that the use of a T-1 line is not economical and that another form of communication is more practical, that EAM can connect through a lower speed alternative. This is purely a business decision for an EAM.

[60] ISE Rule 713.

[61] Our rules distinguish between quotes and orders. While they are similar, *i.e.*, firm interests to buy or sell a specific number of contracts at a stated price, there are systematic differences between quotes and orders. For instance, a quote automatically replaces an existing quote from the same market maker. *See* ISE Rule 100(a)(26) (definition of "order") and ISE Rule 100(a)(32) (definition of "quote"). As discussed in this section, quotes also contain parameters that are used to automate certain exchange functions, such as providing intermarket price protection.

executed in full. If there is insufficient size at the ISE BBO to execute the full size of a market order, the order will be executed at the next price level for the size available at that price and then at the next available price and so on until the entire order is executed. A limit order that is marketable against the ISE BBO will be executed for the lesser of the quantity specified in the order or the number of contracts available at the limit price. If the limit order price crosses over the BBO, the limit order could receive multiple executions at different price levels as described above. If the order is a day or good-until-canceled limit order and the entire size of the limit order can not be filled at the limit price or better, the unexecuted portion of the order will be displayed.

C. Intermarket Price Protection

Our system will not automatically execute (1) public customer orders to sell at a price that is below a bid of another options exchange or (2) public customer orders to buy at prices above an offer of another options exchange. The system provides a PMM with the ability to set parameters at which the order will be executed automatically at the better price. These parameters are based on the size of the order and the amount by which the price is better than the PMM's quote. If the order falls outside these parameters and does not receive automatic execution at the better price, the system sends a message to the PMM alerting it to the better price.

Upon receipt of this message, the PMM must determine how to handle the order. For example, the PMM might determine to match the away market price, or the PMM may attempt to get the better price from the away market for the customer order. During this process, however, the order is still in the system. Thus, while a PMM may be seeking the away market price for the order, that order can execute against a new incoming ISE market order at a price that would not "trade through" the away market. This is in contrast to the procedures of the existing options exchanges, which remove these types of orders from their automated execution systems, resulting in possible trade-throughs as their systems receive new orders. By comparison, our system protects both the order being handled by the PMM and incoming orders.[62]

One of the most specious CBOE comments on our rules regards the manner in which we provide this intermarket price protection. Specifically, the CBOE comment letter states:

> Proposed ISE Rule 714 provides that Public Customer Orders to buy or sell option contracts on the exchange will not be automatically executed by the System at prices inferior to the best bid or offer on another national securities exchange *as those best prices are identified in the System*. The CBOE wonders why the ISE has added the disclaimer to its rule providing National Best Bid or Offer

[62] Our system does not provide intermarket price protection to Fill-or-Kill ("FoK") orders, which are filled in their entirety as soon as they are received. If not filled, they are returned. It would not be practicable to attempt to provide such orders with intermarket price protection, since such protection may require the primary market maker to attempt to access a price in another market, which price may not be good (that is, the other market may fade), or may not be good for sufficient size to fulfil the terms of the order. FoK orders are a sophisticated type of order, and persons using these orders will understand the benefits and limitations of their use.

("NBBO") protections. What does it mean "as those best prices are identified in the System"? . . . Will ISE attempt to identify all the other exchanges' prices?

There is no mystery to our language. The ISE receives information regarding the best bids and offers available at other options exchanges through OPRA. Before executing a public customer order at the ISE BBO, the system automatically checks the prices being received from OPRA to identify if there is a better price on another market. In fact, our system actually calculates what we term the "OPRA BBO," which is the highest bid and lowest offer of all options exchanges other than the ISE, and checks to ensure that the OPRA BBO does not contain a better price before automatically executing a customer order at the ISE BBO. However, we understand that OPRA on occasion has experienced delays, and that the best disseminated price from a market may not be the current price available on that market. Thus, due to the inherent limitations of the current market data systems, ISE Rule 714 states that we are protecting orders against the best prices "as those best prices are identified in the System" from the OPRA feed.

This language is remarkably similar to CBOE Rule 6.8, Interpretation .02, which provides that CBOE orders "will not be automatically executed on RAES at prices inferior to the current best bid or offer in any other market, *as such best bids and offers are identified in RAES*." (Emphasis added.) While the CBOE rule does not explain how its system implements the rule, we assume that the CBOE also receives its away market data from OPRA and is subject to the same risk that the data on which the system depends might experience delays. We therefore assume that the CBOE included the disclaimer "as such best bids and offers are identified in RAES" for the same reason we included the language in our rule, so that market participants would understand the nature of the protection its system provides. The flimsiness of this CBOE argument again demonstrates that the main purpose behind its comment letter is to raise any and all issues it can identify, regardless of merit, to delay our entry into the market and to maintain its own competitive advantages under the current anticompetitive market structure.

Finally, it is important for the Commission to note that, in all respects, the obligation of our PMMs to protect orders against better prices in other markets is the same as or exceeds that of our competitors. Unlike the market for stocks, there is no linkage between the markets, and thus no rules that prohibit an options exchange from trading through another exchange's quote. Nevertheless, competitive realities have led all options markets to address potential trade-throughs. On our market, a PMM must determine how to handle an order in a manner consistent with its market maker responsibilities, and firms must determine whether to route orders to the ISE based upon their best execution obligations. Whether a PMM determines to match a better price in another market is subject to the same regulatory scrutiny as at any other options exchange. This is a competitive issue in that broker-dealers will not route customer orders to the ISE if our PMMs do not provide competitive intermarket price protection.

The comments on "price protection" are a prime example of where certain commentators suggest that the Commission should use the ISE's registration as a vehicle to cure all the ills of the current options market structure. However, as should now be clear, the real interests of these commentators is not to cure the ills of the market, from which they

benefit, but to stem competition. We have repeatedly expressed our willingness to work towards an improved options market structure. We believe that the time is right to consider such concepts as industry-wide firm quotes, an intermarket linkage, and enhanced trade-through protection. However, until these structural changes become reality, we cannot be held to a higher standard than the existing exchanges.

D. Market Maker Quotes

Various comments question our quotation practices and our use of the industry-wide "trade or fade" practice. Our quotation rules are the most sophisticated and competitive of all the options markets, and provide many of the enhancements to the options market that Chairman Levitt recently raised for industry-wide consideration. Indeed, the ISE will be the first exchange to require independent quoting by its market makers, with each market maker being responsible for determining its own quotation prices according to the market maker's own determination of variables (such as volatility) entered into its own options pricing model. We believe that requiring competitive quotations within our market will result in greater liquidity at narrower quotation spreads.

As to our "trade or fade" rule, this is the unfortunate practice that currently operates on all the options markets.[63] Nevertheless, we believe that we have applied this rule to our market in a way that improves upon industry practice. For example, our quotes are firm for customer orders for the full size displayed, not a pre-set number as in the other markets. However, as in the other markets, our market makers are not required to trade with non-customer orders at their quoted price so long as they "fade," or change, their quote. Accordingly, the displayed ISE BBO may not be available for non-customer orders.

Our system enables market makers to set parameters establishing the amount of their quotation size that will be available for execution against non-customer orders, with the system automatically executing non-customer orders according to these parameters. Where a marketable non-customer order cannot be executed entirely, the system automatically moves a market maker's bid down or offer up, even though there may be additional size at the current price available for customer orders. This is in marked contrast to the "second look" process on floor-based exchanges, where the trading crowd has an opportunity to consider whether to trade with a non-customer order after it is brought to the trading post. We believe that the "second look" practice raises questions regarding the fairness of a market, and we view our rules and procedures as a vast improvement over current industry practices.

As to "trade or fade" practices generally, we view this practice as troublesome, as well as a significant impediment to the growth and vitality of the options markets. However, as opposed to quotations in underlying equity securities, options quotes are not required to be firm under the Commission's "Firm Quote Rule," Rule 11Ac1-1 under the Act, because options are not "subject securities" as defined in that rule. Thus, each options market must determine the degree to which quotes in its market are firm.

[63] *E.g.,* CBOE Rule 8.51(b).

Chairman Levitt, in his recent letter to the options exchanges raising concerns regarding the current options market structure, recognized that the "trade or fade" rules were outdated. Specifically, he stated that "[e]nhanced market transparency measures, such as firm quotes for all market participants with quote size information, also appear possible." We agree with Chairman Levitt, and responded to his letter by stating that:

> [options] quotes should be firm for all market participants and we will encourage our market makers to have firm quotes for all. However, until this is an industry-wide practice, the ISE quotes will be firm only for customer orders. In addition, the ISE will be the first options exchange to publish the size of its quotes. Indeed, the ISE will reward market makers who publish larger quotes, since the size of a market maker's quotations is a critical factor in allocating trading interest in our matching algorithm.[64]

The competitive reality is that we cannot unilaterally adopt a firm quote rule at this time. Such a rule would put an automated market like the ISE at an extreme competitive disadvantage since we would provide our competitors faster and more efficient access to our market than they would provide to us. Nevertheless, as industry practices change or competitive considerations warrant, we will continue to evaluate whether the ISE should change its rules in this area.

E. ISE BBO Size

The CBOE and Amex raise questions and concerns regarding our execution guarantees for customers and the manner in which we have integrated quotation size into our market. We appreciate our competitors' confusion in this area since quotation size is a concept foreign to the other options markets, which traditionally have not displayed a size associated with their quotations.

By way of background, while the options exchanges do not disseminate quotation size, they have rules that require their market maker crowds to be firm for public customer orders for a specified number of contracts at the displayed bid and offer.[65] This traditionally has been 10 contracts, although some markets are increasing the size of this guarantee for some options series. Thus, when an exchange's best bid or offer is disseminated, a public customer can assume that the price is good for at least the guaranteed size, although in some cases the exchange's crowd might have committed to be firm for a greater number of contracts. While the ISE will be firm for a customer order for the aggregate size of the ISE BBO, it currently is not clear whether vendors will be able to widely disseminate the ISE BBO size. Accordingly, at least until the ISE's size can be widely disseminated, for competitive reasons the ISE has determined that its BBO will be firm for at least 10 contracts. However, as discussed below, we expect that the ISE generally will have depth greater than the execution guarantees offered by some of the trading crowds on the existing exchanges.

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[64] ISE Response Letter, *supra* note 7.

[65] *E.g.*, CBOE Rule 8.51(a).

Our rules give the PMM the responsibility to assure that the ISE BBO is firm for at least 10 contracts.[66] This responsibility arises when the ISE receives a public customer limit order for fewer than 10 contracts that would improve the ISE BBO.[67] In that case, the PMM will determine whether the order is executed or displayed, according to parameters pre-set by the PMM based upon the size of the order and the amount by which the order improves upon the PMM's quote. When an order is displayed, the system displays 10 contracts, with the PMM being responsible for the difference between the size of the customer order being displayed and 10 contracts. The same occurs when a public customer order for 10 or more contracts is alone at the ISE BBO and is partially executed so that the size of the order is reduced below 10 contracts. In this case, the remaining portion either will be executed automatically according to the PMM's pre-set parameters or continue to be displayed, with the PMM being responsible for the difference between the size of the customer order and 10 contracts.

The 10 contract guarantee is a burden for the PMM because, in the case of a customer buy order, the PMM either automatically sells at a price that is lower than its offer or puts itself at risk to buy at a price that is higher than its bid. While imposing this burden on the PMM is necessary with respect to public customer orders, it would not be appropriate to require the PMM to provide the same service to other market professionals. Accordingly, our rules provide that non-customer orders that would cause the size of the ISE BBO to be for fewer than 10 contracts will be rejected. This does not mean that all non-customer orders must be for 10 or more contracts. Rather, it only means that if a non-customer wants to improve upon the ISE BBO, it must do so for at least 10 contracts.

We anticipate that the 10 contract guarantee will be more of a "fail-safe" provision than a common occurrence on our market due to our independent quotation system and the dissemination of quotation size. Since each market maker must independently quote within spread requirements and all quotes must have a size of at least 10 contracts upon entry, simple math would indicate that it is likely that our market regularly will have significant size, depending on the number of market makers quoting at the BBO. Moreover, if the PMM and CMMs want to guarantee a certain size market for competitive reasons, all they have to do is increase the size associated with their quotes. Thus, we view it as likely that we will not often have to use the 10 contract guarantee.

F. Execution Algorithm

The CBOE comment letter contains an extensive criticism of our proposed execution algorithm. The CBOE seems intent in micro-managing how we conduct business and the incentives we have established to provide liquidity in our market. The extent to which each options exchange reaches the right balance of incentives and obligations among

[66] ISE Rule 803(c)(1).

[67] This responsibility arises only when the aggregate ISE best bid or offer falls below 10 contracts, not when the size of an individual quote or order falls below this level. Accordingly, multiple quotes or orders for fewer than 10 contracts may be on the orderbook at the ISE BBO without creating the need for special rules, so long as in aggregate the size of the ISE BBO is equal to or greater than 10 contracts.

professional market participants is an integral part of competition among the exchanges. Indeed, the allocation of executions among professional participants on the ISE is relevant to the CBOE only to the extent that our proposal has a competitive impact on it if market participants prefer our approach. Moreover, as discussed below, the CBOE's criticism is largely based on a lack of understanding of our system.

The ISE is introducing a number of concepts that are new to the options market, and that we believe are significant improvements to the market. First, we will be the only options market that permits the entry of non-customer orders on its orderbook, and that includes such orders in its execution allocations. In addition, as discussed above, we will have competitive quotations in size. Our execution algorithm reflects these features, along with certain basic principles, such as providing that public customer orders will always have priority at a given price. Our execution algorithm works as follows:

- All customer orders must be executed entirely before any market maker quotes or professional orders;
- A market maker quote or professional order must be at the best price to participate in an execution;
- A market maker quote or professional order never executes in an amount greater than the number of contracts in the quote or order;
- CMM quotes and professional orders are handled in size priority, receiving an allocation based upon their proportion of the inside volume;
- A PMM receives a somewhat greater allocation of an execution to reflect the greater obligations of a PMM compared to CMMs; and
- The PMM trades against an entire order up to a stated minimum "odd lot" size.

We designed this algorithm to reflect the unique features of our automated trading system and to encourage vigorous quote competition based on price and size. Specifically, market makers must be quoting at the best price to participate in an allocation. Thus, a market maker will maximize the number of contracts it executes by improving upon the ISE BBO. Moreover, unlike floor-based trading, there is no opportunity for market participants to "step-up" their bids or offers to participate in a trade only after they know about an order, nor is there an opportunity to make allocations in an unfair or arbitrary manner.

We based our trading algorithm on size priority, rather than time priority (other than for customer orders), as the proper course for an electronic derivative market. Size priority encourages market participants to add liquidity to the market. In contrast, time priority creates a "race" to enter trading interest first. This is especially problematic in an electronic market, where entering an order one micro-second (1/100 of a second) ahead of another order is possible and would provide absolute priority for the first order that arrives. It also is problematic in a derivative market, where the price of a quote or order is based, in large part, on the price of the underlying instrument. A time-priority system

would create incentives to create super-fast auto-quoting mechanisms located near the ISE's host system. This is not the type of competition we seek to encourage. Moreover, time priority also rewards market participants who fade their quote first. The first member to move its quote away from the inside market would have priority over members that stay at a better price longer, and then "fade." Again, these are not the incentives we seek to build into the ISE.[68]

One aspect of our trading algorithm that particularly seems to bother both the CBOE and the Amex involves our "odd lot" system, a system these markets obviously misunderstand. Instead of using the algorithm described above to allocate small customer orders among market makers and professional orders, if the PMM is quoting at the BBO for a sufficient number of contracts – and there are no public customer orders at the best price – our algorithm allocates the entire order to the PMM. Since market makers must be quoting at the best price at the time an order is entered to participate in an allocation, the CBOE is incorrect when it states that this aspect of the allocation algorithm would act as a disincentive to other market participants to improve the ISE BBO. Indeed, if a market participant other than the PMM improves the BBO, that market participant will execute against incoming orders, whether the incoming orders are for three or 100 contracts. If a PMM decides to match the improved price, that will add greater liquidity to our market, which we view as positive for our market.

We find it particularly disingenuous for the CBOE to reference its own designated primary market maker ("DPM") participation rights in the context of our execution algorithm and to imply that it is changing those rights for regulatory reasons. It appears to us that the CBOE is seeking to reduce DPM participation rights as part of its sales efforts to encourage its market maker crowds to adopt a DPM system for all of its trading posts. Establishing appropriate trade allocations among professionals requires balancing the interests of different exchange participants. We have done so based on our judgment as to what is best for our market, and we expect the CBOE to do the same for its market.

G. Block Order Mechanism

While members can enter orders of any size into the ISE system, we have designed a way for brokers to anonymously solicit liquidity for the execution of larger-size orders (that is, 50 contracts or more). This facility is called the Block Order Mechanism.[69] As with orders handled by a broker on any other options exchange, a broker (in the case of the ISE, an EAM) will determine how best to handle a customer order. That is, the EAM may, but is not required to, use the Block Order Mechanism, which is our vehicle to solicit liquidity from other market participants. This is similar to a broker who decides to represent a customer order at a trading post on a floor-based exchange instead of entering the order into an exchange's electronic order routing system.

[68] While our competitors question our decision to base our trading algorithm on size priority rather than time priority for professional orders, we note that no options exchange currently uses time priority to allocate trading interest in its crowds.
[69] ISE Rule 716.

The Block Order Mechanism operates as follows: An EAM enters the block order along with a limit price, but specifies exactly what information will be disseminated to the market. The ISE then broadcasts an anonymous message to the market makers assigned to that options class, as well as other broker-dealers bidding or offering in the particular options series at the BBO. We view this as the trading "crowd" for the option.[70] The members of the trading crowd then have a specified amount of time to respond to the message. The responses are internal to the system and are not disclosed to any market participants (including the EAM entering the order). At the end of the response period, the order will automatically be executed, unless there is insufficient size to execute the order consistent with the terms of the order (a fill-or-kill limit order, for example, must be executed in full at the limit price or better).

The CBOE raises concerns regarding the Block Order Mechanism, focusing on the possible execution of orders outside the BBO. The CBOE raises two concerns in two contexts: First, that small customer orders on the ISE may be executed outside the BBO, and, second, that the block order itself may be executed outside the BBO. These comments are baffling and reflect either a misreading of our rules or a fundamental misunderstanding as to how markets operate. Due to the larger size of the orders and unique nature of the Block Order Mechanism, the execution price of a block order executed in this facility may be outside the BBO. In that case, however, better-priced quotes and orders in the orderbook have priority, and receive protection by being executed at the block price. As on every other exchange that provides block protection, orders and quotes on the orderbook are executed at a price better than both the stated price of the order or quote and the BBO, not a worse price. This is the same case for responses to the broadcast, which are treated the same as orders and quotes on the orderbook (that is, the same priority and allocation rules described above are applied to block order responses). Thus, small customer limit orders on the ISE will be executed a price superior to the limit price if a block order is executed outside the BBO.

With respect to the lack of intermarket price protection for the person entering the block order, the CBOE again shows an apparent lack of understanding of market mechanisms. Block trades are larger-size orders that often need liquidity outside the BBO to be executed in full. Thus, customers buying or selling blocks may well purchase options above the offer or sell below the bid. This is an order-by-order judgment that a customer and its broker must make. Indeed, as discussed above, a broker that executes an order on the ISE, like on any other exchange, is subject to a duty to achieve best execution for the customer. In addition, we note that the Block Order Mechanism is a tool for brokers working larger-size orders and requires a manual, order-by-order input. Fifty contracts is merely a minimum requirement for the size of an order or a portion of a larger order that

[70] While the CBOE criticizes what it views as the limited distribution of this broadcast, we believe that this accurately captures those ISE members who have expressed an active interest in trading the options series. This also creates another incentive for members to enter trading interest at the BBO, adding additional liquidity at that price.

may be entered into the mechanism.[71]

H. Facilitation Mechanism

The Facilitation Mechanism[72] operates in a manner similar to the Block Order Mechanism. It is a voluntary system into which an EAM may enter a block-size customer order if the EAM wants to execute the order as principal. As discussed in detail below, an EAM is not otherwise permitted to execute an agency order as principal unless the agency order is first permitted to interact with other interest on the Exchange. After an order is entered into the Facilitation Mechanism, the ISE sends a facilitation broadcast to the members of the same trading "crowd" as described above, which have a limited amount of time to respond.[73] The broadcast contains full information on the terms and conditions of the order, including the facilitation price. The identity of the EAM that entered the order is not disclosed.

The facilitation order will be executed at the facilitation price unless there is sufficient interest on the ISE orderbook to execute the order in its entirety at a better price. If the order is executed at the facilitation price, any better priced orders or quotes on the orderbook receive price protection in the same manner as the Block Order Mechanism, and thus will be executed at the price of the facilitation order. An EAM entering a block size order into the Facilitation Mechanism is guaranteed to execute a minimum portion of the order. All better-priced trading interest on the central orderbook (that is, higher priced bids or lower priced offers than the facilitation price) and any public customer orders at the facilitation price have priority and are always executed at the facilitation price ahead of the facilitating member.[74]

Contrary to the Amex's claim, there is an ability for a member to enter trading interest to provide a facilitation order a better price. To do so, that member can enter an improved quote or order in the ISE orderbook. We adopted this approach – rather than permit responses to be at price superior to the facilitation price. Requiring a member to enter an order into our system will put the member "at risk," since all market participants would see, and have the ability to trade with, the better-priced order. This provides the

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[71] The CBOE's concern that the Block Order Mechanism will be used to execute a large percentage of small customer orders without the benefit of away market price protection is without basis. First, it is not possible, nor would it make sense, for a firm to automatically route orders through the mechanism, particularly considering that an execution will be delayed by the time allowed for market makers to respond to the broadcast message. Second, the average size of customer orders in equity options is less than 10 contracts. Thus, a very small percentage of customer orders will even be eligible for execution through the Block Order Mechanism.

[72] ISE Rule 716.

[73] *See supra* note 70.

[74] ISE Rule 716 has been amended to indicate that the facilitating firm is entitled to a percentage of the original order size, rather than a percentage of the size remaining after execution of better-priced interest and public customer orders at the facilitation price. This is consistent with the CBOE's proposed facilitation rule. Securities Exchange Act Release No. 41609 (July 8, 1999). Other non-substantive changes also have been made to Rule 716.

facilitating firm with an opportunity to consider whether it is willing to facilitate the customer order at that better price. In this case, the firm entering the facilitation order has at least 10 seconds to cancel the facilitation order and to reenter it at the improved price.[75]

We can understand the concerns of the Amex, CBOE and Amex market makers with our proposed Facilitation Mechanism, since this is our competitive response to the rules of the existing options exchanges that significantly hamper the ability of a firm to provide liquidity in facilitating customer orders. While it is critical to our market structure to assure that members do not internalize their customer order flow on the ISE, we also recognize that many "upstairs" firms provide significant liquidity to customers seeking to execute large-size orders. The rules of the existing options markets hamper this by permitting the trading crowd to step ahead of the upstairs firm to execute the entire order when they assess that it might be profitable. Because of this, upstairs firms often will complete OTC options transactions instead of bringing the deal to an exchange.

The purpose of the Facilitation Mechanism is two-fold: It automates the process that occurs on the floor of the options exchanges today, and it provides incentives to EAMs to bring their larger-size transactions to the Exchange. We accomplish the latter by limiting the amount of the order that can be intercepted by other professionals in the trading crowd. This also has the benefit of giving public customers an opportunity to participate in these larger transactions. We do not believe that this is a vehicle that could be used generally to internalize customer orders since, similar to the Block Order Mechanism, the Facilitation Mechanism is a manual process for larger orders that takes some minimum time to execute. Thus, it would not be practical for firms to internalize every order of 50 or more contracts through the mechanism.

I. Limitations on EAMs and Non-Customer Orders

Commentators questioned certain rules we propose limiting the entry of orders, both by customers and EAMs. The CBOE in particular appears to believe that these limitations will favor market makers at the expense of other market participants.[76] We appreciate the CBOE's diligence in ensuring that we strike the appropriate balance in establishing the rights and obligations of our members. However, with due respect to their judgment, we are willing to let the market test whether we have struck the right balance. The CBOE comments fail to recognize the significant benefits that we provide both EAMs and

[75] The CBOE recently proposed to permit brokers to cross agency and facilitation orders of over 500 contracts, with a guarantee of up to 40 percent of the order. Securities Exchange Act Release No. 41609 (July 8, 1999). In a separate filing, the CBOE also proposed a new contingency order type "Cross-Only Orders," which would permit a broker to withdraw a proposed cross if "the crowd does not allow the cross." Securities Exchange Act Release No. 41610 (July 8, 1999). This appears to reach the same result as the ISE requirement that crowd participants give a broker an opportunity to cancel the facilitation order if it is not going to have an opportunity to execute against the order.

[76] Other commentators argued that certain of our rules, such as the Facilitation Mechanism, inappropriately favor EAMs. We take significant comfort in the fact that we are being criticized for favoring each of our classes of members. If anything, this confirms our desire to strike an appropriate balance in our rules.

customers in our market, and the limitations that are necessary on their activity to protect the integrity of the market.

As to the benefits for EAMs, the ISE will be the only options exchange that will permit broker-dealers to enter non-customer orders on its orderbook in every options class traded on the Exchange, and without any maximum limits on the size of such orders that may be entered. EAMs can enter these orders anonymously, and their orders at the BBO will have equal standing with CMMs in execution allocations, as described above. Accordingly, we are providing broker-dealers with unprecedented access to our options market. However, providing this extensive form of access to non-customer orders on an electronic exchange requires us to implement certain safeguards to maintain the integrity of our auction market structure, as well as to assure the quality of executions on the Exchange.

1. Limits on Internalization

First, as discussed above, it is important that EAMs not be permitted to act as dealer for order flow on a regular basis. This could happen on our Exchange if an EAM could enter nearly simultaneous customer and proprietary orders before there is an opportunity for the customer order to interact with other trading interest on the Exchange. Permitting EAM firms to act as dealer for their own customer order flow would not be consistent with an auction market structure and would discourage active quote competition, since dealers would no longer need to bid or offer in the market to execute against orders. On the other hand, as discussed above, we needed to provide a mechanism by which firms could provide liquidity to the market to facilitate the execution of large orders. This required us to adopt rules balancing these diverse interests.

We balanced these interests by adopting our Facilitation Mechanism, which we described in detail above. However, to assure that an EAM does not attempt generally to act as a dealer for its customer orders, we needed to prohibit an EAM from executing, as principal, an order it represents as agent unless the order is first given an opportunity to interact with other trading interest on the Exchange. At the same time, we recognized that if an EAM were bidding or offering in the market for some length of time, the EAM would be indicating a willingness to provide liquidity to the entire market place. In this circumstance, the EAM should not be restricted from trading against its own customer orders at the same price at which it was willing to trade with other market participants.

Again, we balanced these interests by establishing two minutes as the amount of time that an order should be on the orderbook prior to an EAM executing against its own agency orders.[77] We believe that two minutes is an appropriate amount of time to give orders an opportunity to benefit from interacting with other trading interest in our auction market system, as well as to give other market participants an opportunity to trade with an EAM

[77] ISE Rule 717(d). Rule 717(d) states that agency orders must be "exposed" on the Exchange for at least two minutes before an EAM could execute the order as principal. The only way in which an order can be exposed to other trading interest on the Exchange is for the order to be entered into the orderbook.

at the price at which the EAM is willing to trade with its own customer orders. As we gain experience with this rule, the Exchange will evaluate whether the time period should be adjusted.[78]

2. Limits on Solicited Orders

As discussed immediately above, other than for block facilitations, we do not allow EAMs to cross orders on the Exchange. However, because an EAM effectively could accomplish this goal by entering two orders nearly simultaneously, we adopted the limitation on EAMs trading, as principal, against their own customer orders without first exposing such orders to other trading interest on the Exchange. With one exception, there is no similar limitation on EAMs crossing two agency orders. That exception, which parallels the rules of all the existing options exchanges,[79] limits the ability of an EAM to execute solicited orders.[80] Specifically, an EAM must give its agency orders an opportunity to interact with trading interest on the Exchange before executing such orders against orders the EAM solicits from other broker-dealers.[81]

Our limit in this area is more narrowly crafted than similar rules of other options exchanges. While some existing options exchanges limit crossing agency orders with any solicited orders – including orders solicited from public customers – we see no reason to restrict customer-to-customer executions, and thus we have not adopted any limits on such executions. This is yet another example of how we provide EAMs with greater flexibility than is currently available to them elsewhere. Again, we have carefully balanced the interests of EAMs and market makers on the ISE and have created a system that does not favor one class of market participants over another.

[78] Any adjustment to the time period would, of course, require a Form 19b-4 filing with the Commission.
[79] *See, e.g.,* CBOE Rule 6.9.
[80] ISE Rule 717(e).
[81] Orders are generally solicited from broker-dealers only as part of a large transaction. A broker that solicits orders from another broker-dealer to execute against an agency order normally is seeking to find liquidity for its customer.

3. Limits on Market Making

We also adopted rules to prevent EAMs from effectively conducting market making activity on the Exchange. As described above in our discussion of membership structure, the integrity of our market depends on, among other things, ensuring that market making on the Exchange is performed only by PMMs and CMMs, who have affirmative market making obligations, such as providing continuous quotations in both favorable and unfavorable market conditions. Accordingly, the ISE rules provide that EAMs may not enter limit orders that are used effectively to quote and make markets on the ISE.[82]

The ISE uses a definition of the term "market maker" based on the definition in Section 3(a)(38) of the Act. Specifically, an EAM will violate our rules by holding himself out as willing to buy and sell contracts in an options series on a regular or continuous basis. Noting the lack of specificity in that rule, we included factors that we will take into consideration when evaluating whether a person has engaged in market making in violation of the Rule.

4. Limits on Electronic Generation of Orders

Preserving the integrity of our electronic auction market requires us to prohibit EAMs from entering orders that are created and communicated electronically.[83] Indeed, allowing the entry of such orders would undermine our careful balancing of interests between market makers and EAMs and could well threaten our market structure.

First, a system that generates orders electronically essentially would be an automatic quotation system, and, as discussed in detail above, only ISE market makers are allowed to quote on our market. This is fundamentally different from the other options markets, each of which has an automated system that generates only one quotation in an option. In contrast, we give all our market makers the right – indeed, impose on them the obligation – to generate quotes. Thus, the use of automated quotation generation systems are integrally tied to our market making system, and we must limit the use of such systems to our market makers.[84]

In addition, allowing the automatic generation of orders could undermine the quality of our market by penalizing market makers who seek to narrow spreads. Specifically, market makers may well avoid making narrow markets for fear that automatic order-generation systems will hit their quotes a micro-second before the market makers' own automatic quotation system is able to react to a change in the underlying price. This concern is unique to an electronic derivative market such as the ISE.

On the floor-based exchanges, a crowd-based quote is changed instantaneously when the price of an underlying security changes; the autoquote system on the exchange need not

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[82] ISE Rule 717(b).
[83] ISE Rule 717(f).
[84] Our rules do not prohibit the use of options pricing models. Rather, they simply limit the ability for a non-market maker participant from using an options pricing model in a system that automatically generates orders and automatically communicates those orders to the Exchange.

communicate the new quote through a network for it to be "live." In contrast, all orders that are sent to the trading post following the price change of the underlying security must be communicated to the floor through some form of network. By the time the order arrives, the quote has been changed. This creates a structural safeguard against a system generating orders in competition with an autoquote system, with a "race" to see which trading interest enters the system first.

The current floor-based system differs significantly from the ISE's electronic trading system. As discussed above, our market makers will send their quotes to the ISE through the same network that EAMs will use to send orders to the Exchange. Thus, absent our proposed rule, market makers will have to "race" to get their quotations to the ISE prior an EAM's electronically-generated orders. In effect, an electronic system creates a danger that the market will become a contest of who has the fastest system, rather than rewarding market participants that improve the market and provide liquidity to the public. The design of our market requires that we create incentives for improving quotes and providing liquidity, rather than create incentives to build "fast" systems.

5. Limits on Market Orders

Our rules also prohibit non-customers from entering market orders.[85] This is because, in an electronic system, market orders have the potential to create market volatility by trading at different price levels until executed in their entirety. This is less of a concern for public customer orders, whose average size tends to be lower than non-customer orders. We also address this potential concern by having a system in which market makers provide depth at different price levels, as well as through intermarket price protection.

However, these protections do not apply to non-customer orders because quotes are not necessarily firm for these orders and there is no intermarket price protection for these orders. In balancing the costs and benefits of allowing non-customers to enter market orders into the ISE orderbook, we discussed the issue with various options market participants, including potential EAM and market maker members. They indicated that non-customers very rarely, if ever, use market orders to trade listed options. Thus, we determined that the potential positive effects on our market that would result from prohibiting non-customer market orders outweighed the minimal practical effect on non-customer market participants. We believe that this balancing of interests by an exchange is entirely appropriate and fully complies with all the requirements of the Act.

Our decision to prohibit non-customer market orders also required that we address marketable limit orders (orders to buy priced at or above the offer, and orders to sell priced at or below the bid), which can be the practical equivalent to market orders. Accordingly, the ISE rules initially provided that a non-customer limit order that crossed the market by more than two trading increments would be rejected unless the entire order could be executed at the best bid or offer. After exploring further programming that would allow us to better achieve our goal, we have determined to amend our rules to

[85] ISE Rule 717(a).

provide that non-customer limit orders that cross the market will be rejected only if they cannot be *executed* within two trading increments of the best bid or offer (as applicable).

J. Opening Rotations and Fast Markets

The CBOE requested that we explain "what an opening rotation is and what the PMM's role is in conducting the opening rotations." To put it simply, an opening rotation is exactly the same thing as on every other options exchange. As we provided in Exhibit N to our Form 1 filing, the PMM will conduct an opening in each options series based on an algorithm that determines whether a series can be opened at a single price where all market orders are executed in full. If a single price opening is possible, the series can be opened by the PMM. If there is an order imbalance, a single price opening is not possible and the series cannot be opened. In this instance, the market makers appointed to the options class have the responsibility to provide additional liquidity to offset the order imbalance. Once the order imbalance is offset so that a single price opening is possible, the series can be opened. Public customer orders are given priority in the opening algorithm, as they do in every other transaction executed on the ISE.

We handle fast markets in a manner similar to the opening. Our system accumulates buying and selling interest and determines the price at which the most number of contracts can be executed. This essentially is what happens on the existing exchanges when they call a fast market and turn off their automatic execution systems: Orders build-up and executions are slowed so that order imbalances can be handled in an orderly fashion. As on all other exchanges, ISE quotes are not firm during fast markets. However, contrary to the CBOE's assumption, the ISE will continuously update its quotations during fast markets.

VII. Conclusion

The majority of the comment letters urged the Commission to approve our application as quickly as possible. These commentators recognize that the ISE will provide, for the first time, true competition in the U.S. options markets. They also correctly note that our electronic agency-auction market will enhance market transparency and liquidity, decrease spreads and benefit investors. These are the comments of people who use the options markets and who seek to improve the current market structure.

In contrast, a minority of commentators urge the Commission to reject our application, either outright or by increasing the already formidable procedural hurdles that we face. It is not surprising that eight of these commentators represent the entrenched interests in today's options market (assuming that the one commentator traveling incognito is an existing market maker). The other commentator is an electronic communications network seeking to protect its own regulatory interests. It is hardly surprising that the users of the options markets support us, while our competitors oppose us. Every day that existing market participants delay our start-up is another day that they benefit from the current market structure.

Those objecting to our application have not raised a single meritorious issue. Rather,

they purposely misread our Filing, raise phantom objections and elevate irrelevant minutiae to be matters of crisis proportion. We urge the Commission to reject this blatant attempt to preserve the current anticompetitive options market structure. Rather, the Commission should move quickly to approve our application and to demonstrate that it will not tolerate self-serving attempts to prevent the growth of competition in the options market.