

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 19b-4

Proposed Rule Change

By

International Securities Exchange, Inc.

December 17, 2003

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

Consists of 12 Pages

1. Text of the Proposed Rule Change

(a) The International Securities Exchange, Inc. (the "Exchange" or the "ISE") is proposing to amend the procedures for executing stock-option orders under Rule 722.

(b) Inapplicable.

(c) Inapplicable.

2. Procedures of the Self-Regulatory Organization

(a) The Exchange's Board of Directors approved this proposed rule change on September 18, 2003. This action constitutes the requisite approval under the Exchange's Articles of Incorporation and Constitution.

(b) The following person on the staff of the Exchange is prepared to respond to questions and comments on this proposed rule change:

Katherine Simmons
Vice President and Associate General Counsel
(212) 897-0233

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

(a) Purpose – The Exchange proposes to enhance the execution of stock-option orders in two respects: (1) to automate the transmission of the stock legs of a stock-option combination order to a broker-dealer on behalf of members; and (2) to allow for the pricing of the options legs of stock-option combination orders in penny increments.

Automatic Transmission of Stock Legs

Supplementary Material .01 to Rule 722 currently describes a manual procedure by which a stock-option order may be executed on the Exchange. This manual procedure requires each party to a stock-option trade to take steps immediately to transmit the stock leg of the order to a non-Exchange market for execution. The Exchange proposes to offer an automated process for the communication of stock-option orders by electronically transmitting the orders related to the stock leg(s) for execution on behalf of the parties to the trade. In order to participate in this automated process for stock-option orders, each member will be required to enter into a customer agreement with the designated broker-dealer. In addition, each member will be responsible for whatever fees and other charges the designated broker-dealer imposes for executing the trades. The ISE will not receive any fees related to the stock portion of the stock-option trade. Members will be able to continue using the current manual procedure for execution of stock-option orders if they choose.

The electronic communication of the orders by the Exchange eliminates the necessity for each party to the trade to separately communicate orders to the broker-dealer for execution, thereby making the process more efficient. Once the orders are communicated to the broker-dealer for execution, the broker-dealer has complete responsibility for determining whether the orders may be executed in accordance with all of the rules applicable to execution of equity orders, including compliance with the applicable short-sale, trade-through and trade reporting rules. As with the current manual procedure, if the broker-dealer cannot execute the equity orders at the designated price, the stock-option combination order will not be executed on the Exchange.

Penny Pricing For Options Legs of Stock-Option Orders

Because the options leg of a stock-option order must be executed in \$.05 increments (for options trading below \$3) and \$.10 increments (for options trading at or above \$3),¹ while the stock leg of a stock-option order trades in \$.01 increments, it is not always possible to achieve a proposed net price for stock-option orders. For example, suppose an investor proposes to buy stock and sell options at a net price of \$8.50. If the stock is \$11.72 bid to \$11.74 offered, and the option is \$3.20 bid to \$3.30 offered, a net price of \$8.50 cannot be achieved without executing the option leg at \$3.22, \$3.23, or \$3.24.² Therefore, we propose to allow for the execution of the option legs of stock-option combination orders in one-cent increments to allow investors greater opportunities to receive execution of their stock-option orders. Options legs of a stock-option order will continue to be reported through OPRA with a code that indicates that the trade was part of a complex order. The actual price of the trade will be reported.

(b) Basis – The ISE believes that the rule change is consistent with the Securities Exchange Act of 1934 (the "Act") in general, and Section 6(b)(5) in particular. The proposed rule change is intended to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. The automated procedure for transmitting the stock leg of a stock-option order will provide a more efficient means for members to execute orders, and the execution of the options leg of a stock-option order in \$.01 minimum increments will improve investors ability to receive execution of their orders.

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

This proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

¹ ISE Rule 710.

² To execute the order within the bid and offer for the stock and the option, a net price of \$8.50 could only be achieved by (1) executing the stock at \$11.72 and the option at \$3.22 (\$11.72 – \$8.50); (2) executing the stock at \$11.73 and the option at \$3.23 (\$11.73 – \$8.50); or (3) executing the stock at \$11.74 and the option at \$3.24 (\$11.74 - \$8.50).

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

6. Extension of Time Period for Commission Action

The Exchange does not consent to an extension of the time period specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule change Based on Rules of Another Self-Regulatory Organization or of the Commission

This proposed rule change is not based on the rules of another self-regulatory organization or of the Commission.

9. Exhibits

Exhibit A – Text of the Proposed Rule Change.

Exhibit 1 – Form of Notice of Proposed Rule Change for Publication in the *Federal Register*.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the self-regulatory organization has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

International Securities Exchange, Inc.

By: Michael J. Simon
Senior Vice President, General Counsel and Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-ISE-2003-37)

[Date]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by
International Securities Exchange, Inc., Relating to Stock-Option Orders.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),¹
and Rule 19b-4 thereunder,² notice is hereby given that on October , 2003, the
International Securities Exchange, Inc. (the "Exchange" or the "ISE") filed with the
Securities and Exchange Commission the proposed rule change as described in Items I,
II, and III below, which items have been prepared by the self-regulatory organization.
The Commission is publishing this notice to solicit comments on the proposed rule
change from interested persons.

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

The Exchange is proposing to amend Rule 722 to automate the procedure for
executing the stock leg of a stock-option order and to allow for the execution of the
options leg of a stock-option order in \$.01 increments. The text of the proposed rule
change is available from the Office of the Secretary of the Exchange, and from the
Commission.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in sections A, B and C below, of the most significant aspects of such statements.

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

Purpose – The Exchange proposes to enhance the execution of stock-option orders in two respects: (1) to automate the transmission of the stock legs of a stock-option combination order to a broker-dealer on behalf of members; and (2) to allow for the pricing of the options legs of stock-option combination orders in penny increments.

Automatic Transmission of Stock Legs

Supplementary Material .01 to Rule 722 currently describes a manual procedure by which a stock-option order may be executed on the Exchange. This manual procedure requires each party to a stock-option trade to take steps immediately to transmit the stock leg of the order to a non-Exchange market for execution. The Exchange proposes to offer an automated process for the communication of stock-option orders by electronically transmitting the orders related to the stock leg(s) for execution on behalf of the parties to the trade. In order to participate in this automated process for stock-option orders, each member will be required to enter into a customer agreement with the designated broker-dealer. In addition, each member will be responsible for whatever fees and other charges the designated broker-dealer imposes for executing the trades. The ISE

will not receive any fees related to the stock portion of the stock-option trade. Members will be able to continue using the current manual procedure for execution of stock-option orders if they choose.

The electronic communication of the orders by the Exchange eliminates the necessity for each party to the trade to separately communicate orders to the broker-dealer for execution, thereby making the process more efficient. Once the orders are communicated to the broker-dealer for execution, the broker-dealer has complete responsibility for determining whether the orders may be executed in accordance with all of the rules applicable to execution of equity orders, including compliance with the applicable short-sale, trade-through and trade reporting rules. As with the current manual procedure, if the broker-dealer cannot execute the equity orders at the designated price, the stock-option combination order will not be executed on the Exchange.

Penny Pricing For Options Legs of Stock-Option Orders

Because the options leg of a stock-option order must be executed in \$.05 increments (for options trading below \$3) and \$.10 increments (for options trading at or above \$3),³ while the stock leg of a stock-option order trades in \$.01 increments, it is not always possible to achieve a proposed net price for stock-option orders. For example, suppose an investor proposes to buy stock and sell options at a net price of \$8.50. If the stock is \$11.72 bid to \$11.74 offered, and the option is \$3.20 bid to \$3.30 offered, a net price of \$8.50 cannot be achieved without executing the option leg at \$3.22, \$3.23, or \$3.24.⁴ Therefore, we propose to allow for the execution of the option legs of stock-

³ ISE Rule 710.

⁴ To execute the order within the bid and offer for the stock and the option, a net price of \$8.50 could only be achieved by (1) executing the stock at \$11.72 and the option at \$3.22 (\$11.72 – \$8.50); (2) executing the

option combination orders in one-cent increments to allow investors greater opportunities to receive execution of their stock-option orders. Options legs of a stock-option order will continue to be reported through OPRA with a code that indicates that the trade was part of a complex order. The actual price of the trade will be reported.

Basis – The ISE believes that the rule change is consistent with the Act in general, and Section 6(b)(5) in particular. The proposed rule change is intended to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. The automated procedure for transmitting the stock leg of a stock-option order will provide a more efficient means for members to execute orders, and the execution of the options leg of a stock-option order in \$.01 minimum increments will improve investors ability to receive execution of their orders.

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

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on
Comments on the Proposed Rule Change
Received from Members, Participants or Others

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

III. Date of Effectiveness of the Proposed Rule
Change and Timing for Commission Action

stock at \$11.73 and the option at \$3.23 (\$11.73 – \$8.50); or (3) executing the stock at \$11.74 and the option at \$3.24 (\$11.74 - \$8.50).

Within 35 days of the date of publication of this notice in the *Federal Register* or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(a) by order approve such proposed rule change; or

(b) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of this publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁵

Secretary

⁵ 17 CFR 200.30-3(a)(12).

Exhibit A

Text of the Proposed Rule Change

Underlining indicates additions; [brackets] indicate deletions.

Rule 722. Complex Orders

* * *

(b) *Applicability of Exchange Rules.* Except as otherwise provided in this Rule, complex orders shall be subject to all other Exchange Rules that pertain to orders generally.

(1) *Minimum Increments.* Bids and offers on complex orders may be expressed in any decimal price, and the option leg(s) of a stock-option order may be executed in one cent increments, regardless of the minimum increments otherwise [appropriate] applicable to the individual option legs of the order. Complex orders expressed in net price increments that are not multiples of the minimum increment are not entitled to the same priority under subparagraph (b)(2) of this Rule as such orders expressed in increments that are multiples of the minimum increment.

* * *

Supplementary Material to Rule 722

.01 A bid or offer made as part of a stock-option order (as defined in (a)(5)(i) above) or a SSF-option order (as defined in (a)(5)(ii) above) is made and accepted subject to the following conditions: (1) the order must disclose all legs of the order and must identify the SSF security (which in the case of a single stock future requires sufficient identification to determine the market(s) on which the single stock future trades) and the price at which the non-option leg(s) of the order is to be filled; and (2) concurrent with the execution of the options leg of the order, the initiating member and each member that agrees to be a contra-party on the non-option leg(s) of the order must either elect to have the stock leg(s) of a stock-option order electronically communicated to a designated broker-dealer for execution as provided in .02 below or take steps immediately to transmit the non-option leg(s) to a non-Exchange market(s) for execution. Failure to observe these requirements will be considered conduct inconsistent with just and equitable principles of trade and a violation of Rule 400.

A trade representing the execution of the options leg of a stock-option or SSF-option order may be cancelled at the request of any member that is a party to that trade only if market conditions in any of the non-Exchange market(s) prevent the execution of the SSF leg(s) at the price(s) agreed upon.

.02 Automated Stock-Option Orders. A Member may elect to have the Exchange electronically communicate the stock leg(s) of a stock-option order to a designated broker-dealer for execution. To make such an election, the Member must enter into a brokerage agreement with the designated broker-dealer. The Exchange will automatically transmit the stock leg(s) of a trade to the designated broker-dealer for execution on behalf of the Member. A trade of a stock-option order will be automatically cancelled if market conditions prevent the execution of the stock or option leg(s) at the prices necessary to achieve the agreed upon net price.