broker in the execution of that order. The Exchange believes that this is the current practice on the Exchange and in the industry.

2. Statutory Basis

The Exchange believes that restricting a DPM from unnecessarily charging brokerage commission for agency orders will benefit both investors and will preserve the competitiveness of the Exchange. The Exchange believes that the proposed rule change is consistent with section 6(b) of the Act [3] in general and furthers the objectives of section 6(b)(5) of the Act [4] in particular in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest.

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

The Exchange believes that 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

No written comments were solicited or received with respect to the proposed rule change.

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

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 Exchange 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, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–CBOE–2004–73 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR–CBOE–2004–73. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions.

You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–CBOE–2004–73 and should be submitted on or before January 5, 2005.

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

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. E4–3649 Filed 12–14–04; 8:45 am]

BILLING CODE 8010–01–P

[3] 15 U.S.C. 78f(b).

[4] 15 U.S.C. 78f(b)(5).

[5] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–50819; File No. SR–ISE–2003–06]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 2 and 3 Thereto by the International Securities Exchange, Inc. To Establish Rules Implementing a Price Improvement Mechanism

December 8, 2004.

I. Introduction

On February 25, 2003, the International Securities Exchange, Inc. (''ISE'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change to establish rules implementing a Price Improvement Mechanism (''PIM''). On February 25, 2004, the ISE submitted Amendment No. 1 to the proposed rule change.[3] The proposed rule change, as amended, was published for comment in the **Federal Register** on March 3, 2004.[4] The Commission received one comment letter with respect to the proposal and Amendment No. 1.[5] On June 24, 2004, the ISE filed Amendment No. 2 to the proposed rule change,[6] and a written response to the Comment Letter.[7] On October 28, 2004, the ISE

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated February 24, 2004 (''Amendment No. 1''). In Amendment No. 1, the ISE replaced the proposed rule text in its entirety.

[4] *See* Securities Exchange Act Release No. 49323 (February 26, 2004), 69 FR 10087 (''Notice'').

[5] *See* Letter from Kenneth R. Leibler, Chairman and Chief Executive Officer, Boston Stock Exchange, Inc. (''BSE'') to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 24, 2004 (''Comment Letter''). A discussion of the Comment Letter is provided below in Section IV, Discussion and Commission Findings.

[6] *See* Letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated June 23, 2004 (''Amendment No. 2''). As noted below, in Amendment No. 2, the ISE proposes to clarify its rules to address issues raised by the Comment Letter and Commission staff.

[7] *See* Letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Jonathan G. Katz, Secretary, Commission, dated June 23, 2004 (''Response Letter'').

filed Amendment No. 3 to the proposed rule change.[8]

This order approves the proposed rule change, as amended by Amendment No. 1, publishes notice of Amendments No. 2 and 3 to the proposed rule change, and grants accelerated approval of Amendments No. 2 and 3.

II. Description of the Proposal

The ISE proposes to establish an auction, known as the PIM, that would allow an ISE Electronic Access Member (''EAM'') to enter matched trades (''Crossing Transactions''). A Crossing Transaction would be comprised of an order that the EAM represents as agent (''Agency Order'') and an order that is executable against the Agency Order for the full size of the Agency Order (the ''Counter-Side Order'').[9] A Member must enter the Crossing Transaction at a price at least one cent better than the national best bid and offer (''NBBO'').[10]

The ISE would broadcast the Crossing Transaction to all ISE Members.[11] During a three-second auction, all ISE Members could enter ''Improvement Orders,'' in penny increments, to improve the price of the Agency Order.[12] Improvement Orders may be for the account of a Public Customer or for the Member's own account.[13] During the exposure period, the aggregate size of the best prices, including the Counter-Side Order, Improvement Orders, and any change to either, would continually be updated and broadcast to all Members.[14]

After three seconds, the ISE would execute the Agency Order against the best prices as follows: (1) All Public Customer Improvement Orders and unrelated Public Customer orders on the book at the best price would be executed first; (2) all unrelated agency orders on the book for the account of a non-Member broker-dealer would then be executed; (3) if the entering EAM is at the best price, it would then execute against the greater of one contract or 40 percent of the Agency Order; and (4) the remainder of the order would be allocated to all other interest, which includes Improvement Orders and unrelated orders on the book for the account of an ISE Member (including ISE market makers), at the best price based on size.[15]

The PIM exposure period would be terminated immediately, prior to the expiration of the three-second exposure period, upon the receipt of certain orders in the regular Exchange market (''unrelated orders''). Specifically, the PIM would terminate when a market or marketable limit order is received in the same series [16] or when a non-marketable limit order on the same side of the market as the Agency Order is received that would cause the price of the Crossing Transaction to be outside of the best bid or offer on the Exchange.[17]

Under proposed ISE Rule 723(d)(5), as originally proposed and published in the Notice, in the case where an unrelated market or marketable limit order on the opposite side of the market from the Agency Order is received, the order would execute against the Agency Order at a price that is mid-way between the best Counter-Side interest and the bid or offer on the Exchange.[18] The Exchange proposes to change this provision to state that when a market order or marketable limit order on the opposite side of the market from the Agency Order ends the exposure period, it would participate in the execution of the Agency Order at the price that is mid-way between the best Counter-Side interest and the NBBO, so that both the unrelated order and the Agency Order receive price improvement.[19]

When a market order or marketable limit order on the same side of the market from the Agency Order ends the exposure period, the unrelated order would execute against any unexecuted interest in the PIM after the Agency Order is executed in full to provide the unrelated order with the opportunity for price improvement.[20] In Amendment No. 2, the ISE proposes to clarify that in such instances, executions in the PIM would be handled such that at a given price, Public Customer interest is executed in full before any non-Customer interest.[21] After Public Customer interest at a given price, agency orders for the account of non-Member broker-dealers would be executed in full before any proprietary interest of Members.[22] Finally, Member proprietary interest would participate in the execution of the Agency Order upon the percentage of the total number of contracts available at the price that is represented by the size of the non-Customer's interest.[23] In Amendment No. 2, the Exchange also proposes to clarify that when an unrelated order on the same side of the market from the Agency Order ends the exposure period, and the Counter-Side Order is at the same price as Member interest, the Counter-Side Order would not be allocated the greater of one contract or forty percent of the initial size of the Agency Order before other Member interest is executed.[24]

As originally proposed, Supplementary Material .01 to proposed ISE Rule 723 provided that it would be considered conduct inconsistent with just and equitable principles of trade for any Member to enter orders, quotes, Agency Orders, Counter-Side Orders or Improvement Orders for the purpose of disrupting or manipulating the PIM. In Amendment No. 2, the ISE proposes to clarify that such conduct would include, but not be limited to, engaging in a pattern of conduct where the Member submitting an Agency Order into the PIM breaks up the Agency Order into separate orders for two or fewer contracts for the purpose of gaining a higher allocation percentage than the Member would have otherwise received in accordance with the allocation procedures established for the situation in which

[8] *See* Letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated October 14, 2004 (''Amendment No. 3''). In Amendment No. 3, the ISE proposed to add new Supplemental Material .06 to proposed ISE Rule 723, to clarify that paragraphs (c)(5), (d)(5), and (d)(6) of ISE Rule 723 will be effective for a pilot period expiring on July 18, 2005. Supplemental Material .06 to proposed ISE Rule 723 also would state that during the pilot period, the Exchange will submit certain data on a confidential basis relating to the frequency with which the exposure period is terminated by unrelated orders.

[9] *See* proposed ISE Rule 723(b). The Counter-Side Order may represent interest for the EAM's own account, or interest the EAM has solicited from one or more other parties, or a combination of both. *See* Amendment No. 2, *supra* note 6.

[10] *See* proposed ISE Rule 723(b)(1). A PIM could not be initiated unless there are at least three ISE Market Makers quoting in the series. Moreover, there could be only one PIM ongoing in a series at any given time. Therefore, a PIM could not be initiated during an ongoing PIM in the same series. *See* proposed ISE Rule 723, Supplementary Material .04.

[11] The broadcast message would include the series, price, and size of the Agency Order and whether it is to buy or sell. *See* proposed ISE Rule 723(c); *see also* Amendment No. 2, *supra* note 6.

[12] *See* proposed ISE Rule 723(c)(1). The ISE would broadcast Improvement Orders to all Members. Crossing Transactions and Improvement Orders would not be displayed in the ISE BBO and would not be disseminated to the Options Price Reporting Authority.

[13] *See* proposed ISE Rule 723(c)(2).

[14] *See* proposed ISE Rule 723(c)(4); *see also* Amendment No. 2, *supra* note 6.

[15] *See* proposed ISE Rule 723(d). This sized-based allocation formula for the remainder of the order would be the same formula the Exchange applies in its regular market, without any special allocation rights for the ISE Primary Market Maker. *See* ISE Rule 713, Supplementary Material .01.

[16] *See* proposed ISE Rule 723(c)(5).

[17] *Id.* Under such circumstances: (1) the PIM would be concluded; (2) the Agency Order executed; and (3) the non-marketable limit order would be displayed on the ISE book.

[18] *See* Amendment No. 1, *supra* note 3.

[19] *See* proposed ISE Rule 723(d)(5); *see also* Amendment No. 2, *supra* note 6.

[20] *See* proposed ISE Rule 723(d)(6); *see also* Amendment No. 2, *supra* note 6.

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

the Counter-Side Order is at the same price as Member interest.[25] Also, the ISE proposes to clarify that ISE Rule 717(f), which places limitations on electronic orders, would not apply to transactions executed pursuant to ISE Rule 723.[26]

Finally, the ISE proposes in Amendment No. 2 to amend the text of ISE Rule 400 regarding solicited orders. The proposed addition to ISE Rule 400 would clarify that nothing in the Supplementary Material .01 to ISE Rule 400 is intended to prohibit a member from soliciting interest to execute against an order it represents as agent, the execution of which is governed by ISE Rule 717(e) (Solicitation Orders), and Supplementary Material .02 to ISE Rule 717.

In Amendment No. 3, the ISE proposes new Supplemental Material .06 to proposed ISE Rule 723 to establish that paragraphs (c)(5), (d)(5), and (d)(6) of ISE Rule 723 would be effective for a pilot period expiring on July 18, 2005.[27] The ISE also proposes in new Supplemental Material .06 that the Exchange would submit data relating to the frequency with which the exposure period is terminated by unrelated orders.[28]

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 2 and 3, including whether Amendments No. 2 and 3 are consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send e-mail to *rule-comments@sec.gov.* Please include File Number SR-ISE–2003–06 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR-ISE–2003–06. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the ISE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–ISE–2003–06 and should be submitted on or before January 5, 2005.

IV. Discussion and Commission Findings

After careful review of the amended proposal and consideration of the Comment Letter and Response Letter, the Commission finds that the proposed rule change to establish rules for the implementation of the ISE PIM is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange[29] and, in particular, the requirements of section 6 of the Act.[30] Specifically, as discussed in greater detail below, the Commission finds that the proposal is consistent with section 6(b)(5) of the Act,[31] which requires, in part, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

Specifically, the Commission believes that approving the ISE's proposal to establish the PIM should confer important benefits to the public by increasing competition between and among the options exchanges, resulting in better prices and executions for investors. The Comment Letter argues that because the ISE market structure does not include many of the elements of the Boston Options Exchange (''BOX'') market structure, the ISE PIM lacks basic customer protections and will discourage price competition and aggressive bidding.[32] The Commission does not agree with these objections, and notes that market structures need not be identical to be consistent with the Act; in fact, such a policy would likely result in less competition between markets and fewer innovations.

The Commission believes that the proposed ISE PIM provides limitations on internalization comparable to the other exchanges' rules that guarantee members the right to internalize their customers' orders. In particular, as discussed below, the ISE's proposal would require an EAM seeking to utilize the PIM to expose its Customer Order before trading with that order and would further require a minimum of three ISE market makers to be quoting in a particular series before a PIM could be initiated. The Commission also believes that the access to the PIM for those who may wish to compete for an Agency Order should be sufficient to provide opportunities for a meaningful, competitive auction.

The Commission therefore finds that, for the reasons discussed more fully below, the ISE's proposal is consistent with the Act.

A. Need for Both PIM and ISE Facilitation Mechanism

In the Comment Letter, BSE argues that the ISE should have only one facilitation process in its system.[33] The Comment Letter notes that ISE Rule 716(d) currently provides for a facilitation mechanism (''ISE Facilitation Mechanism'') by which an EAM can facilitate block-size[34] Public Customer orders. According to the Comment Letter, the election of a PIM

[25] *See* proposed ISE Rule 723, Supplementary Material .01; *see also* Amendment No. 2, *supra* note 6.

[26] *See* proposed ISE Rule 723, Supplementary Material .05; *see also* Amendment No. 2, *supra* note 6.

[27] *See* proposed ISE Rule 723, Supplementary Material .06; *see also* Amendment No. 3, *supra* note 8.

[28] *Id.*

[29] In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[30] 15 U.S.C. 78f.

[31] 15 U.S.C. 78f(b)(5).

[32] *See* Comment Letter, *supra* note 5, at pp. 1–6.

[33] *See* Comment Letter, *supra* note 5, at p. 11.

[34] ''Block''-size is defined under the ISE Rules as orders for at least 50 contracts. *See* ISE Rule 716(a).

by an EAM to facilitate a Customer Order would always be better for the Customer than the election of the ISE Facilitation Mechanism, whereas the election of the ISE Facilitation Mechanism would always be better for the EAM than the election of the PIM. The Comment Letter maintains that for orders of over 50 contracts, EAMs would have an incentive to seek first to facilitate an order through the ISE Facilitation Mechanism and, if it appeared that the EAM would lose its guaranteed allocation, the EAM would cancel the facilitation order and elect the PIM.

The Commission does not agree with the Comment Letter's assertions for several reasons. First, the ISE rules specifically provide that it would be a violation of an ISE Member's duty of best execution to its Customer if the Member were to cancel a facilitation order to avoid execution of the order at a better price.[35] Therefore, the BSE's argument that an EAM could exploit the availability of both the Facilitation Mechanism and the PIM by simply canceling its facilitation order after it has been entered into the ISE Facilitation Mechanism to avoid losing its allocation guarantee is not accurate, as such conduct would be a violation of Exchange rules.

Second, the Commission notes that ISE Members have an obligation of best execution with respect to their Customer Orders. The Commission has long held the view that in satisfying its duty of best execution,[36] which requires a broker to seek the most favorable terms reasonably available under the circumstances for a customer's transaction, a broker must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.[37] The Commission believes that this obligation would require an EAM to evaluate whether the PIM or Facilitation Mechanism would provide better execution to customers' orders.

B. Three Market Maker Requirement

Proposed ISE Rule 723 would require that there be at least three Market Makers quoting in a relevant series at the time an EAM submits its Crossing Transaction into the PIM.[38] The Commission believes that this requirement will improve the opportunity for an Agency Order to be exposed to a competitive auction.[39]

C. Solicitation Process

The ISE's proposal would permit an ISE EAM to solicit interest from other parties to participate in the Counter-Side Order in the PIM.[40] In its Comment Letter, BSE argues that it is unclear whether ISE market makers may be solicited to participate in the Counter-Side Order.[41] The Commission notes, however, that an EAM would be prohibited from soliciting an order from an ISE Market Maker, pursuant to ISE Rule 717(g).[42] Furthermore, the Commission emphasizes that a blanket exemption from ISE Rule 717(g) would not be permitted without Commission approval of a proposed rule change submitted by the Exchange under section 19(b) of the Act.[43]

D. Three-Second PIM

1. Content of Broadcast Message

Under the ISE proposal, upon entry of a Crossing Transaction into the PIM, a broadcast message would be sent to all ISE members to begin the exposure period. The BSE suggests that the only information provided to ISE members in the PIM broadcast would be the aggregate size of the best-priced Improvement Orders (not improved Counter-Side Orders) and that this would be insufficient information for market participants to make fully-informed decisions about how to compete for the Agency Order.[44] In response to the Comment Letter, the ISE proposes in Amendment No. 2 to clarify that the broadcast message would include the series, price, and size of the Agency Order, and whether the Agency Order is a buy or sell order. The ISE also proposes to clarify that during the exposure period, the aggregate size of the best prices, (including the Counter-Side Order, Improvement Orders, and any changes to either) would continually be updated and broadcast to all ISE Members.[45]

The Commission believes that the proposed content of the broadcast message at the initiation of the PIM should provide sufficient information to permit interested market participants to participate in the auction. In addition, the Commission does not believe that it is necessary for the ISE to provide information about prices and sizes below the best price.

2. Duration of the PIM

The ISE proposes that the duration of each PIM be three seconds.[46] The Commission believes that a three-second PIM should afford electronic crowds sufficient time to compete for Agency Orders submitted by an EAM. In reaching this conclusion, the Commission believes that the timeframes necessary for exposure and execution of orders be adjudged in light of the ISE's market structure. The Commission reiterates that the critical issue is determining whether the proposed three-second timeframe gives participants in a fully automated marketplace sufficient time to respond to a PIM broadcast to compete and provide price improvement for Agency Orders and whether electronic systems are available to ISE members that would allow them to respond to PIM broadcasts in a meaningful way within the proposed timeframe.[47] The Commission notes that the ISE is a fully electronic exchange where crowd members interact by electronic means. The Commission also notes that electronic systems are readily available to ISE members—if not already in place—to allow them to respond to PIM broadcasts.[48]

3. Premature Termination of the PIM

As proposed, the PIM would end prematurely under certain circumstances:[49] (1) Upon the receipt of a market or marketable limit order on

[35] *See* ISE Rule 716, Supplementary Material .01.

[36] A broker-dealer's duty of best execution derives from common law agency principals and fiduciary obligations and is incorporated both in the rules of the self-regulatory organization, and through judicial and Commission decisions, in the antifraud provisions of the federal securities laws. *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (''Order Handling Rules Release''), note 348 and accompanying text.

[37] *See id.*

[38] *See* proposed ISE Rule 723(b)(1); *see also* BOX Rules Chapter V, Sec. 18(e).

[39] *See* Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (Order approving the BOX as an options trading facility of the BOX).

[40] *See* proposed ISE Rule 723(a).

[41] *See* Comment Letter, *supra* note 5.

[42] ISE Rule 717(g) prohibits an EAM from causing the entry of orders for the account of an ISE Market Maker.

[43] 15 U.S.C. 78s(b).

[44] *See* Comment Letter, *supra* note 5, at pp. 11–15.

[45] *See* Amendment No. 2, *supra* note 6; *see also* proposed ISE Rule 723(c)(4).

[46] The PIM would end prior to the expiration of the three-second exposure period under certain circumstances. *See* proposed ISE Rule 723(c)(5). *See also infra* notes 49–57 and accompanying text for a more detailed discussion.

[47] *See supra* note 40.

[48] The Commission notes that the ISE offers a facilitation mechanism through which an EAM can facilitate Public Customer orders of 50 contracts or more. The ISE facilitation mechanism currently employs an exposure period of ten seconds. *See* ISE Rule 716(d) and Supplemental Material .02 to ISE Rule 716.

[49] With respect to the same series, no PIM will run simultaneously with another PIM, nor will PIMs be permitted to queue or overlap in any manner. *See* proposed ISE Rule 723, Supplementary Material .04.

the Exchange in the same series on the opposite side of the market from the Agency Order;[50] (2) upon the receipt of a market or marketable limit order on the Exchange in the same series on the same side of the market as the Agency Order;[51] (3) upon the receipt of a non-marketable limit order in the same series on the same side of the market as the Agency Order that would cause the price of the Crossing Transaction to be outside of the best bid or offer on the Exchange.[52]

The ISE's proposal would provide these unrelated orders with the opportunity for price improvement.[53] The Commission, however, is concerned that this could result in an Agency Order being disadvantaged by the premature conclusion of a PIM, in that it would not have received the full three second auction exposure period in which to receive price improvement.[54]

The Commission notes that proposed ISE Rule 723, Supplementary Material .01 states that it would be considered conduct inconsistent with just and equitable principles of trade for any ISE Member to enter orders, quotes, Agency Orders, Counter-Side Orders, or Improvement Orders for the purposes of disrupting or manipulating the PIM.[55] The Commission believes that this proposed rule should help to address its concern, because ISE Members would be prohibited from deliberately entering unrelated orders in the ISE system to end the PIM prematurely to disrupt or manipulate it.[56]

Moreover, the ISE has proposed that those portions of proposed ISE Rule 723 relating to the premature termination of the PIM be effective on a pilot basis. The Commission believes that approval of these provisions on a pilot basis is appropriate and will afford both the Exchange and the Commission an opportunity to analyze the impact of unrelated orders on the PIM, as well as the ISE's surveillance procedures with respect to the PIM.[57]

E. Competition in the PIM

Under the ISE's proposal, all ISE Members would be permitted to participate in a PIM.[58] Improvement Orders entered by ISE members may be for their own account or for the account of a Public Customer.[59] In addition, unrelated orders could compete in standard increments to trade with the Agency Order in the PIM. Such unrelated orders could include agency orders on behalf of Public Customers, market makers on other exchanges, and non-ISE member broker-dealers, as well as non-Improvement orders submitted by ISE members.

The BSE questions how Improvement Orders from Public Customers would be handled by an EAM.[60] In its Response Letter, the ISE clarifies that Public Customer orders would be handled as provided under the current ISE Rules. Specifically, there would be no limitations on the ability of Public Customers to participate in the PIM, and ISE members may represent Public Customers in a PIM under any type of instruction they wish to accept without restriction.[61] The Commission believes that the lack of restrictions on the participation of Public Customers in the PIM should increase the opportunity for them to participate in the PIM.

The BSE also argues that under ISE Rule 717, which prohibits customers from creating and transmitting orders electronically unless such orders are non-marketable limit orders to buy (sell) that are priced higher (lower) than the best ISE bid or offer, Public Customers would not be permitted to participate in the PIM.[62] In response, the ISE, in Amendment No. 2, proposes that ISE Rule 717(f) would not apply to transactions executed pursuant to proposed ISE Rule 723.[63] The Commission believes that Amendment No. 2 sufficiently clarifies the application of ISE Rule 717.

Finally, the BSE argues that a lack of time priority would discourage price competition in the PIM.[64] The Commission disagrees with this assertion and, instead, continues to believe that allocations based on price/size priority are consistent with the Act.[65]

F. Improvement Orders

As discussed above, during the PIM, ISE members may submit Improvement Orders. Improvement Orders would be submitted in penny increments and would be valid only in the PIM process. The BSE asks whether an ISE Member that submits an Improvement Order may reduce the size of the Improvement Order at the same price.[66] In its Response Letter, the ISE notes that its proposed rules provide that an Improvement Order may be modified only to increase the size at the same price, or improve the price of the Improvement Order for any size up to the size of the Agency Order.[67] The Commission believes that the proposed ISE rules make clear that ISE Members would not be permitted to reduce the size of an Improvement Order without improving its price.

G. PIM Trade Allocation

With multiple trading of options, individual options markets are under significant pressure to attract or retain business. One approach to increasing business on an exchange is to allow members a preference in trading with customer orders that they bring to the exchange. The Commission, however, has expressed its concern that proposals by options exchanges that guarantee a significant portion of orders to any market participant could erode the incentive to display aggressively priced quotes.[68] Thus, the Commission must weigh whether the proposed

[50] *See* proposed ISE Rule 723(c)(5)(ii).

[51] *Id.*

[52] *See* proposed ISE Rule 723(c)(5)(iii).

[53] *See supra* notes 16–23 and accompanying text.

[54] The Commission notes that under the BOX rules, the BOX Price Improvement Period ("PIP") auction can be terminated prior to the three-second period only in cases where an executable unrelated order is submitted to BOX on the same side as the customer order that was initially entered into the PIP. *See* BOX Rules, Chapter V, Section 18(i). The BOX rules, unlike the ISE proposal, do not permit the unrelated order to be executed against unexecuted interest in the PIP after the facilitated customer order is executed in full.

[55] *See* proposed ISE Rule 723, Supplementary Material .01. *See also* Amendment No. 2, *supra* note 6.

[56] In addition, the ISE has provided Commission staff with details regarding its proposed PIM surveillance procedures. *See* Letter to Nancy Sanow, Assistant Director, Division, Commission, from Michael J. Simon, Senior Vice President & General Counsel, ISE, dated October 14, 2004. The Commission notes that as a matter of Commission policy, surveillance programs and procedures are generally kept confidential. Disclosure of specific surveillance procedures could provide market participants with information that could aid attempts at avoiding regulatory detection of inappropriate trading activity.

[57] The ISE's surveillance plan and procedures are subject to inspection by the Commission, to ensure that the ISE adequately monitors its market and its members, and enforces its rules and the federal securities laws, including the anti-fraud provisions.

[58] *See* proposed ISE Rule 723(c).

[59] *Id.*

[60] *See* Comment Letter, *supra* note 5, at p. 16.

[61] *See* Response Letter, *supra* note 7, at pp. 4–5.

[62] *See* Comment Letter, *supra* note 5, at p. 19.

[63] *See* Amendment No. 2, *supra* note 6. *See also* proposed ISE Rule 723, Supplementary Material .05. In its Response Letter, the ISE stated that ISE Rule 717(f) was not intended to be applied to orders entered into the PIM. *See* Response Letter, *supra* note 7, at p. 5.

[64] *See* Comment Letter, *supra* note 5, at pp. 6–8.

[65] *See* Securities Exchange Act Release Nos. 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003) (Order approving the CBOE Hybrid System where, pursuant to CBOE Rule 6.45A, the applicable floor procedure committee could determine to weight the allocation algorithm so that the entire allocation would be based on size pro rata); and 46514 (September 18, 2002), 67 FR 60267 (September 25, 2002) (Order approving ISE proposal relating to the allocation of customer orders on a price/size priority basis).

[66] *See* Comment Letter, *supra* note 5, at p. 16.

[67] *See* Response Letter, *supra* note 7 p. 5; *see also* proposed ISE Rule 723(c)(3).

[68] *See, e.g.*, Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778 (August 9, 2000).

participation right would so substantially reduce the ability of other market participants to trade with an order that it would reduce price competition. As the Commission has noted previously:

> It is difficult to assess the precise level at which guarantees may begin to erode competitive market maker participation and potential price competition within a given market. In the future, after the Commission has studied the impact of guarantees, the Commission may need to reassess the level of these guarantees. For the immediate term, the Commission believes that 40% is not clearly inconsistent with the statutory standards of competition and free and open markets.[69]

The ISE PIM proposal would provide that at the conclusion of the PIM exposure period, the Agency Order would be executed in full against the best-priced orders, including orders and quotes in the Exchange market, Improvement Orders, and the Counter-Side Order.[70] The ISE would execute the Agency Order against the best prices as follows: (1) All Public Customer Improvement Orders and unrelated Public Customer orders on the book at the best price would be executed first; (2) all unrelated agency orders on the book for the Account of a non-Member broker-dealer would then be executed; (3) if the Counter-Side Order is at the best price, it would then be executed against the greater of one contract or 40% percent of the Agency Order; and (4) the remainder of the order would be allocated to all other interest, which includes Improvement Orders and unrelated orders on the book for the account of an ISE Member (including ISE market makers), at the best price pro-rata based on size.[71]

The BSE argues that the ISE's proposal to allow a 40% guarantee to the Counter-Side Order based on the size of the original order is inconsistent with facilitation rules for BOX's PIP auction.[72] However, the Commission believes that the ISE's proposal, which entitles (subject to certain exceptions) an EAM who submits the Counter-Side Order to 40% of the Agency Order, is not inconsistent with the Act. In addition, the Commission notes that the guarantee for the EAM bringing an Agency Order to the PIM is consistent with the facilitation guarantees in place at other options exchanges.[73]

The Commission believes that the ISE PIM proposal should promote price competition within the PIM by providing ISE Members with a reasonable opportunity to compete for a significant percentage of the incoming order and, therefore, should protect investors and the public interest. The Commission continues to believe that a 40% allocation is consistent with the statutory standards for competition and free and open markets.

On a related note, the BSE points out that the proposal does not describe the order of priority among the excess Improvement Orders in the situation where an unrelated marketable order on the same side of the market as the Agency Order terminates the PIM.[74] In response, the ISE proposes in Amendment No. 2 to clarify that these executions would follow the same execution priority rules described in proposed ISE Rule 723(d)(1)-(4).

H. Section 11(a) of the Act

Section 11(a) of the Exchange Act[75] prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, ''covered accounts'') unless an exception applies. Section 11(a)(1)(G)[76] and Rule 11a1–1(T)[77] under the Act provide an exception to the general prohibition in Section 11(a) on an exchange member effecting transactions for its own account. Specifically, a member that ''is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more of such activities, and whose gross income normally is derived principally from such business and related activities''[78] and effects a transaction in compliance with the requirements in Rule 11a1–1(T)(a)[79] may effect a transaction for its own account. Among other things, Rule 11a1–1(T)(a) requires that an exchange member presenting a bid or offer for its own account or the account of another member shall grant priority to any bid or offer at the same price for the account of a non-member of the exchange.[80] Because proposed ISE Rule 723 would require EAMs and Exchange Market Makers to yield priority in the PIM to all non-Member orders, the Commission believes that the proposal is consistent with the requirements in section 11(a) and Rule 11a1–1(T) under the Act.

Under the proposal, Public Customer interest in the PIM would be executed in full before orders for the account of non-Member broker-dealers could be executed. The BSE argues that section 11(a) does not require Public Customers to be treated preferentially to other non-Members.[81] The Commission notes, however, that section 11(a)(1)(G) of the Act and the rules thereunder do not prohibit Public Customers from being treated preferentially relative to other non-Members. Instead, the statute and the rules require only that non-Member orders receive priority over Member orders. Under the ISE's proposed rules, Public Customer and non-Member broker-dealer orders would receive first priority. Therefore, the Commission believes that the proposed ISE PIM priority execution rules would comply with section 11(a) of the Act.[82]

I. Quote Rule

The BSE argues that the proposed ISE PIM rules violate Rule 11Ac1–1 under the Act (the ''Quote Rule''),[83] because inbound unrelated market or marketable limit orders on the same side of the market as the Agency Order would be permitted to execute against any unexecuted interest in the PIM after the Agency Order is executed in full on a pilot basis until July 18, 2005.[84] In response, the ISE has requested an exemption from the Quote Rule for unexecuted interest in the PIM auction after the Agency Order has been executed in full.[85] Under separate cover,

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[69] *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (order approving registration of the ISE as a national securities exchange).

[70] *See* proposed ISE Rule 723(d).

[71] *See* proposed ISE Rule 723(d)(1)-(4).

[72] *See* Comment Letter, *supra* note 5, at p. 9. *See also* BOX Rules, Chapter V, Sec. 18 (f).

[73] *See* Securities Exchange Act Release No. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (approving proposal by the Chicago Board Options Exchange, Inc. to establish rules for CBOEdirect trading system). *See also* ISE Rule 716(d) (ISE Facilitation Mechanism).

[74] *See* Comment Letter, *supra* note 5, at p. 18.

[75] 15 U.S.C. 78k(a).

[76] 15 U.S.C. 78k(a)(1)(G).

[77] 17 CFR 240.11a1–1(T).

[78] 15 U.S.C. 78k(a)(1)(G)(i). Paragraph (b) of Rule 11a1–1(T) under the Act provides that a member shall be deemed to meet the requirements of Section 11(a)(1)(G)(i) of the Act if during its preceding fiscal year more than 50% of its gross revenues was derived from one or more of the sources specified in that section. In addition to any revenue which independently meets the requirements of Section 11(a)(1)(G)(i), revenue derived from any transaction specified in paragraph (A), (B), or (D) of Section 11(a)(1) of the Act or specified in Rule 11a1–4(T) shall be deemed to be revenue derived from one or more of the sources specified in Section 11(a)(1)(G)(i).

[79] 15 U.S.C. 78k(a)(1)(G)(ii).

[80] 17 CFR 240.11a1–1(T)(a)(3).

[81] *See* Comment Letter, *supra* note 5, at p. 19.

[82] 15 U.S.C. 78k(a).

[83] 17 CFR 240.11Ac1–1.

[84] *See* Comment Letter, *supra* note 5, at p. 19.

[85] *See* Letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Annette

the Commission granted the ISE a limited exemption pursuant to paragraph (e) of the Quote Rule from its obligations under paragraph (b) of the Quote Rule that permits the Exchange to collect from its members the quotation sizes and aggregate quotation sizes communicated to the Exchange by responsible brokers or dealers with respect to Counter-Side Orders in connection with the PIM without making such quotation sizes available to quotation vendors.[86] The Commission believes that the exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system because it would permit the ISE to execute unrelated orders against trading interest priced better than the NBBO.[87]

J. Trade-Through Issues

As noted above, the PIM would automatically terminate under certain circumstances, including upon the receipt of a non-marketable limit order in the same series on the opposite side of the market as the Agency Order that would cause the price of the Crossing Transaction to be outside of the best bid or offer on the Exchange.[88] The BSE argues that the proposed PIM is inconsistent with the options intermarket linkage plan,[89] because a PIM execution could ''trade through'' [90] another exchange's market in such a case.[91] In Amendment No. 2, the ISE proposes to amend its proposal to state that when a market order or marketable limit order on the opposite side of the market from the Agency Order ends the exposure period, it would participate in the execution of the Agency Order at the price that is mid-way between the best counter-side interest and the NBBO.[92]

The Commission notes that all orders executed in the PIM are ''guaranteed'' at a better price than the NBBO at the initiation of the PIM. The Commission believes that the trade should be considered to have occurred at the time the order is guaranteed at a price at least a penny better than the NBBO. Accordingly, the Commission does not believe that it should be considered a trade-through if a trade is executed through the PIM at a price that is better than the NBBO at the commencement of the PIM, but because of a change in the NBBO—inferior to the NBBO at the conclusion of the PIM. Therefore, the Commission finds that ISE's proposed PIM is consistent with the Linkage Plan. The Commission reminds brokers, however, that they must always consider their best execution obligations.

K. No Minimum Size Requirement for PIM

One of the principal differences between the ISE's proposed PIM and most other exchanges' rules that guarantee members the right to trade with their customer orders is that the PIM would be available for orders of fewer than 50 contracts. Under the ISE's proposal, there would be no minimum size requirement for orders entered into the PIM, for a pilot period expiring on July 18, 2005.[93]

The Commission believes that the ISE's proposal may provide small customer orders with benefits not available under the rules of most other exchanges, and is consistent with the Act. In particular, any Agency Order entered into the PIM is guaranteed an execution at the end of the auction at a price at least a penny better than the NBBO. In addition, the Commission believes that the ISE's proposal provides the opportunity for more market participants to compete in its auction. For example, the ISE would permit all members and Public Customers to participate in the PIM.

The Commission will evaluate the PIM during the pilot period to determine whether it would be beneficial to customers and to the options market as a whole to approve any proposal requesting permanent approval to permit orders of fewer than 50 contracts to be submitted to the PIM. In addition, the Commission will examine the data submitted by the ISE with respect to situations in which the PIM is terminated prematurely by an unrelated order. To aid the Commission in its evaluation, the ISE represents that it will provide the following information each month:

(1) The number of orders of fewer than 50 contracts entered into the PIM;

(2) The percentage of all orders of fewer than 50 contracts sent to ISE that are entered into ISE's PIM;

(3) The percentage of all ISE trades represented by orders of fewer than 50 contracts;

(4) The percentage of all ISE trades effected through the PIM represented by orders of fewer than 50 contracts;

(5) The percentage of all contracts traded on ISE represented by orders of fewer than 50 contracts;

(6) The percentage of all contracts effected through the PIM represented by orders of fewer than 50 contracts;

(7) The spread in the option, at the time an order of fewer than 50 contracts is submitted to the PIM;

(8) Of PIM trades, the percentage done at the NBBO plus \$.01, plus \$.02, plus \$.03, *etc.*;

(9) The number of orders submitted by EAMs when the spread was \$.05, \$.10, \$.15, etc. For each spread, specify the percentage of contracts in orders of fewer than 50 contracts submitted to ISE's PIM that were traded by: (a) The EAM that submitted the order to the PIM; (b) ISE Market Makers assigned to the class; (c) other ISE members; (d) Public Customer Orders; and (e) unrelated orders (orders in standard increments entered during PIM);

(10) The number of times that a market or marketable limit order in the same series on the same side of the market as the Agency Order prematurely ended the PIM auction, and the number of times such orders were entered by the same (or affiliated) firm that initiated the PIM that was terminated;

(11) The percentage of PIM early terminations due to the receipt of a market or marketable limit order in the same series on the same side of the market that occurred within a ½ second of the start of the PIM auction; the percentage that occurred within one second of the start of the PIM auction; the percentage that occurred within one and ½ second of the start of the PIM auction; the percentage that occurred within 2 seconds of the start of the PIM auction; the percentage that occurred within 2 and ½ seconds of the PIM auction; and the average amount of price improvement provided to the Agency Order where the PIM is terminated early at each of these time periods;

(12) The number of times that a market or marketable limit order in the same series on the opposite side of the

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Nazareth, Director, Division, Commission, dated November 15, 2004.

[86] *See* Letter from Robert L.D. Colby, Deputy Director, Division, Commission, to Michael J. Simon, Senior Vice President and General Counsel, ISE, dated December 8, 2004.

[87] *Id.*

[88] Under such circumstances, (1) the PIM would be concluded; (2) the Agency Order executed; and (3) the non-marketable limit order would be displayed on the ISE book.

[89] *See* Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (Order approving the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage or ''Linkage Plan'').

[90] A trade-through means a transaction in an options series at a price that is inferior to the NBBO. *See* Linkage Plan, Section 2(29).

[91] *See* Comment Letter, *supra* note 5, at p. 18.

[92] *See* Response Letter, *supra* note 7, at p. 5; *see also* Amendment No. 2, *supra* note 6.

[93] The July 18, 2005, pilot expiration date corresponds to the expiration of a similar pilot program for the BOX's PIP, which provided that there is no minimum size requirement for orders entered into the PIP, encompassing a period of 18 months from commencement of the BOX. *See* BOX Rules, Chapter V, Sect. 18, Supplementary Material .01.

market as the Agency Order prematurely ended the PIM auction and at what time the unrelated order ended the PIM auction, and the number of times such orders were entered by the same (or affiliated) firm that initiated the PIM that was terminated;

(13) The percentage of PIM early terminations due to the receipt of a market or marketable limit order in the same series on the opposite side of the market that occurred within a ½ second of the start of the PIM auction; the percentage that occurred within one second of the start of the PIM auction; the percentage that occurred within one and ½ second of the start of the PIM auction; the percentage that occurred within 2 seconds of the start of the PIM auction; the percentage that occurred within 2 and ½ seconds of the PIM auction; and the average amount of price improvement provided to the Agency Order where the PIM is terminated early at each of these time periods;

(14) The number of times that a non-marketable limit order in the same series on the same side of the market as the Agency Order that would cause the price of the Crossing Transaction to be outside of the best bid or offer on the Exchange prematurely ended the PIM auction and at what time the unrelated order ended the PIM auction, and the number of times such orders were entered by the same (or affiliated) firm that initiated the PIM that was terminated;

(15) The percentage of PIM early terminations due to the receipt of a market or marketable limit order in the same series on the same side of the market as the Agency Order that would cause the price of the Crossing Transaction to be outside of the best bid or offer on the Exchange that occurred within a ½ second of the start of the PIM auction; the percentage that occurred within one second of the start of the PIM auction; the percentage that occurred within one and ½ second of the start of the PIM auction; the percentage that occurred within 2 seconds of the start of the PIM auction; the percentage that occurred within 2 and ½ seconds of the PIM auction; and the average amount of price improvement provided to the Agency Order where the PIM is terminated early at each of these time periods; and

(16) The average amount of price improvement provided to the Agency Order when the PIM auction is not terminated early (*i.e.*, runs the full three seconds).

VI. Accelerated Approval of Amendments No. 2 and 3

Pursuant to section 19(b)(2) of the Act,[94] the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission hereby finds good cause for approving Amendments No. 2 and 3 to the proposal, prior to the 30th day after publishing notice of Amendments No. 2 and 3 in the **Federal Register**. The revisions made to the proposal in the ISE's Amendment No. 2 clarify the operation of the PIM and were provided in response to issues raised in the Comment Letter and by Commission staff. In addition, the ISE in Amendment No. 3 established that paragraphs (c)(5), (d)(5), and (d)(6) of proposed ISE Rule 723 would be effective for a pilot period expiring on July 18, 2005. The Commission believes that the proposed changes in Amendments No. 2 and 3 are necessary to the proper functioning and implementation of the ISE PIM. The Commission further believes that Amendments No. 2 and 3 do not raise issues of regulatory concern that warrant further delay. Therefore, the Commission believes that accelerated approval of Amendments No. 2 and 3 is appropriate. Accordingly, pursuant to section 19(b)(2) of the Act,[95] the Commission finds good cause to approve Amendments No. 2 and 3 prior to the 30th day after notice of the Amendment is published in the **Federal Register**.

VII. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with section 6(b)(5) of the Act.[96]

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[97] that the proposed rule change (SR–ISE–2003–06) and Amendment No. 1 are approved; and that Amendments No. 2 and 3 thereto are approved on an accelerated basis, except that provisions relating to paragraphs (c)(5), (d)(5), and (d)(6) of ISE Rule 723 are approved on a pilot basis until July 18, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[98]

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. 04–27395 Filed 12–14–04; 8:45 am]

BILLING CODE 8010–01–P

[94] 15 U.S.C. 78s(b)(2).

[95] 15 U.S.C. 78s(b)(2).

[96] 15 U.S.C. 78f(b)(5). In connection with the issuance of this approval order, neither the Commission or its staff is granting any exemptive or no-action relief from the requirements of Rule 10b–10. Accordingly, a broker-dealer executing a customer order through the PIM will need to comply with all applicable requirements of that Rule.

[97] 15 U.S.C. 78s(b)(2).

[98] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–50823; File No. SR–NASD–2004–168]

Self-Regulatory Organizations; Notice of Filing of and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Certificate of Designation for Preferred Stock of The Nasdaq Stock Market, Inc.

December 8, 2004.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on November 1, 2004 the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), through its subsidiary, The Nasdaq Stock Market, Inc. (''Nasdaq''), filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in items I, II, and III below, which items have been prepared by Nasdaq. Pursuant to Rule 19b–4(f)(3),[3] Nasdaq has designated this filing as one solely concerned with the administration of the self-regulatory organization, and as such, the filing is immediately effective. 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

Nasdaq is filing with the Commission a Certificate of Designations, Preferences and Rights (''Certificate of Designation'') of Series C Cumulative Preferred Stock (''Series C Preferred'') authorized to be issued to the NASD. The issuance of the Series C Preferred is part of a transaction between the NASD and Nasdaq whereby 1,338,402 shares of Nasdaq's Series A Cumulative Preferred

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] 17 CFR 240.19b–4(f)(3).