

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71405; File No. SR-Topaz-2014-05)

January 27, 2014

Self-Regulatory Organizations; Topaz Exchange, LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Regarding System Protections

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 January 17, 2014, the Topaz Exchange, LLC (d/b/a ISE Gemini) (the “Exchange” or “Topaz”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which items have been prepared by the Exchange. 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 proposes to specify in its rules certain system protections contained in the trading system.

The text of the proposed rule change is available on the Exchange’s Internet website at <http://www.ise.com>, at the principal office of the Exchange, and at the Commission’s Public Reference Room.

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 Exchange 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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

A, B and C below, of the most significant aspects of such statements.

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

1. Purpose

The purpose of the proposal is to specify in the Exchange’s rules certain existing trading system protections that prevent the entry and/or execution of orders in certain circumstances. These protections are in addition to the system protection currently described in Rule 714 that prevents orders from being automatically executed at prices that are inferior to a protected bid or offer on another exchange (“trade through protection”) pursuant to the requirements of the Intermarket Linkage Plan (the “Plan”) and rules adopted by the Exchange to implement the Plan (the “Linkage Rules”).³

Specifically, Topaz Rule 714 provides that incoming orders will not be automatically executed at prices that are inferior to the national best bid or offer (“NBBO”). Thus, the language currently contained in Rule 714 reflects how the trading system assures compliance with the prohibition on trading through the NBBO contained in Topaz Rule 1901. Rule 714 also indicates that the prohibition on trade-throughs does not apply with respect to non-firm quotations as provided in Topaz Rule 1900(k). The Exchange proposes to make several non-substantive changes to the text and format of Topaz Rule 714 with respect to these linkage-related provisions for clarity,⁴ and to add a reference to intermarket sweep orders (“ISOs”). Pursuant to Topaz Rule 1901, ISOs are eligible to be executed at a price that is inferior to the

³ Linkage Rules of the International Securities Exchange, LLC (“ISE”) are incorporated by reference into the Topaz rulebook. The ISE Linkage Rules are provided in Chapter 19 of the ISE rulebook.

⁴ The current text of Rule 714 references non-firm quotations on the Exchange. This language preceded the adoption of the Linkage Rules and is no longer applicable. Accordingly, the Exchange proposes to delete this language.

NBBO. For clarity, the Exchange believes it is appropriate to specify in Rule 714 that the system does not prevent the automatic execution of an ISO at a price that is inferior to the NBBO.

The Exchange also is proposing to amend Rule 714 to add additional circumstances in which the trading system does not provide automatic executions as follows:

- Price Level Protection. There is a limit on the number of price levels at which an incoming order to sell (buy) will be executed automatically when there are no bids (offers) from other exchanges at any price for the options series. In such a circumstance, incoming orders are automatically executed at each successive price level until the maximum number of price levels is reached,⁵ and any balance is either handled by the primary market maker (“PMM”) (in the case of Priority Customer Orders)⁶ or canceled (in the case of Professional Orders).⁷ The number of price levels, which may be between

⁵ For example, assume the parameter is set to three tick levels, the best bid on Topaz in an options series that is traded in penny increments is \$1.50, and there are no bids in the series from any other exchanges. If a Priority Customer market order to sell is received, the system will not automatically execute the incoming order at a price below \$1.48. Therefore, such an order will execute the full size available at \$1.50, \$1.49 and \$1.48, and any unexecuted balance will be handled by the PMM. In this respect, the PMM has the obligation under existing Exchange rules to engage in dealings for his own account when, among other things, there is a temporary disparity between the supply of and demand for a particular options contract, and to act with due diligence in handling orders. See infra, notes 13 and 14 and accompanying text.

⁶ Pursuant to Topaz Rule 100(a)(37A) and (37B), a Priority Customer Order is an order for the account of a person or entity that (i) is not a broker or dealer in securities, and (ii) does not place more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s).

⁷ Pursuant to Topaz Rule 100(a)(37C), a Professional Order is an order that is for the account of a person or entity that is not a Priority Customer.

1 and 10, is determined by the Exchange from time-to-time on a class-by-class basis. Currently, this limit is set to three price levels.⁸

- Limit Order Price Protection. There is a limit on the amount by which incoming limit orders to buy may be priced above the Exchange's best offer and by which incoming limit orders to sell may be priced below the Exchange's best bid. Limit orders that exceed the pricing limit are rejected upon entry. The limit is established by the Exchange from time-to-time, on a class-by-class basis, as the greater of: (i) an absolute amount not to exceed \$2.00, or (ii) a percentage of the Exchange's best bid/offer not to exceed 10 percent.⁹ The Exchange currently has these limits set to \$1.00 and 1 percent respectively.¹⁰
- Size Limitation. There is a limit on the number of contracts an incoming order may specify. Orders or quotes that exceed the maximum number of contracts are rejected upon entry.¹¹ The maximum number of contracts, which shall not be less than 10,000, is

⁸ The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the price level limit to allow members the opportunity to perform any system changes. Any change to the price level limit would be subject to consultations with members.

⁹ For example, if the Topaz best bid is \$3.00 and the limits are set to the greater of \$1.00 or 1% (which equals \$0.03 in this example), a limit order to sell that is entered with a limit price below \$2.00 will be rejected.

¹⁰ The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the limit order price check to allow members the opportunity to perform any system changes. Any change to the limit order price check would be subject to consultations with members.

¹¹ For example, if the limit is set to 800,000 contracts, an order with a size of 800,001 or greater would be rejected by the system.

established by the Exchange from time-to-time on a class-by-class basis. Currently, this limit is set to 999,999 contracts.¹²

The Exchange further proposes that, in the event of unusual market conditions and in the interest of a fair and orderly market, the Exchange may temporarily establish the levels at which the order protections are triggered as necessary and appropriate.

When the PMM handles Priority Customer orders that are not automatically executed or canceled pursuant to the price level protection described above, they must do so pursuant to their obligations under Topaz Rule 803 and consistent with Rule 400 (Just and Equitable Principles of Trade). Rule 803 states, among other things, that market makers have a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular options contract, or a temporary distortion of the price relationships between options contracts of the same class.¹³ The Rule also specifies that a PMM must act with due diligence in handling orders and must accord priority to such orders over the PMM's principal orders.¹⁴ In addition to these existing provisions, the Exchange proposes to specify in Rule 803(c) that PMMs are required to address orders they handle as soon as practical by either (i) executing all or a portion of the orders at a

¹² The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the size limit to allow members the opportunity to perform any system changes. Any change to the size limit would be subject to consultations with members.

¹³ Rule 803(b).

¹⁴ Rule 803, Supplementary Material .01. The Exchange currently conducts surveillance of PMMs to assure that orders are handled timely, that such orders are executed at appropriate prices, and that such orders are afforded priority over the PMM's principal orders. This surveillance includes all orders handled by the PMM regardless of whether they are handling them via operation of the NBBO trade through protection and price level protection.

price that at least matches the NBBO and that improves upon the Exchange’s best bid (in the case of a sell order) or the Exchange’s best offer (in the case of a buy order),¹⁵ or (ii) releasing all or a portion of the order for execution against bids and offers on the Exchange.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the “Act”)¹⁶ in general, and furthers the objectives of Section 6(b)(5) of the Act¹⁷ in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. The system protections described above were implemented in the interest of protecting investors and to assure fair and orderly markets on the Exchange.

Specifically, the Exchange operates an electronic marketplace in which orders are processed and executed in less than one second. Without any safeguards, orders that outsize the liquidity available at the displayed best bid or offer on the Exchange could potentially trade at prices far below the best bid and far above the best offer, creating extreme volatility in the marketplace and poor executions for investors. The primary safeguard in the national market system that protects against such occurrences is the prohibition against trading through protected bids and offers on other options exchanges, as this links the liquidity available across markets

¹⁵ A PMM cannot provide an execution at the same price as the Exchange’s best bid or offer (as applicable) because that would allow the PMM to by-pass the execution priority rules contained in Rule 713. The Exchange conducts surveillance to detect instances when the PMM executes an order it is handling at the same price as the Topaz best bid or offer (as applicable). It is not a violation for the PMM to execute an order at the same price as the Topaz best bid or offer when the PMM is the only market participant at that price.

¹⁶ 15 U.S.C. 78f(b).

¹⁷ 15 U.S.C. 78f(b)(5).

and in most circumstances, provides a stop-gap on each individual exchange. However, not all products are multiply traded, and even in multiply-traded options series, it is possible that Topaz could be the only exchange disseminating a protected bid and/or offer in a particular options series at any given sub-second during the trading day.

Accordingly, the Exchange designed its system to provide the price level protection described above when there are no other protected bids and offers in the national market system. The Exchange believes that limiting the number of price levels at which an incoming order will execute in these circumstances appropriately balances the interests of investors seeking execution of their orders and the Exchange's obligations to provide a fair and orderly market. While Professional Orders are canceled in these circumstances, the Exchange seeks to provide a higher level of service for Priority Customer orders by having them handled by the PMM, which has an affirmative obligation to provide liquidity and price continuity. This procedure also provides an opportunity for liquidity to refresh in the market, further providing better execution potential for Priority Customer orders. The Exchange believes that providing this service for Priority Customer orders is appropriate and consistent with feedback from members that enter Priority Customer orders on the Exchange, who prefer that Priority Customer orders not be canceled in this circumstance.

Similarly, the Exchange's experience and member feedback indicates that the current limit of three price levels has worked well to balance the interests of investors receiving execution of their orders while protecting them from being executed at unreasonable prices. Nevertheless, the Exchange believes it is appropriate to maintain some flexibility to adjust the number of price level so that it can continually evaluate market conditions and investor needs. In this respect, under the proposal, the Exchange has the flexibility to adjust the number of price

levels up to ten. The Exchange believes this limit is sufficient to give it the ability to make appropriate adjustments as necessary and appropriate to maintain fair and orderly markets.

The Exchange also represents that the proposal merely clarifies the existing PMM obligations by specifying that the PMM must address orders it handles by either providing an execution or releasing orders for execution against bids and offers on the Exchange. The proposal further specifies that the price at which a PMM may execute an order must be at least equal to the NBBO and improve upon the best bid (offer) on the Exchange.¹⁸ While this was not previously stated explicitly in the Rules for this specific circumstance, the Exchange has always applied the obligations contained in Topaz Rule 803(b) and Supplementary Material .01 thereto, as well as Rule 400 and Rule 713, consistent with the additional proposed language and has enforced compliance accordingly.¹⁹ Moreover, the Exchange believes the specified order handling provisions are appropriate to assure compliance with all applicable Exchange Rules with respect to the handling of orders by the PMM.²⁰

The limit order price protection and size limitation for regular orders were designed to reject orders upon entry that were likely submitted in error. Limit orders that are entered with prices that cross the market by a large amount are likely to have been entered in the wrong options series, on the wrong side of the market, or with an erroneous price (e.g., a bid of \$15 rather than \$1.50). Similarly, orders entered with an unreasonably large size (e.g., 1 million contracts or more) are likely to have been entered in error. The Exchange believes that it is in the interest of fair and orderly markets and the protection of investors to reject these orders upon entry, and thereby prevent erroneous transactions from occurring.

¹⁸ See supra, note 15.

¹⁹ See supra, notes 14 and 15.

²⁰ Id.

The Exchange further believes that the Exchange's experience and member feedback indicates that the current limits of \$1.00 and 1 percent for the limit order price protection, and 999,999 contracts for the size limitation, has worked well to provide the protection of rejecting orders that have been entered in error while assuring that valid orders are not rejected. In this respect, the Exchange notes that orders below the established limits may well have been entered in error, but that it is highly unlikely that orders entered above the current limits were not entered in error. The Exchange believes it is appropriate to maintain some flexibility to adjust the limits so that it can continually evaluate the extent to which such limits could be reduced to prevent the entry of additional erroneous orders without rejecting legitimate orders. In this respect, under the proposal, the Exchange has specified that the limit order price protection limits shall not exceed \$2.00 and 10 percent respectively. The Exchange believes that these limits provide sufficient flexibility for the Exchange to make appropriate adjustments in the interest of maintaining fair and orderly markets. The Exchange also notes that it has specified that the order size limitation shall not be less than 10,000 contracts. The Exchange notes in this respect that a block-size options order is defined as an order of at least 50 contracts,²¹ and that an order of 500 contracts is considered a very large institutional-size order (a block-size order in the equities market is an order of at least 10,000 shares).²² Accordingly, the Exchange believes that it would not be unreasonable to set a size limit as low as 10,000 contracts should the Exchange determine that it was necessary to maintain fair and orderly markets and to protect investors from executing orders entered with an erroneously large size.

²¹ Rule 716(a).

²² See, e.g., Rule 716(e) (providing that the minimum size of an order entered into the Solicited Order Mechanism is 500 contracts); and Rule 715(j) (providing that a qualified Contingent Cross Order must be for at least 1,000 contracts).

Finally, the Exchange notes that it will give members at least a two week notice prior to changing the level at which the system protections are triggered to allow members to perform any system changes, and that the Exchange provides these protections for the benefit of, and in consultation with, its members. Notwithstanding, the Exchange also recognizes that the applicable protections may not be appropriate in unusual market conditions. In this respect, the Exchange has included in the proposal a provision providing that, in the event of unusual market conditions and in the interest of a fair and orderly market, the Exchange may temporarily establish the levels at which the system protections are triggered that are beyond those specified in the rule. The Exchange believes this is consistent with its obligation to assure a fair and orderly market, and that the need for such flexibility is recognized in other Exchange rules, such as those related to position limits, quote-width differentials and market maker risk parameters.²³ In the event that the Exchange temporarily revises the levels at which the protections are triggered, it will immediately notify all members.

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

The proposed rule change specifies circumstances in which the trading system does not provide an automatic execution in the interest of protecting investors against the execution of erroneous orders or the execution of orders at erroneous prices. As such, the proposal does not impose any burden on competition.

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

²³ See Rule 412 (regarding position limits), Rule 803 (regarding maximum quotation spreads) and Rule 804 (regarding market maker risk parameters).

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

The Exchange believes that the foregoing proposed rule change may take effect upon filing with the Commission pursuant to Section 19(b)(3)(A)²⁴ of the Act and Rule 19b-4(f)(6) thereunder²⁵ because the foregoing proposed rule change does not (i) significantly affect the protection of investors or the public interest, (ii) impose any significant burden on competition, and (iii) become operative for 30 days after its filing date, or such shorter time as the Commission may designate.

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is: (i) necessary or appropriate in the public interest; (ii) for the protection of investors; or (iii) otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or 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

²⁴ 15 U.S.C. 78s(b)(3)(A).

²⁵ 17 CFR 240.19b-4(f)(6).

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Topaz-2014-05 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-Topaz-2014-05. 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 website (<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 website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-Topaz-2014-05 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁶

Kevin M. O'Neill
Deputy Secretary

²⁶ 17 CFR 200.30-3(a)(12).