

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-64091; File No. SR-ISE-2011-04)

March 17, 2011

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Approving a Proposed Rule Change to Establish New Classes of Market Makers for Index Options

I. Introduction

On January 12, 2011, the International Securities Exchange, LLC (“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”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend its rules to establish two new classes of market makers for index options traded on the Exchange. The proposed rule change was published for comment in the Federal Register on January 31, 2011.<sup>3</sup> The Commission received no comments regarding the proposal. This order approves the proposed rule change.

II. Description of the Proposal

The Exchange proposed to amend its rules to establish the following new classes of market makers for certain index options traded on the Exchange: Index Options Primary Market Makers (“IXPMM”)<sup>4</sup> and Index Options Competitive Market Makers (“IXCMM”),<sup>5</sup> collectively referred to as IXMMs.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 63761 (January 25, 2011), 76 FR 5412 (“Notice”).

<sup>4</sup> An IXPMM is defined in new ISE Rule 2013(a) as a primary market maker in Eligible Index Options traded on the Exchange pursuant to new ISE Rule 2013.

<sup>5</sup> An IXCMM is defined in new ISE Rule 2013(a) as a competitive market maker in Eligible Index Options traded on the Exchange pursuant to new ISE Rule 2013.

The Exchange's proposal to separate out and introduce a new class of market maker trading licenses that are specific to index options is intended to allow an opportunity for additional market participants, who are not currently maker makers on the Exchange's First Market, to trade new index options as index-specific market makers.<sup>6</sup>

Because the Exchange's proposal primarily focuses on newly-listed index products, the proposal describes how the existing 28 cash-settled indexes traded on the Exchange will be treated. Specifically, index options listed on the Exchange prior to December 31, 2010 ("Legacy Index Options") already have an PMM assigned. The proposal does not affect those assignments, and such PMMs will simply continue to function as PMMs (i.e., as an IXPMM) in its currently-assigned index option(s). In addition, except as provided above, the proposal provides that all current and future First Market PMMs and CMMs may trade (as an IXCMM) all existing and future index products, including both Legacy Index Options and Eligible Index Options without having to purchase a separate IXCMM trading license. Market participants that are not currently a PMM or CMM on the Exchange's First Market will be required to purchase a new IXMM license in order to trade in index options on the Exchange.<sup>7</sup>

Eligible Index Options. New ISE Rule 2013(c) defines "Eligible Index Options" as: (i) index options that have a 6-month average daily volume of less than 10,000 contracts in the US market; and (ii) index options that have a trading history of less than 6 months, in which case the eligibility threshold would be prorated proportionately over the time that an index was listed in the

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<sup>6</sup> See Notice, supra note 3, 76 FR at 5412. An IXMM license, by itself, would not allow the holder thereof to trade in equity or ETF options traded on the Exchange.

<sup>7</sup> IXMM trading licenses will not represent ownership of any equity interest in the Exchange.

US market.<sup>8</sup> Prior to the listing of an Eligible Index Option, the Exchange will conduct a one-time eligibility test to determine whether an index product is an Eligible Index Option. The Exchange will conduct the eligibility test when an index product is qualified for listing under ISE rules and prior to its certification with the Options Clearing Corporation.<sup>9</sup> The following index products are not Eligible Index Options: Russell 2000 Index (“RUT”), the NASDAQ-100 Index (“NDX”), and the Mini-NASDAQ-100 Index (“MNX”).<sup>10</sup>

Legacy Index Options. ISE defines Legacy Index Options as index options listed on the Exchange prior to December 31, 2010.<sup>11</sup> New ISE Rule 2013(c)(3) provides that the current First Market PMM that has an allocation as PMM in a particular Legacy Index Option will be deemed to be the IXPMM for Legacy Index Options and, accordingly, will not need to purchase an IXPMM license to continue to trade as an IXPMM in that Legacy Index Option. In the event a Legacy Index Option is de-listed and subsequently re-listed, ISE will allocate the IXPMM license for that index through the auction process described in Rule 2013.<sup>12</sup>

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<sup>8</sup> For example, if an index has a trading history for just three months in the US market, the prorated eligibility threshold applied by ISE would be 20,000 ADV.

<sup>9</sup> The Exchange currently follows this process with regards to the listing of all equity (including ETF) and index option products traded on the Exchange.

<sup>10</sup> See new ISE Rule 2013(c)(2).

<sup>11</sup> As of December 31, 2010, the following indexes are Legacy Index Options: Mini FTSE 100 (symbol, UKX); ISE Semiconductors (BYT); ISE Electronic Trading (DMA); ISE-Revere Natural Gas (FUM); ISE Water (HHO); ISE Homeland Security (HSX); ISE Long Gold (HVY); ISE 250 (IXZ); ISE U.S. Regional Banks (JLO); ISE Oil and Gas Services (OOG); ISE Integrated Oil and Gas (PMP); ISE Bio-Pharmaceuticals (RND); ISE Homebuilders (RUF); ISE SINDEX (SIN); ISE Nanotechnology (TNY); ISE Revere Wal-Mart Supplier (WMX); KBW Bank Index (BKX); KBW Mortgage Finance Index (MFX); Morgan Stanley Technology Index (MSH); Morgan Stanley Retail Index (MVR); Nasdaq Q-50 Index (NXTQ); Mini-Russell 2000 (RMN); Russell 1000 Index (RUI); S&P Mid Cap 400 Index (MID); Standard & Poor’s Small Cap 600 Index (SML);

<sup>12</sup> In other words, the delisting of a Legacy Index Option terminates its status as a Legacy Index Option for purposes of new ISE Rule 2013.

There will be one IXPMM per each Eligible Index Option and Legacy Index Option.<sup>13</sup> IXPMM trading licenses shall be permanently granted as long as the IXPMM meets its stated market quality commitments.<sup>14</sup> By contrast, all IXCMM trading licenses will be for a term of one year.

Allocations Generally. Traditionally, new index products on the Exchange have been allocated as part of the general allocation to ISE's "First Market," which is the general market for higher-volume equity, ETF and index options. The Exchange states that it will offer IXMM trading licenses in a manner similar to how it offers foreign currency ("FX") options trading licenses to FX market makers.<sup>15</sup> IXPMM allocations will be based on the same methodology ISE currently uses for FXPMMs in its FX products, which is based, in part, on market quality commitments.

IXPMM Allocations for Eligible Index Options. Current and future First Market PMMs/CMMs may acquire an IXPMM trading license by participating in an auction, which involves the submission of a monetary bid and market quality commitments.

IXPMM trading licenses will be sold by means of a sealed bid auction conducted by the Exchange. A separate auction would be conducted for each index option for which ISE seeks to allocate an IXPMM. The "winning" bid at which an IXPMM trading license is sold is referred to as the "Auction Price." Together with its bid, a member seeking an IXPMM trading license must provide, at a minimum, market quality commitments regarding: (1) the average quotation size it

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<sup>13</sup> See new ISE Rule 2013(c)(3) and (e)(1).

<sup>14</sup> See new ISE Rule 2013(e)(1). The Board or designated committee, however, may suspend or terminate any trading license of a market maker whenever, in the Board's or designated committee's judgment, the interests of a fair and orderly market are best served by such action. See new ISE Rule 2013(e)(1).

<sup>15</sup> See Securities Exchange Act Release No. 55575 (April 3, 2007), 72 FR 17963, 17964 (April 10, 2007) (SR-ISE-2006-59).

will disseminate in an Eligible Index Option; and (2) the maximum quotation spread it will disseminate in such product at least 90% of the time. At the end of the auction, the Exchange will determine the winning bidder for an IXPMM trading license based on bid amount and market quality commitment, and may reject a bid if the Exchange deems a market quality commitment to be unrealistic or significantly inferior to market quality commitments submitted by other bidding members. In an auction for a trading right for an Eligible Index Option, ISE will give preferred consideration to a First Market PMM/CMM where bid and quality commitments are equal to those submitted by a new member who is not a First Market PMM/CMM.

Once allocated, the IXPMM may change its market quality commitment only to the extent that the new commitments are an improvement to its existing commitment. Under new Rule 2013(e)(4), the Exchange will review and assess market quality commitments on a quarterly basis to ensure IXPMMs are in compliance with their stated commitments. At the discretion of the Exchange and subject to the procedural protections provided under the rules of the Exchange,<sup>16</sup> failure to meet stated commitments may result in ISE terminating an allocation and conducting an auction to reallocate the failing IXPMM's index option.<sup>17</sup>

IXCMM Allocations. Current and future First Market PMMs may request, and if requested will be allocated, an IXCMM trading license without having to pay any additional fee. A member who is not a First Market PMM/CMM will be required to purchase an IXCMM trading license to trade as an IXCMM on the Exchange. IXCMM trading licenses will be available for purchase at any time during a calendar year.<sup>18</sup> All IXCMM trading licenses will expire at the end of the

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<sup>16</sup> See Chapter 17 of ISE Rules.

<sup>17</sup> See supra note 14.

<sup>18</sup> IXCMM trading licenses sold during a calendar year will be prorated to reflect the number of trading days in the year. See new ISE Rule 2013(f)(2).

calendar year in which they are issued but, upon request by a PMM or CMM, will be renewed for subsequent years on an annual basis.<sup>19</sup>

IXMM Duties and Privileges. By amending ISE Rule 802(b) to permit the allocation of Eligible Index Options, subject to new Rule 2013, ISE is subjecting market makers in Eligible Index Options to the obligations imposed on Exchange market makers under Chapter 8 of the Exchange's rules. Accordingly, once an IXPMM obtains a trading license in an Eligible Index Option, the IXPMM will have all of the responsibilities and privileges of a PMM under the Exchange's rules.<sup>20</sup> Similarly, once an IXCMM obtains a trading license in an Eligible Index Option, the IXCMM will have all the responsibilities and privileges under the Exchange's rules.

After an IXPMM has purchased a trading license, the IXPMM may terminate its status as IXPMM in an index option if the IXPMM is unable to meet its obligations, provided the IXPMM gives at least 60 days prior written notice to the Exchange of such termination. In the event the Exchange is unable to re-allocate the IXPMM's index option product within the notice period and the index option product is singly listed on ISE, then the IXPMM will be required to continue to fulfill its obligations in that product until all open interest has been closed. An IXCMM may terminate its trading license prior to its scheduled expiration by providing at least 10 days prior written notice to the Exchange.

### III. Discussion

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<sup>19</sup> See Notice, supra note 3, 76 FR at 5414.

<sup>20</sup> For example, IXPMMs will enjoy privileges that include, among other things, participation rights and small order execution preference while accepting responsibilities that include, among other things, the obligation to provide continuous quotations in an Eligible Index Option for which it has been allocated, to conducting the opening rotation on a daily basis for as long as the IXPMM retains an allocation in an Eligible Index Option.

The Commission finds that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act,<sup>21</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, 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.

The Commission believes that the provisions governing the two new classes of market makers that will be permitted to trade Eligible Index Options and Legacy Index Options on the Exchange, IXPMMs and IXCMMs, are consistent with the Act. The Commission notes that IXPMMs and IXCMMs will be subject to identical obligations that correspond to the market making obligations applicable to First Market PMMs and CMMs, respectively.<sup>22</sup> The Commission notes that, to obtain a trading license, IXPMMs will be required to provide the Exchange with market quality commitments<sup>23</sup> and, if an IXPMM continuously fails to meet its stated market quality commitments, the Exchange may terminate its IXPMM allocation.<sup>24</sup>

The Commission believes that the procedures under which the Exchange proposes to offer IXMM licenses are reasonably designed to award such allocations in a fair and reasonable manner. In particular, the Commission believes that provisions governing IXCMM trading licenses are designed to ensure that market maker trading licenses will be widely available because the Exchange will make an unlimited amount of IXCMM licenses available for purchase

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<sup>21</sup> 15 U.S.C. 78f(b)(5). In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>22</sup> See supra note 20.

<sup>23</sup> See new ISE Rule 2013(e)(3).

<sup>24</sup> See new ISE Rule 2013(e)(4).

by members who are not PMMs or CMMs on the Exchange's First Market.<sup>25</sup> In addition, the requirement that bidders provide market quality commitment in addition to their bid for an IXPMM allocation will allow the Exchange to grant IXPMM trading licenses in an objective manner without awarding a trading license solely based on the highest bid.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>26</sup> that the proposed rule change (SR-ISE-2011-04) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>27</sup>

Cathy H. Ahn  
Deputy Secretary

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<sup>25</sup> See new ISE Rule 2013(f).

<sup>26</sup> 15 U.S.C. 78s(b)(2).

<sup>27</sup> 17 CFR 200.30-3(a)(12).