

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-64115; File No. SR-ISE-2006-01)

March 23, 2011

Self-Regulatory Organizations; International Securities Exchange, Inc. (n/k/a the International Securities Exchange, LLC); Order Approving a Proposed Rule Change to Amend Exchange Rule Governing Directed Orders

I. Introduction

On January 5, 2006, the International Securities Exchange, Inc. (n/k/a 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 proposal to amend ISE Rule 811 to allow the identity of a firm entering a Directed Order to be disclosed to a Directed Market Maker (“DMM”). The proposed rule change was published for comment in the Federal Register on January 19, 2006.<sup>3</sup> The Commission received comment letters from the Interactive Brokers Group supporting the proposal, and from Citadel opposing the proposal.<sup>4</sup> This order approves the proposed rule change.

---

<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. 53103 (January 11, 2006), 71 FR 3144.

<sup>4</sup> See letters to Nancy M. Morris, Secretary, Commission, from Thomas Peterffy, Chairman, and David M. Battan, Vice President, Interactive Brokers Group, dated February 10, 2006 (“IB Letter”) and Adam C. Cooper, Senior Managing Director & General Counsel, Citadel, dated February 27, 2006 (“Citadel Letter”), incorporating by reference a letter from Adam C. Cooper, Senior Managing Director & General Counsel, Citadel, dated January 11, 2006 (“Citadel Letter II”).

In reviewing this proposed rule change, the Commission also considered a comment letter by the American Stock Exchange in response to a proposed rule change submitted by the ISE to amend ISE Rule 811 to allow the identity of a firm entering a Directed Order to be disclosed to a DMM on a temporary basis, which became immediately effective upon filing with the Commission. See Securities Exchange Act Release No. 53104 (January 11, 2006), 71 FR 3142

## II. Description of the Proposal

The Exchange currently operates a Directed Order system in which Electronic Access Members (“EAMs”) can send an order to a DMM for possible price improvement.<sup>5</sup> If a DMM accepts Directed Orders generally, that DMM must accept all Directed Orders from all EAMs. Once such a DMM receives a Directed Order, it either (i) must enter the order into the Exchange’s Price Improvement Mechanism (“PIM”) auction and guarantee its execution at a price better than the ISE best bid or offer (“ISE BBO”) by at least a penny and equal to or better than the National Best Bid and Offer (“NBBO”)<sup>6</sup> or (ii) must release the order into the Exchange’s limit order book, in which case there are certain restrictions on the DMM interacting with the order.

On January 5, 2006, ISE filed a proposed rule change, which became immediately effective upon filing with the Commission, to alter its existing Directed Order system on a temporary basis so that the system would disclose the identity of the firm entering a Directed Order to a DMM.<sup>7</sup> The rule permitting the ISE system to identify to DMMs the firm from which a Directed Order originates continues to operate on a pilot basis through

---

January 19, 2006 (SR-ISE-2006-02). See also letter to Nancy M. Morris, Secretary, Commission, from Neal L. Wolkoff, Chairman & Chief Executive Officer, American Stock Exchange, dated February 3, 2006 (“Amex Letter”) and February 7, 2006 (“Amex Letter II”).

<sup>5</sup> See Securities Exchange Act Release No. 52331 (August 24, 2005), 70 FR 51856 (August 31, 2005) (SR-ISE-2004-16).

<sup>6</sup> See ISE Rule 723.

<sup>7</sup> See Securities Exchange Act Release No. 53104 (January 11, 2006), 71 FR 3142 (January 19, 2006) (rule change was effective until June 30, 2006). The Commission received three comment letters regarding the temporary system change. See IB Letter, Amex Letter, and Amex Letter II, supra note 4.

May 31, 2011.<sup>8</sup> ISE proposes in this filing to amend ISE Rule 811 to permit the identity of an EAM that enters a Directed Order to be made available to the DMM and thus to make permanent its rule change that has been operating on a pilot basis for the past five years.

### III. Discussion

After careful review of the proposal and of the comment letters, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>9</sup> and, in particular, the requirements of Section 6 of the Act.<sup>10</sup> Specifically, as discussed below, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>11</sup> which requires, among other things, that the rules of a national securities

---

<sup>8</sup> See Securities Exchange Act Release Nos. 53104 (January 11, 2006), 71 FR 3142 (January 19, 2006) (SR-ISE-2006-02); 54083 (June 30, 2006), 71 FR 38920 (July 10, 2006) (SR-ISE-2006-35); 54542 (September 29, 2006), 71 FR 59170 (October 6, 2006) (SR-ISE-2006-57); 55144 (January 22, 2007), 72 FR 3890 (January 26, 2007) (SR-ISE-2007-05); 56155 (July 27, 2007), 72 FR 43306 (August 3, 2007) (SR-ISE-2007-67); 59176 (January 24, 2008), 73 FR 5615 (January 30, 2008) (SR-ISE-2008-08); 59276 (January 22, 2009), 74 FR 5007 (January 28, 2009) (SR-ISE-2009-02); 59943 (May 20, 2009), 74 FR 25296 (May 27, 2009) (SR-ISE-2009-28); 60956 (November 6, 2009), 74 FR 58674 (November 13, 2009) (SR-ISE-2009-93); and 63357 (November 22, 2010), 75 FR 73144 (November 29, 2010) (SR-ISE-2010-110).

<sup>9</sup> Citadel argues that this proposal facilitates anti-competitive behavior and therefore violates Section 3(f) of the Act. See Citadel Letter II, supra note 4, at 6. Section 3(f) of the Act requires the Commission to consider or determine whether this proposed rule change is necessary or appropriate in the public interest and, in addition to the protection of investors, will promote efficiency, competition, and capital formation. In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. As discussed below, the Commission does not believe the proposal is anti-competitive. 15 U.S.C. 78c(f).

<sup>10</sup> 15 U.S.C. 78f.

<sup>11</sup> 15 U.S.C. 78f(b)(5).

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 and are not designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

A. Proposal is Not Unfairly Discriminatory

Under the proposal, the ISE system would provide the identity of an EAM that enters a Directed Order to the DMM to whom the order is directed. Citadel argues that the lack of anonymity of Directed Orders allows the DMM receiving such orders to discriminate in its determination regarding for which orders the DMM would provide an opportunity for price improvement through the ISE's PIM auction.<sup>12</sup> The principal criticism of ISE's proposal is that it is inconsistent with the requirement in Section 6(b)(5) of the Act that the rules of an exchange not be "designed to permit unfair discrimination between customers, issuers, brokers, or dealers."<sup>13</sup> Section 6(b)(5) of the Act prohibits an exchange from establishing rules that treat these market participants in an unfairly discriminatory manner. Section 6(b)(5) of the Act does not prohibit exchange members or other broker-dealers from discriminating, so long as their activities are otherwise consistent with the federal securities laws. Nor does Section 6(b)(5) of the Act require exchanges to preclude discrimination by broker-dealers. Broker-dealers

---

<sup>12</sup> See Citadel Letter II, supra note 4, at 4-5.

<sup>13</sup> 15 U.S.C. 78f(b)(5). See Citadel Letter II, supra note 4, at 5; and Amex Letter, supra note 4, at 2.

commonly differentiate between customers based on the nature and profitability of their business.

Currently under ISE's rules, an EAM may provide an opportunity for price improvement to a customer order by submitting it to the PIM. An EAM may decide who to accept as its customers and further choose to provide an opportunity for price improvement to some customer orders, but not others, by exercising discretion as to whether it chooses to send a particular order to the PIM auction.<sup>14</sup> An EAM would know the identity of its customer in deciding whether to provide this opportunity for price improvement. A DMM may also provide an opportunity for price improvement to Directed Orders by submitting them to the PIM. The proposed rule change would enable a DMM to consider the identity of the EAM directing the order when deciding whether to provide an opportunity for price improvement.<sup>15</sup> Thus, the proposal will provide information to DMMs that is the same information available to other ISE members when they decide whether to provide price improvement to a particular order.

While customer anonymity may be valuable in ensuring that broker-dealers comply with legal obligations in a variety of circumstances, such as market makers' firm quote obligations, customer anonymity is not required of exchanges, particularly when disclosure of customer identity could provide benefits to certain customers beyond those

---

<sup>14</sup> See also Chapter V, Section 18 of the Boston Options Exchange Rules (Price Improvement Period) and Rule 6.74A of the Chicago Board Options Exchange, Incorporated (Automated Improvement Mechanism).

<sup>15</sup> Specialists and other market makers may establish payment for order flow relationships with firms on a discretionary basis. A specialist or market maker may pay varying amounts for order flow received from different firms or different customers within firms. Unlike payment for order flow, which principally benefits intermediaries and, indirectly, their customers through possibly lower fees and better services, customers' orders executed through the PIM auction directly benefit customers with the opportunity for an improved price.

required by the federal securities laws or exchange rules. In particular, market makers may be willing to offer better execution prices to certain customers' orders (e.g., retail customers' orders). The Commission does not believe that it would be inconsistent with the federal securities laws for the Exchange to provide, under the circumstances set forth in this proposal, the means for DMMs to differentiate between customers in providing price improvement or other non-required advantages to certain customers. The Exchange's proposal treats all DMMs the same and establishes no requirements for which orders a DMM chooses to provide an opportunity for price improvement. The Commission does not believe that the absence of Exchange rules specifying which orders a DMM may execute at prices better than its public quote is unfairly discriminatory.

Accordingly, while the proposal would permit a DMM to discriminate among customers in providing prices better than its quote, the Commission does not believe that this discrimination is inconsistent with Section 6(b)(5) of the Act.

B. Impact of Proposal on Market Quality and Competition

Citadel argues that the proposal would discourage aggressive quoting and would be detrimental to price improvement.<sup>16</sup> The Commission has considered this comment and does not believe that the rule change proposed by ISE would discourage DMMs from quoting aggressively. The Commission believes that a DMM has an incentive to quote aggressively to gain priority with respect to orders entered on the limit order book. Further, the Commission believes that the commenter's argument that the proposal will harm market quality rests on a number of premises that are unlikely to occur. The commenter assumes that ISE's proposal will lead to less aggressive quoting across all

---

<sup>16</sup> See Citadel Letter II, supra note 4, at 8-9.

options exchanges and a widening of the NBBO. The Commission does not believe that this will occur because there is rigorous competition for order flow across options exchanges so any widening of quotes on one market is an opportunity for another option market to capture order flow.<sup>17</sup> In fact, the Options Order Protection and Locked/Crossed Market Plan provides protection from one exchange ignoring better quoted prices on another market and will continue to promote quote competition across options exchanges.<sup>18</sup>

In addition, allowing a DMM to know the identity of firms sending Directed Orders may provide further incentive to that DMM to provide price improvement. A DMM that receives a Directed Order would be required to decide whether to send the order to the PIM and guarantee a price better than the ISE BBO and equal to or better than the NBBO to such order, or to release the order to the book. The DMM's decision about whether to choose to guarantee a particular order at a price better than the ISE BBO and equal to or better than the NBBO may be affected by this proposal because it provides DMMs with information to differentiate between orders from informed traders (*i.e.*, their competitors) and orders from uninformed traders. It is well known in academic literature and industry practice that prices tend to move against market makers after trades with informed traders, often resulting in losses for market makers.<sup>19</sup> Thus, there is

---

<sup>17</sup> See Robert Battalio, "Third Market Broker-Dealers: Cost Competitors or Cream Skimmers?" *Journal of Finance*, 1997; and Robert Battalio, Robert Jason Greene, and Robert Jennings, "How do Competing Specialists and Preferencing Dealers Affect Market Quality?" *Review of Financial Studies*, 1997.

<sup>18</sup> See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009).

<sup>19</sup> See Stoll, H. R., "The supply of dealer services in securities of markets," *Journal of Finance* 33 (1978), at 1133-51; Glosten, L. and P. Milgrom, "Bid ask and transaction prices in a specialist market with heterogeneously informed agents,"

a strong economic rationale for market makers not providing informed traders price improvement. Uninformed investors end up bearing the cost of these market maker losses through wider spreads that market makers need to quote to uninformed investors due to informed order flow.<sup>20</sup>

Citadel also argues that the Commission has previously sought to eliminate similar anti-competitive practices allowed by self-regulatory organizations (“SROs”) involving lack of order anonymity.<sup>21</sup> In particular, Citadel cites a 1996 investigation of NASD and Nasdaq Stock Market in which “[s]ome market makers, without disclosure to their customers, shared information with each other about their customers’ orders, including the size of the order and, on occasion, the identity of the customer.”<sup>22</sup> Citadel asserts that the “Commission concluded that this anti-competitive behavior violated the antifraud provisions of the Exchange Act, among other provisions.”<sup>23</sup>

The Commission does not believe that the proposal will result in market maker conduct like that in the NASD case, which found that market makers were collaborating with other market participants against the interests of their customers contrary to the fair dealing obligations of market makers.<sup>24</sup> Unlike the NASD case, the interests of the DMM’s customers are not harmed by this proposal because information pertaining to a

---

Journal of Financial Economics 14 (1985), at 71-100; and Copeland, T., and D. Galai, “Information effects on the bid-ask spread,” Journal of Finance 38 (1983), at 1457-69.

<sup>20</sup> Id.

<sup>21</sup> See Citadel Letter II, supra note 4, at 6.

<sup>22</sup> See Securities Exchange Act Release No. 37542 (August 8, 1996) (File No. 3-8919) (Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market), at 5.

<sup>23</sup> See Citadel Letter II, supra note 4, at 6.

<sup>24</sup> See Securities Exchange Act Release No. 37542, supra note 22, at 59.



DMM's Directed Orders is not shared among competing DMMs and all orders sent to ISE must be executed at a price no worse than the NBBO.<sup>25</sup>

Finally, Amex contends that the proposal is anti-competitive because providing the identity of an EAM to DMMs provides them with the ability to enter into anti-competitive customer allocation arrangements.<sup>26</sup> Amex argues that if ISE Market Makers know the identities of order flow providers, they could agree to allocate those order flow providers among themselves and provide price improvement to only those that each has been allocated.<sup>27</sup> There is, however, no evidence that customer allocation arrangements exist between Market Makers. The Commission is today approving only the proposed rule change, which permits a DMM to determine from which EAM it will accept Directed Orders. The Commission is not approving any customer allocation arrangements among Market Makers.

For the foregoing reasons, the Commission finds that the proposed rule change 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.<sup>28</sup>

---

<sup>25</sup> See ISE Rule 811(e).

<sup>26</sup> See Amex Letter, supra note 4, at 2.

<sup>27</sup> Id.

<sup>28</sup> 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>29</sup> that the proposed rule change (SR-ISE-2006-01) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>30</sup>

Cathy H. Ahn  
Deputy Secretary

---

<sup>29</sup> 15 U.S.C. 78s(b)(2).

<sup>30</sup> 17 CFR 200.30-3(a)(12).