SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69110; File No. SR-ISE-2013-22)

March 11, 2013

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Proposed Rule Change to Suspend Certain Market Maker Quotation Requirements and to Suspend Rule 720 Regarding Obvious Errors During Limit Up-Limit Down States in Securities that Underlie Options Traded on the ISE

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 March 8, 2013, the International Securities Exchange, LLC ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and II 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 suspend certain market maker quotation requirements and to suspend Rule 720 regarding obvious errors during limit up-limit down states in securities that underlie options traded on the ISE on a pilot basis. The text of the proposed rule change is available on the Exchange's Web site 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

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

2 17 CFR 240.19b-4.

in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B and C below, of the most significant aspects of such statements.

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

1. Purpose

On May 31, 2012, the Commission approved the Plan to Address Extraordinary Market Volatility (the "Plan"),[3] which establishes procedures to address extraordinary volatility in NMS Stocks. The procedures provide for market-wide limit up-limit down requirements that prevent trades in individual NMS Stocks from occurring outside of specified Price Bands. These limit up-limit down requirements are coupled with Trading Pauses to accommodate more fundamental price moves. The Plan procedures are designed, among other things, to protect investors and promote fair and orderly market.[4]

ISE is not a participant in the Plan because it does not trade NMS Stocks. However, the ISE trades options contracts overlying NMS Stocks. Because options pricing models are highly dependent on the price of the underlying security and the ability of options traders to effect hedging transactions in the underlying security, the implementation of the Plan will impact the trading of options classes traded on the Exchange. Specifically, under the Plan, upper and lower price bands will be calculated based on a reference price for each NMS Stock.[5] When one side of the market for an individual security is outside the applicable price band, the national best bid or national best offer will be disseminated with a flag identifying it as non-executable (i.e., a

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3 Securities Exchange Act Release No. 67091 (May 31, 2012), 77 F.R. 33498 (June 6, 2012) (File No. 4-631) ("Plan Approval Order").

4 Id. at 33511 (Preamble to the Plan)

5 The reference price equals the arithmetic mean price of eligible reported transactions for the NMS Stock over the immediately preceding five-minute period. See Section I(T) of the Plan.

"Straddle State"). When the other side of the market reaches the applicable price band, such national best bid or offer will be disseminated with a flag identifying it as a Limit State Quotation.[6] If trading for a security does not exit a Limit State within 15 seconds, a Trading Pause will be declared by the Primary Listing Exchange.[7] The Trading Pause will last at least five minutes[8] and will end when the Primary Listing Exchange disseminates a Reopening Price.[9]

When the national best bid (offer) for a security underlying an options class is non-executable, the ability for options market participants purchase (sell) shares of the underlying security and the price at which they may be able to purchase (sell) shares will become uncertain, as there will be a lack of transparency regarding the availability of liquidity for the security.[10] This uncertainty will be factored into the options pricing models of market professionals, such as

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[6] See Section I(D) of the Plan. The Limit State will end when the entire size of all Limit State Quotations are executed or cancelled.

[7] See Section VII(A) of the Plan. The Primary Listing Exchange is the market on which an NMS Stock is listed. If an NMS Stock is listed on more than one market, the Primary Listing Exchange is the market on which the security has been listed the longest. See Section I(O) of the Plan. A trading pause may also be declared when the national best bid (offer) is below (above) the lower (upper) price band and the security is not in a Limit State, and trading in that security deviates from normal trading characteristics. See Section VII(A)(2) of the Plan.

[8] A Trading Pause may last longer than 5 minutes if, for example, the Primary Market declares a Regulatory Halt, or if there is a significant order imbalance. See Section VII(B) of the Plan. If the Primary Listing Exchange does not report a Reopening Price within ten minutes after the declaration of a trading Pause and has not declared a Regulatory Halt, all trading centers may begin trading the security. Id.

[9] The Reopening Price is the price of a transaction that reopens trading on the Primary Listing Exchange following a Trading Pause or a Regulatory Halt, or, if the Primary Listing Exchange reopens with quotations, the midpoint of those quotations. The Exchange notes that under ISE Rule 702(c), trading on the Exchange is halted whenever trading in the underlying security has been paused by the primary listing market. Accordingly, the Exchange need not adopt any rule changes to address this aspect of the Plan.

[10] See Letter to Boris Ilyevsky, Managing Director, ISE, from Thomas Price, Managing Director, Securities Industry and Financial Markets Association, dated October 4, 2012 ("SIFMA Letter"). A copy of the letter is provided in Exhibit 2 to the filing.

options market makers, which will likely result in wider spreads and less liquidity at the best bid and offer for the options class. Accordingly, during a Limit State, the Exchange will automatically reject all incoming orders that do not contain a limit price to protect them from being executed at prices that may be vastly inferior to the prices available immediately prior to or following a Limit State or Straddle State.[11] Such un-priced orders include market orders and stop orders, which become market orders when the stop price is elected. The Exchange will also cancel any unexecuted market orders and unexecuted stop orders.

In light of the unusual market conditions, the Exchange proposes to suspend the maximum quotation spread requirement for market maker quotes contained in Rule 803(b)(5) and the continuous market maker quotation requirements contained in Rule 804(e) when the security underlying an option class is in a Limit State or Straddle State. The Exchange believes it may be very difficult for market makers to price options classes when there is uncertainty as to whether they are unable to buy and sell the underlying security, or at what prices and in what quantity. While some market makers may choose to provide liquidity in such circumstances, the risk associated with doing so may be too great for others.[12] The Exchange proposes to remove maximum spread requirements to encourage market makers to choose to provide liquidity during Limit States and Straddle States, as market makers will be discouraged from entering any quotations if they must do so within the maximum spread requirement.

The Exchange also proposes to exclude transactions executed during a Limit State or Straddle State from the provision of ISE Rule 720, on a one-year pilot basis. Rule 720 provides a process by which a transaction may be busted or adjusted when the execution price of a

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11 See SR-ISE-2013-20 (filed March 4, 2013).

12 The time periods associated with Limit States and Straddle States will not be considered by the Exchange when evaluating whether a market maker complied with the continuous quotation requirements contained in Rule 804(e).

transaction deviates from the option's theoretical price by a certain amount. Under Rule 720, the theoretical price is the national best bid price for the option with respect to a sell order and the national best offer for the option with respect to a buy order.[13] As discussed above, during a Limit State or Straddle State, options prices may deviate substantially from those available prior to or following the limit state. The Exchange believes this provision would give rise to much uncertainty for market participants as there is no bright line definition of what the "theoretical value" should be for an option when the underlying NMS stock has an unexecutable bid or offer or both. Determining "theoretical value" in such a situation would be often times very subjective as opposed to an objective determination giving rise to additional uncertainty and confusion for investors. Accordingly, the Exchange does not believe that the approach employed under Rule 720, which by definition depends on a reliable national best bid and offer in the option, is appropriate during a Limit State or Straddle State.[14]

After careful consideration, the Exchange believes the application of the current rule would be impracticable given the lack of a reliable national best bid or offer in the options market during Limit States and Straddle States, and produce undesirable effects. Pursuant to Rule 720, market participants have five minutes (in the case of a market maker) and 20 minutes (in the case of an Electronic Access Member) to notify the Exchange to review a transaction as

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13 Rule 720 provides that if there are no quotes from other options exchanges for comparison purposes, the theoretical price will be determined by designated personnel in the Exchange's market control center. However, given that options market makers and other industry professionals will have difficulty pricing options during Limit States and Straddle States, the Exchange does not believe it would be reasonable for ISE personnel to derive theoretical prices to be applied to transactions executed during such unusual market conditions.

14 See SIFMA Letter, supra note 10 (requesting that exchange obvious error rules that reference theoretical prices be reviewed to ensure that options exchange officials do not have the discretion to cancel executions of limit orders and stop limit orders during a limit or straddle state).

an obvious error under 720(c) and market participants have until 8:30 a.m. the following day to request that the Exchange review a trade as a catastrophic error under Rule 720(d).[15] The Exchange believes that during periods of extraordinary volatility, the review period for transactions under the obvious error and catastrophic error provisions would allow market participants to re-evaluate a transaction that occurred during a Limit State or Straddle State at a later time, which is potentially unfair to other market participants and would discourage market participants from providing liquidity during Limit States or Straddle States. For example, 20 minutes after a transaction that occurs during extraordinary volatility that triggers a Limit State or Straddle State the market could look drastically different from a price and liquidity level The Exchange believes that market participants should not be able to benefit from the time frame to review their transactions in these situations. Suspending application of Rule 720 would mitigate two of the undesirable aspects described above – (i) the moral hazard associated with granting a second look to trades that went against the market participant after market conditions have changed and (ii) gaming the obvious error rule to retroactively adjust market maker quotes by adjusting the execution price at a later time.

The Exchange notes that there are additional protections in place outside of the Obvious and Catastrophic Error Rule that will continue to safeguard customers. First, SEC Rule 15c3-5 requires that, "financial risk management controls and supervisory procedures must be reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous."[16] Secondly, the Exchange has price checks

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15 For transactions in expiring options series that take place on expiration Friday, the Member must notify the Exchange by 5:00 p.m. Eastern Time on that same day. See Rule 720(d)(1).

16 See Securities and Exchange Act Release No. 63241, 75 FR 69791 (November 15, 2010) (S7-03-10).

applicable to limit orders that rejects limit orders that are priced sufficiently far through the NBBO that it seems likely an error occurred. The requirements placed upon broker dealers to adopt controls to prevent the entry of orders that appear to be erroneous, coupled with Exchange functionality that filters out orders that appear to be erroneous serve to sharply reduce the incidence of errors arising from situations, for example, where a participant mistakenly enters an order to pay $20 for an option offered at $2. The Exchange also notes that pursuant to ISE Rule 705(d), the Exchange may compensate Members for losses resulting directly from the malfunction of the Exchange's systems, and that this protection is independent from ISE Rule 720. Accordingly, the Exchange believes it is appropriate to eliminate any potential protection applying the obvious error rule might provide during Limit and Straddle States, as its application may produce inequitable results.

The Exchange proposes to review the operation of this provision during the one-year pilot period for the proposal and analyze the impact of the Limit and Straddle States accordingly.[17] In this respect, the Exchange notes that its current obvious error rule does not contain a provision that permits the Exchange to review trades on its own motion. The Exchange believes that in normal market conditions, such a provision is not necessary and undermines the objective nature of the rule. However, during the pilot period, the Exchange will evaluate whether adopting such a provision for review trades during Limit and Straddle states is necessary and appropriate.

The Exchange notes that these proposed changes are consistent with the views of the Securities Industry and Financial Markets Association's ("SIFMA") Listed Options Trading

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[17] During the pilot, the Exchange will provide the commission with data regarding the how Limit and Straddle States effect the quality of the options market.

Committee.[18]

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the "Act")[19] in general, and furthers the objectives of Section 6(b)(5) of the Act[20] 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.

In consideration of the substantial risk associated with market making during such unusual market conditions, the Exchange believes exempting market makers from their continuous quotation obligations during Limit States and Straddle States, and removing maximum spread requirements for market makers quotes during such states, is necessary and appropriate to promote just and equitable principles of trade. As stated above, it may be very difficult for market makers to price options classes when there is uncertainty as to whether they will be able to buy and sell the underlying security, or at what prices and in what quantity. Moreover, giving options market makers the flexibility to choose whether to enter quotes and to do so without spread restrictions is necessary to encourage market makers to provide liquidity in options classes overlying securities that may enter a Limit State or Straddle State. The Exchange believes that encouraging liquidity in such options classes will help to assure a more fair and orderly market for investors leading up to, during, and following Limit States and Straddle States.

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18 Id.

19 15 U.S.C. 78f(b).

20 15 U.S.C. 78f(b)(5).

All other requirements related to market maker quotes will be applicable to market makers that choose to enter quotes during a Limit State or Straddle State. In this respect, the Exchange notes that such market makers continue to be subject to many obligations, including the obligation to maintain a fair and orderly market in their appointed classes, and that market makers are not permitted to make bids or offers or enter into transactions that are inconsistent with such course of dealings. Given that market makers are subject to these additional obligations when entering quotes, the Exchange believes it is appropriate to apply its normal execution principles if market makers choose to enter quotes during Limit States or Straddle States, even if they are not under an obligation to provide liquidity during these brief periods. The Exchange also notes that it would be impractical to apply a different execution algorithm during such brief and infrequent unusual market conditions, and that in any such case, the Exchange believes that removing incentives for market makers to provide liquidity during Limit States or Straddle States would serve to decrease the quality of its markets during these brief and unusual market conditions. For these reasons, the Exchange believes that the balance between the benefits provided to market makers and the obligations imposed upon market makers during Limit States and Straddle States by the proposed rule change is appropriate

The Exchange further believes that it is necessary and appropriate in the interest of promoting fair and orderly markets to exclude transactions executed during a Limit State or Straddle State from the provision of ISE Rule 720. The Exchange believes the application of the current rule will be impracticable given the lack of a relievable national best bid or offer in the options market during Limit States and Straddle States, and that the resulting actions (i.e., busted trades or adjusted prices) may not be appropriate given market conditions. This change would ensure that limit orders that are filled during a Limit State or Straddle State would have certainty of execution in a manner that promotes just and equitable principles of trade, removes impediments to, and perfects the mechanism of a free and open market and a national market system. Moreover, given that options prices during brief Limit States or Straddle States may deviate substantially from those available shortly following the Limit State or Straddle State, the Exchange believes giving market participants five minutes (in the case of a market maker) and 20 minutes (in the case of an Electronic Access Member) to re-evaluate a transaction would create an unreasonable adverse selection opportunity that would discourage participants from providing liquidity during Limit States or Straddle States. In this respect, the Exchange notes that by rejecting market orders and stop orders, and cancelling pending market orders and stop orders, only those orders with a limit price will be executed during a Limit State or Straddle State. Therefore, on balance, the Exchange believes that removing the potential inequity of busting or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying Rule 720 during such unusual market conditions. Additionally, as discussed above, there are additional pre-trade protections in place outside of the Obvious and Catastrophic Error Rule that will continue to safeguard customers.

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

The Exchange does not believe that the proposal will have any impact on competition among exchanges or market participants on the Exchange, as the proposal provides that market makers may, but are not required to, provide liquidity during Limit States and Straddle States, and that transactions executed during such states will not be reviewed pursuant to Rule 720.

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

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

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

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove 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 No. SR-ISE-2013-22 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 No. SR-ISE-2013-22. 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 such 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 No. SR-ISE-2013-22 and should be submitted on or before [insert date 15 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[21]

Kevin M. O'Neill
Deputy Secretary

[21] 17 CFR 200.30-3(a)(12).