SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71669; File No. SR-ISE-2014-10)

March 10, 2014

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Proposed Rule Change Related to Complex Orders

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 February 25, 2014, the International Securities Exchange, LLC (the "Exchange" or the "ISE") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I 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 the Substance of the Proposed Rule Change

The Exchange proposes to amend its rules by limiting certain types of complex orders from legging into the regular market. The text of the proposed rule change is available on the Exchange's website 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 A, B and C below, of the most significant aspects of such statements.

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

2 17 CFR 240.19b-4.

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

1. Purpose

The Exchange currently provides functionality that automatically removes a market maker's quotes in all series of an options class when certain parameter settings are triggered. Specifically, there are four parameters that can be set by market makers on a class-by-class basis. Pursuant to Rules 722 and 804, these parameters are mandatory for market maker quotes. Market makers establish a time frame during which the system calculates: (1) the number of total contracts executed by the market maker in an options class; (2) the percentage of the total size of the market maker's quotes in the class that has been executed; (3) the absolute value of the net between contracts bought and contracts sold in an options class; and (4) the absolute value of the net between (a) calls purchased plus puts sold in an options class, and (b) calls sold plus puts purchased in an options class.[3] Once the limits established by these parameters are triggered, the market maker's quotes are removed. The purpose of this functionality is to allow market makers to provide liquidity across potentially hundreds of options series without being at risk of executing the full cumulative size of all such quotes before being given adequate opportunity to adjust their quotes.

Standard complex orders can contain up to eight (8) legs in the trading system today while complex orders with a stock component can contain up to eight (8) option legs and a stock leg. As discussed above, by checking the risk parameters following each execution in an options series, the risk parameters allow market makers to manage their risk. This is not the case, however, when a complex order legs into the regular market. Because the execution of each leg

[3] See Securities Exchange Act Release No. 70132 (August 7, 2013), 78 FR 49311 (August 13, 2013) (SR-ISE-2013-38).

is contingent on the execution of the other legs, the execution of all the legs in the regular market is processed as a single transaction, not as a series of individual transactions. One market maker's quotes in the regular market can thus be hit in up to 8 instruments at the same time by a complex order.

For example, if individual orders to buy 10 contracts for the Jan 30 call, Jan 35 call and Jan 40 call are entered, each is processed as it is received and the market maker quotation parameters are calculated following the execution of each 10-contract order. Thus, if the first, or second order trigger a market maker's risk setting, their quotes will be adjusted prior to the processing of the subsequent order. However, if a complex order to buy all three of these strikes with a quantity of 10 contracts is entered and is executed against bids and offers for the individual series, the market maker parameters for quotes in the regular market are calculated following the execution of all 30 contracts (the sum of the three legs of 10 contracts each).

The legging-in of complex orders presents higher risk to market makers as compared to regular orders being entered in multiple series of an options class in the regular market as it can result in market makers exceeding their parameters by a greater number of contracts. At the request of market makers, the Exchange amended its rules to prevent complex orders from legging into the regular market if they have a large number of legs. Specifically, the Exchange currently limits the legging functionality to complex orders with no more than either two or three legs, as determined by the Exchange on a class by class basis.[4] However, despite the current limitations, certain market participants continue to use atypical multi-leg strategies (2 or more legs) to trade with multiple quotes from a single market maker thereby causing the single leg market maker to trade far more than its limit allows. Although market makers can limit their risk

[4] Id.

by use of the Exchange's risk parameters, the market maker's quotes are not removed until after a trade is executed. As a result, because of the way complex orders leg into the regular market as a single transaction, market makers end up trading more than the limitations they have set and are therefore exposed to greater risk. In turn, market makers are forced to change their trading behavior to account for the additional risk by widening their quotes, hurting the Exchange's quality of markets and the quality of the markets in general available for trading.

At the request of members and to further minimize the impact to single leg market makers, the Exchange now proposes to amend Rule 722 to limit a potential source of unintended market maker risk when certain types of complex orders leg into the regular market.[5] Specifically, complex orders with two option legs where both legs are buying or both legs are selling and both legs are calls or both legs are puts will be executed only in the complex order book and will not be permitted to leg into the regular market. For example:

- Buy Call 1, Buy Call 2
- Sell Call 1, Sell Call 2
- Buy Put 1, Buy Put 2
- Sell Put 1, Sell Put 2

The Exchange also proposes a similar restriction to limit complex orders with three option legs, where all legs are buying or all legs are selling regardless of whether the option is a call or a put. For example:

- Buy Call 1, Buy Call 2, Buy Put 1
- Buy Put 1, Buy Put 2, Buy Put 3

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[5] Pursuant to ISE Rule 722(b)(3)(ii), complex orders may be executed against bids and offers on the Exchange for the individual legs of the complex order, provided the complex order can be executed while maintaining a permissible ratio by such bids and offers.

- Buy Call 1, Buy Call 2, Buy Call 3
- Buy Put 1, Buy Put 2, Buy Call 3
- Sell Put 1, Sell Put 2, Sell Call 1

Strategies that involve these types of combinations of options are not traditional complex order strategies used by retail or professional investors, designed to gain exposure to a particular option class' movement. The vast majority of complex order strategies are made up of calendar and vertical spreads, butterflies and straddles, strategies that seek to hedge the potential move of the underlying security or to capture premium from an anticipated market event. In contrast, the atypical strategies illustrated above are primarily geared towards an aggressive directional capture of volatility. Through a combination of buying or selling multiple option legs at once, regardless of the implied directional move represented by a call versus a put, a market participant using one of these strategies is aggressively buying or selling volatility. By using the complex order mechanism that allows for the simultaneous executions of all legs, these strategies aim to bypass a single leg market maker's risk settings and result in an artificially large transaction that distorts the market for other related instruments, including the underlying security. These distortions in the market for the underlying security and related option series are caused by the simultaneous hedging activity triggered by such strategies. By legging in and potentially bypassing the risk settings of several market participants, these strategies create a larger trade than otherwise possible through the use of 'simple' or single-leg orders which then results in the affected market participants needing to immediately hedge these outsized positions. This activity in turn causes an immediate distortion in the market of the related securities as these market participants attempt to simultaneously buy or sell the underlying security or related option series. This type of effect can also be a result of a simple, large order affecting several

liquidity providers, but in the case of a complex strategy, involving several legs and therefore more size, the impact is more pronounced. By limiting these types of complex orders from legging in, the Exchange will strengthen the effectiveness of the risk tools it provides and thereby allow liquidity providers to post tighter and more liquid markets for regular orders and traditional complex orders, while at the same time reducing the frequency and size of related market distortions.

Further, the Exchange currently offers an order type called "legging orders"[6] to provide additional liquidity for complex orders resting on the complex order book. A complex order resting on the complex order book may be executed either by: (i) trading against an incoming complex order that is marketable against the resting complex order, or (ii) trading in the regular market when the net price of the complex order can be satisfied by executing all of the legs against the best bids or offers on the Exchange for the individual options series. Under current rules, legging orders may be generated automatically for simple two-legged options orders with the same quantity on both legs. However, with this proposed rule change, which in part applies to simple two-legged options orders with the same quantity on both legs, legging orders cannot be executed for these complex orders due the manner in which the trading system is designed. Specifically, the same component in the trading system handles both the trading of complex orders in the regular market and the execution of legging orders. Therefore, the proposed limitation to exclude these complex orders from trading in the regular market also means that the trading system will not generate legging orders for these types of two-legged complex orders.

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[6] A legging order is a limit order on the regular limit order book that represents one side of a complex order that is to buy or sell an equal quantity of two options series resting on the Exchange's complex order book. See ISE Rule 715(k).

The Exchange proposes to adopt language in proposed Rule 722(b)(3)(ii)(A) to note that the trading system will not generate legging orders for these complex orders.[7]

Additionally, the Exchange's Facilitation Mechanism has been available for the execution of complex orders since 2005[8] and the Solicited Order Mechanism has been available for the execution of complex orders since 2006.[9] And since 2011, members have also been able to execute complex orders in the Price Improvement Mechanism.[10] All three mechanisms expose orders to all Exchange members for 500 milliseconds to provide an opportunity for price improvement. Complex orders are processed in these mechanisms at a net price in the same manner as single-legged orders. If an improved net price for a complex order being executed can be achieved from bids and offers for the individual legs of the complex order in the Exchange's auction market, the order being executed receives an execution at the better net price. A single component in the trading system component handles both the trading of a new complex order with the regular order book upon arrival and at the end of the 500 millisecond exposure period. For complex orders that are the subject of this proposed rule change, if an improved net price for such complex orders being executed can be achieved from bids and offers for the individual legs of the complex order, the auction order cannot trade with the individual legs. Because an auction order, such as a PIM or a Facilitation cannot trade outside the ISE's best bid or offer, the auction order will be cancelled at the end of the 500 millisecond exposure period. The cancellation of

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7 The Exchange is not proposing to adopt similar language in proposed Rule 722(b)(3)(ii)(B) because legging orders cannot be generated for complex orders with 3 option legs.

8 See Securities Exchange Act Release No. 52327 (August 24, 2005), 70 FR 51854 (August 31, 2005) (SR-ISE-2004-33).

9 See Securities Exchange Act Release No. 53729 (April 26, 2006), 71 FR 26154 (May 3, 2006) (SR-ISE-2006-15).

10 See Securities Exchange Act Release No. 64805 (July 5, 2011), 76 FR 40758 (July 11, 2011) (SR-ISE-2011-30).

auction orders in such instances is similar to the current handling of situations when the bid or offer at the ISE, made up of individual series, becomes better than the net price of the complex auction order on the same side (bid better during an auction order where the agency side is the buyer, ask better during an auction where the agency side is the seller). In these instances, at the end of the 500 millisecond exposure period, if the net price of the auction order is inferior to the bid or offer on the same side of auction order, the auction is cancelled without any execution. With respect to the bids and offers for the individual legs of a complex order entered into the three mechanisms, the priority rules for complex orders contained in Rule 722(b)(2) will continue to apply.

The Exchange proposes to amend Supplementary Material .08 to Rule 716 and Supplementary Material .10 to Rule 723 to reflect how complex orders listed in proposed Rule 722(b)(3)(ii)(A) and (B) are treated in the Exchange's three auction mechanisms.

The Exchange notes that the number of these atypical complex orders is small relative to the total number of complex orders executed on the Exchange on a given day. The Exchange believes that the potential risk to market makers in the regular market of allowing these atypical complex orders out-weighs the potential benefit of offering such functionality to a very limited number of orders. With this proposal, the Exchange is not entirely restricting the execution of these types of complex orders. These orders may still be executed in the complex order book thus, will rest on the complex order book until they are traded or cancelled by the member that entered them.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the "Act")[11] in general, and furthers the objectives of Section 6(b)(5) of the Act[12] 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 Exchange believes it is reasonable to limit the types of complex orders that are eligible to leg-into the regular market. In this respect, the Exchange notes that the vast majority of complex orders sent to the Exchange will be unaffected by this rule change. Moreover, the Exchange believes that the potential risk of continuing to offer legging functionality for complex orders such as those impacted by the proposed rule change limits the amount of liquidity that market makers are willing to provide in the regular market. In particular, market makers may reduce the size of their quotations in the regular market because they are at risk of executing the cumulative size of their quotations across multiple options series without an opportunity to adjust their quotes. Accordingly, reducing market maker risk in the regular market by limiting the legging functionality as proposed herein will benefit investors by encouraging additional liquidity in the regular market. This benefit to investors far exceeds the small amount of potential liquidity provided by the few complex orders this proposal seeks to restrict to trading in the complex order book.

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

The proposed rule change does not impose any burden on competition. The proposed change to limit legging functionality, as proposed, will reduce risk to market makers that are

[11] 15 U.S.C. 78f(b).

[12] 15 U.S.C. 78f(b)(5).

quoting in the regular market. As such, the proposal may encourage market makers to increase the size of their quotations, thereby adding liquidity on the Exchange.

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 up to 90 days (i) as the Commission may designate 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 Number SR-ISE-2014-10 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-ISE-2014-10. 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 offices 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-ISE-2014-10, 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.[13]

Kevin M. O'Neill
Deputy Secretary

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[13] 17 CFR 200.30-3(a)(12).