

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-74521; File No. SR-ISE-2014-43)

March 17, 2015

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Amending its Information Barrier Rules

I. Introduction

On September 15, 2014, International Securities Exchange, LLC (“Exchange” or “ISE”) 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 amending its information barrier rules. The proposed rule change was published for comment in the Federal Register on October 6, 2014.<sup>3</sup> The Commission received one comment letter regarding the proposed rule change<sup>4</sup> and one response letter from ISE.<sup>5</sup> On November 17, 2014, the Commission extended the time period in which to either approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to January 2, 2015.<sup>6</sup> On December 31, 2014, the Commission instituted proceedings to determine whether to approve or disapprove

---

<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. 73261 (September 30, 2014), 79 FR 60226 (“Notice”).

<sup>4</sup> See Letter from John Kinahan, Chief Executive Officer, Group One Trading, L.P., dated October 27, 2014 (“Group One Letter”).

<sup>5</sup> See Letter from Michael J. Simon, Secretary and General Counsel, International Securities Exchange, LLC, dated November 14, 2014 (“ISE Response Letter”).

<sup>6</sup> See Securities Exchange Act Release No. 73614 (November 17, 2014), 79 FR 69547 (November 21, 2014).

the proposed rule change.<sup>7</sup> On March 9, 2015, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>8</sup> This order approves the proposed rule change, as modified by Amendment No. 1.

## II. Description of the Proposal

The Exchange proposes to amend ISE Rules 810 (Limitations on Dealings) and 717 (Limitations on Orders) governing information barriers. Specifically, the Exchange proposes to amend Rule 810 to permit information to flow to a member's EAM unit, which handles the customer/agency side of the business, from its affiliated Primary Market Maker ("PMM") and/or Competitive Market Maker ("CMM") (jointly, "market makers") unit. As amended, ISE Rule 810 will allow EAMs to know where, and at what price, their affiliated market makers are either quoting or have orders on the order book<sup>9</sup> and to use that information to influence routing

---

<sup>7</sup> See Securities Exchange Act Release No. 73973 (December 31, 2014), 80 FR 583 (January 6, 2015).

<sup>8</sup> In Amendment No. 1 the Exchange clarifies that an Electronic Access Member ("EAM") would only have access to the publicly available orders and quotes of its affiliated market maker. In addition, the Exchange clarifies that the proposed rule change would not permit a member's EAM unit to access any non-public order or quote information of its affiliated market maker, including any hidden or undisplayed size or price information. The Exchange also clarifies that market makers are not allowed to post hidden or undisplayed orders and quotes on the Exchange. Finally, the Exchange clarifies that its members would not expect to receive any additional order or quote information as a result of this proposed rule change. Amendment No. 1 is not subject to notice and comment because it is a technical amendment that does not materially alter the substance of the proposed rule change or raise any novel regulatory issues.

Amendment No. 1 has been placed in the public comment file for SR-ISE-2014-43 at <http://www.sec.gov/comments/sr-ise-2014-43/ise201443.shtml> (see letter from Michael J. Simon, Secretary and General Counsel, International Securities Exchange, LLC, to Secretary, Commission, dated March 9, 2015) and also is available at the Exchange's website at [www.ise.com](http://www.ise.com).

<sup>9</sup> According to ISE Rule 805(b)(1)(ii), market makers may only have orders on the order book in option classes to which they are not appointed.

decisions. The Exchange represents that it currently provides guidance to its members that ISE Rule 810 is to be interpreted as a two-way information barrier between the EAM unit and its affiliated market maker unit.<sup>10</sup>

The Exchange also proposes to amend ISE Rule 717, Supplementary Material .06 to specify that the orders of a EAM unit and its affiliated PMM and/or CMM unit may interact within one second without violating the ISE Rule 717(d) and (e) order exposure requirements when the firm can demonstrate that: (1) the customer order was marketable when routed; (2) the EAM was not handling the affiliated market maker quote/order; and (3) the affiliated market maker quote/order was in existence at the time the customer order(s) were entered into the ISE system. In combination, the proposed amendments to ISE Rules 810 and 717 will make it possible for an EAM to route a customer order to the ISE to immediately interact with the quote or an order of an affiliated market maker, but only subject to the conditions stated above.

### III. Comment Letter and ISE's Response

As noted above, the Commission received one comment letter<sup>11</sup> opposing the proposed rule change.<sup>12</sup> The commenter asserts that the proposed one-way information barrier would introduce a conflict of interest which could result in EAMs routing orders based on self-interest as opposed to the customer's interest.<sup>13</sup> The commenter disagrees with the Exchange's premise that the proposed rule change would not compromise market integrity or cause customer harm.<sup>14</sup> The commenter also indicates that although other exchanges may interpret their rules to permit

---

<sup>10</sup> See Notice, supra note 3, 79 FR 60226, 60226.

<sup>11</sup> See Group One Letter, supra note 4.

<sup>12</sup> See ISE Response Letter, supra note 6.

<sup>13</sup> See Group One Letter at 1, supra note 4.

<sup>14</sup> Id.

the sharing of information between the various units of a firm, such sharing only weakens a customer's chance of best execution.

The commenter believes there are two specific scenarios where a customer may be harmed under this proposed rule change. First, the commenter states that EAMs could route customer orders to an affiliated market maker's quote at an exchange's best bid or offer rather than to an exchange with a better fill rate or price improvement mechanism.<sup>15</sup> Second, the commenter argues that an EAM holding a large customer order that could influence the price in the underlying could opt to route away from the quote of its affiliated market maker to avoid the potential risk of the trade and deprive the customer of a fill they were otherwise entitled to.<sup>16</sup>

The commenter indicates that these routing scenarios are not "mere conjecture" as broker-dealers "openly admit" that numerous factors are built into routing decisions that are primarily beneficial to broker-dealers.<sup>17</sup> The commenter also notes that there are litigation and academic studies that suggest that routing decisions are negatively impacted by conflicts of interest. The commenter believes that the erosion of information barriers would increase the likelihood that customer orders are routed based on the firm's best interest as opposed to duty of best execution owed to the customer.<sup>18</sup> The commenter concludes that two-way information barriers are the "only way to truly guard customer interests and protect against the misuse of material non-public information," and a shift to a one-way information barrier would not provide any benefits EAM customers.<sup>19</sup> The commenter also believes that exchange rules should be

---

<sup>15</sup> Id.

<sup>16</sup> Id. at 2.

<sup>17</sup> Id.

<sup>18</sup> Id.

<sup>19</sup> Id.

written and interpreted in a way that prevents conflicts of interest from ever arising, and a two-way information barrier takes the potential conflict of interest out of the equation.<sup>20</sup>

The ISE responds that the commenter did not raise any new issues and its concerns were addressed in the Notice.<sup>21</sup> The ISE states that nothing in the proposed rule change would relieve members of their best execution obligation to obtain the most favorable terms reasonably available for customer orders.<sup>22</sup> The Exchange notes that, as a national securities exchange, it has a comprehensive surveillance program to monitor member compliance with applicable securities and regulations, including best execution.<sup>23</sup> ISE also represents that it would continue to monitor for abnormalities in interaction rates between members, and investigate and take appropriate regulatory action against members that fail to comply with their best execution obligations.<sup>24</sup> ISE believes that its surveillance tools will allow it to fulfill its regulatory responsibilities.<sup>25</sup> ISE also suggests that the filing is a competitive imperative as other options exchanges currently interpret their information barrier rules to be one way barriers that permit members to make routing decisions based on the quotes and orders of affiliated business units.<sup>26</sup>

#### IV. Discussion and Commission Findings

After careful consideration, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and

---

<sup>20</sup> Id.

<sup>21</sup> See ISE Response Letter at 1, supra note 6.

<sup>22</sup> Id.

<sup>23</sup> Id.

<sup>24</sup> Id.

<sup>25</sup> Id.

<sup>26</sup> Id. at 2.

regulations thereunder applicable to a national securities exchange.<sup>27</sup> The Commission believes that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(5)<sup>28</sup> in particular, in that it is 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 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.

Amended ISE Rule 810 permits a less restrictive, one-way information barrier between market makers and other business units, as opposed to the prior rule that required a prescriptive, two-way information barrier. Nonetheless, the Commission notes that Exchange members are still required to have policies and procedures that are reasonably designed to prevent the misuse of material, non-public information consistent with Section 15(g) of the Act<sup>29</sup> and ISE Rule 408.<sup>30</sup> The Commission notes that the EAM unit of a member would not, pursuant to the proposed rule change, have access to any non-public quote or order information, including hidden or undisplayed price or size information, of an affiliated market maker.<sup>31</sup> The Commission also notes that the Exchange has represented that its ongoing surveillance for

---

<sup>27</sup> In approving this rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

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

<sup>29</sup> See 15 U.S.C. 78o(g). Section 15(g) of the Act requires every broker or dealer to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse...of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer."

<sup>30</sup> Further, Exchange members will continue to be subject to ISE Rules 400 (Just and Equitable Principles of Trade), 401 (Adherence to Law), and 405 (Manipulation).

<sup>31</sup> See Amendment No. 1, supra note 8.

manipulative conduct and the Financial Industry Regulatory Authority’s exam program that reviews for member compliance with such policies and procedures should provide a regulatory framework that guards customer interests and protects against the misuse of material non-public information.<sup>32</sup>

Finally, as noted above, the commenter expressed concern that this proposed rule change would introduce a conflict of interest that would erode the duty of best execution and harm customers. The Exchange believes, and the Commission agrees, that this proposed rule change, as modified by Amendment No. 1, does not alter a broker-dealer’s duty of best execution.<sup>33</sup>

Although the proposed rule change, as modified by Amendment No. 1, will permit EAMs to know and consider the quotes of its affiliated market makers when making routing decisions, the Commission continues to expect that routing decisions related to the duty of best execution will be premised solely on customer considerations such as the likelihood of execution, the opportunity to obtain price improvement, availability of best price and minimization of market impact.<sup>34</sup> The Commission emphasizes that a broker-dealer’s duty of best execution exists whether an EAM determines to route customer order flow toward its affiliated market maker or away from its affiliated market maker. Further, the Commission notes that in response to the commenter’s concern that the proposed rule change would negatively impact best execution considerations, ISE stated that it would “continue to monitor for abnormalities in interaction

---

<sup>32</sup> See Notice, supra note 3, 79 FR 60226, 60227.

<sup>33</sup> See Notice, supra note 3, 79 FR 60226, 60227; ISE Response Letter at 1, supra note 6.

<sup>34</sup> See e.g., FINRA Rule 5310 (Best Execution and Interpositioning); see also Securities Exchange Act Release No. 34-51808, 70 FR 37496, 37537-8 (Jun. 29, 2005) (File No. S7-10-04) (Regulation NMS Final Rules); Securities Exchange Act Release No. 37619A, 61 FR 48290, 48322-3 (Sep. 12, 1996) (File No. S7-30-95) (Order Execution Obligations Final Rules).

rates between members, and will investigate and take appropriate regulatory action against members that fail to comply with their best execution obligations ... [and that] these surveillance tools will allow ISE to comply with its regulatory responsibilities, consistent with treatment across competitor options exchanges.”<sup>35</sup> Among other things, the Commission’s oversight of the ISE program is designed to evaluate the ISE’s performance in regard to that representation.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act<sup>36</sup> that the proposed rule change (SR-ISE-2014-43), as modified by Amendment No. 1, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>37</sup>

Jill M. Peterson  
Assistant Secretary

---

<sup>35</sup> See ISE Response Letter at 1, supra note 6.

<sup>36</sup> 15 U.S.C. 78s(b)(2).

<sup>37</sup> 17 CFR 200.30-3(a)(12).