

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-78423; File No. SR-ISE-2015-30)

July 27, 2016

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Disapproving a Proposed Rule Change to Amend Rule 804(g)

I. Introduction

On November 10, 2015, the International Securities Exchange, LLC (“ISE” or the “Exchange”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to require Clearing Member³ approval for a market maker⁴ to resume trading after the activation of a market-wide speed bump under ISE Rule 804(g). The proposed rule change was published for comment in the Federal Register on November 30, 2015.⁵

On January 13, 2016, the Commission extended the time period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ A “Clearing Member” is a Member that is self-clearing or an Electronic Access Member that clears transactions executed on or through the facilities of the Exchange for other Members of the Exchange. See ISE Rule 100(a)(8). An “Electronic Access Member” is an Exchange Member that is approved to exercise trading privileges associated with EAM Rights. See Article XIII, Section 13.1(1) of the Second Amended and Restated Constitution of ISE.

⁴ ISE has two categories of market makers: Primary Market Makers (“PMMs”) and Competitive Market Makers (“CMMs”). A PMM is appointed to each options class traded on the Exchange, but a CMM may or may not be appointed to each such options class. See ISE Rule 802.

⁵ See Securities Exchange Act Release No. 76506 (November 23, 2015), 80 FR 74829 (“Notice”).

determine whether to disapprove the proposed rule change to February 28, 2016.⁶ On February 26, 2016, the Commission instituted proceedings under Section 19(b)(2)(B) of the Act⁷ to determine whether to approve or disapprove the proposed rule change.⁸ Specifically, the Commission instituted proceedings to allow for additional analysis of, and input from commenters with respect to, the proposed rule change's consistency with Section 6(b)(5) of the Act.⁹ On May 26, 2016, the Commission extended the time period for Commission action on the proceedings to determine whether to disapprove the proposed rule change.¹⁰ The Commission did not receive any comments on the proposed rule change and the Exchange did not submit a response to the Commission's order instituting proceedings. This order disapproves the proposed rule change.

II. Description of the Proposal

The Exchange has an automated quotation adjustment functionality that is governed by its Rule 804(g)(1) (for regular orders) and Supplementary Material .04 to Rule 722 (for complex orders). Pursuant to these Rules, the Exchange will automatically remove a market maker's quotations in all series of an options class or in all complex order strategies of an options class when, during a specified time period, the market maker exceeds certain execution parameters.¹¹ All market makers are required by ISE to provide these specific parameters. Additionally, the Exchange will automatically remove a market maker's quotes in all classes when, during a

⁶ See Securities Exchange Act Release No. 76893, 81 FR 3217 (January 20, 2016).

⁷ 15 U.S.C. 78s(b)(2)(B).

⁸ See Securities Exchange Act Release No. 77246, 81 FR 11305 (March 3, 2016) ("Order Instituting Proceedings").

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ See Securities Exchange Act Release No. 77928, 81 FR 35409 (June 2, 2016).

¹¹ See ISE Rule 804(g)(1) and Supplementary Material .04 to Rule 722 for a description of the parameters. The time period is specified by the market maker.

specified time period, the total number of quote removal events (“curtailment events”) described in Rule 804(g)(1) and in Supplementary Material .04 to Rule 722 exceed a specified market-wide parameter (“market-wide speed bump”).¹² As with the functionality to remove all option series of an options class or complex order strategies of an options class, all market makers are required by ISE to specify a market-wide parameter. The market-wide speed bump is available for quotes only on ISE or across both ISE and ISE’s affiliated exchange, ISE Gemini, LLC.¹³ The Exchange states that, after a market-wide speed bump is triggered and the trading system removes all of a market maker’s quotes, the market maker may re-enter the market and resume trading upon notification to the Exchange’s Market Operations.¹⁴

Under the proposal, the Exchange seeks to amend the process by which market makers can re-enter the market. Specifically, the proposal requires Clearing Member approval before a market maker can resume trading after triggering a market-wide speed bump.¹⁵ Following a market-wide speed bump, the proposed rule requires: (1) a market maker to notify its Clearing Member(s) when it is ready to resume trading; and (2) each applicable Clearing Member to inform the Exchange directly when its authorization has been given for the market maker to resume trading.¹⁶ In order to “facilitate a better response time” from Clearing Members so that a market maker can re-enter the market, the proposal also allows the Exchange staff to notify

¹² See ISE Rule 804(g)(2). The time period for a market-wide speed bump is also specified by the market maker.

¹³ Id.

¹⁴ See Notice, supra note 5, at 74830.

¹⁵ See proposed Rule 804(g)(2).

¹⁶ See id.

Clearing Member(s) when a market maker's quotes have been removed pursuant to the market-wide speed bump.¹⁷

III. Discussion and Commission Findings

Under Section 19(b)(2)(C) of the Act,¹⁸ the Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to such organization.¹⁹ The Commission shall disapprove a proposed rule change if it does not make such a finding.²⁰ Rule 700(b)(3) of the Commission's Rules of Practice states that the "burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder ... is on the self-regulatory organization that proposed the rule change" and that a "mere assertion that the proposed rule change is consistent with those requirements ... is not sufficient."²¹

After careful consideration, the Commission does not find that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable

¹⁷ See id.

¹⁸ 15 U.S.C. 78s(b)(2)(C).

¹⁹ See 15 U.S.C. 78s(b)(2)(C)(i).

²⁰ See 15 U.S.C. 78s(b)(2)(C)(ii); see also 17 CFR 201.700(b)(3).

²¹ See 17 CFR 201.700(b)(3). "The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding. Any failure of a self-regulatory organization to provide the information elicited by Form 19b-4 may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder that are applicable to the self-regulatory organization." Id.

to a national securities exchange.²² In particular, the Commission does not find that the proposed rule change is consistent with Section 6(b)(5) of the Act,²³ which, among other things, requires that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, 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 has stated in the past that, because market makers receive favorable treatment from an exchange, they must also be subject to sufficient and commensurate affirmative obligations, including the obligation to hold themselves out as willing to buy and sell options for their own account on a regular or continuous basis.²⁴ Accordingly, under ISE's current rules, a market maker must enter continuous quotations for the options classes to which it is appointed.²⁵ In return, the market maker receives certain benefits, including participation entitlements²⁶ and an exception from the prohibition in Section 11(a) of the Act.²⁷

The Exchange proposes to require Clearing Member approval before a market maker can resume trading after triggering a market-wide speed bump. The Exchange states in its filing that

²² In disapproving the proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²³ 15 U.S.C. 78f(b)(5).

²⁴ See, e.g., Securities Exchange Act Release No. 68341 (December 3, 2012), 77 FR 73065, 73076 (December 7, 2012) (approving the application of Miami International Securities Exchange, LLC for registration as a national securities exchange); Securities Exchange Act Release No. 70050 (July 26, 2013), 78 FR 46622 (August 1, 2013) (approving the application of Topaz Exchange, LLC for registration as a national securities exchange); Securities Exchange Act Release No. 76998 (January 29, 2016), 81 FR 6066 (February 4, 2016) (approving the application of ISE Mercury, LLC for registration as a national securities exchange).

²⁵ See ISE Rule 804(e).

²⁶ See, e.g., ISE Rule 713.

²⁷ 15 U.S.C. 78k(a).

the Clearing Member should approve a market maker's re-entry into the market after a market-wide speed bump because the Clearing Member guarantees the market maker's trades and bears the ultimate financial risk associated with the transactions.²⁸ The Exchange notes that, while not all market makers are Clearing Members, all market makers require a Clearing Member's consent to clear transactions on their behalf in order to conduct business on the Exchange.²⁹ The Exchange asserts that the proposed rule change will permit Clearing Members to better monitor and manage the potential risks assumed by market makers and will provide Clearing Members with greater control and flexibility over their risk tolerance and exposure.³⁰ The Exchange further contends that, "[w]hile in some cases [the proposed rule change] may result in a minimal delay for a market maker that wants to reenter the market quickly following a market-wide speed bump, the Exchange believes that Clearing Member approval...ensure[s] that the market maker does not prematurely enter the market without adequate safeguards..."³¹

As noted above, on February 26, 2016, the Commission instituted proceedings under Section 19(b)(2)(B) of the Act³² to determine whether to approve or disapprove the proposed rule change.³³ In the order instituting proceedings, the Commission noted that the Exchange does not address how the proposal would impact the continuous quoting obligations of market makers and

²⁸ See Notice, supra note 5, at 74830.

²⁹ Each market maker authorized to trade on the Exchange must obtain from a Clearing Member a "Market Maker Letter of Guarantee" wherein the Clearing Member accepts financial responsibility for all Exchange transactions made by the market maker. See ISE Rule 808.

³⁰ See Notice, supra note 5, at 74830. Under ISE's current rules, the Exchange may share any Member-designated risk settings in the trading system with the Clearing Member that clears transactions on behalf of the Member. See ISE Rule 706(a).

³¹ See Notice, supra note 5, at 74830.

³² 15 U.S.C. 78s(b)(2)(B).

³³ See Securities Exchange Act Release No. 77246, 81 FR 11305 (March 3, 2016) ("Order Instituting Proceedings").

provided no basis for its statement that the proposed rule would result in only a “minimal delay” for a market maker seeking to resume quoting following a market-wide speed bump.

Accordingly, the Commission stated that the proposed rule change raises questions regarding the ability of market makers to meet their quoting obligations, and whether the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act. The Exchange did not respond to the issues raised in the Commission’s order instituting proceedings.

The Commission does not believe the Exchange has met its burden to demonstrate that the proposed rule change is consistent with the Act and the rules and regulations issued thereunder. The Exchange proposes to require Clearing Member approval before a market maker can resume trading following a market-wide speed bump so that Clearing Members can better monitor and manage their potential risks. Providing this additional risk management tool to Clearing Members, however, necessarily will delay the resumption of quoting by market makers and the resulting potential market quality benefits to all users of the Exchange. Although the Exchange states that any delay would be minimal, it provides no evidence to support that assertion. The Exchange also has not explained why Clearing Member risks cannot effectively be addressed through other means, such as bilateral, contractual arrangements between Clearing Members and market makers that do not impede a market maker’s ability to promptly resume quoting and enhance the Exchange’s market quality.

Accordingly, the Commission does not believe that the Exchange has met its burden to demonstrate that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder. In particular, the Commission does not find that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act, which requires that the rules of an exchange, among other things, 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.³⁴

IV. Conclusion

For the foregoing reasons, the Commission does not find 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.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁵ that the proposed rule change (SR-ISE-2015-30) be, hereby is, disapproved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁶

Robert W. Errett
Deputy Secretary

³⁴ 15 U.S.C. 78f(b)(5).

³⁵ 15 U.S.C. 78s(b)(2).

³⁶ 17 CFR 200.30-3(a)(12).