

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60584; File No. SR-ISE-2009-35)

August 28, 2009

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Granting Approval of Proposed Rule Change Relating to Qualified Contingent Cross Orders

I. Introduction

On June 15, 2009, the 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”)¹ and Rule 19b-4 thereunder,² a proposed rule change to provide for Qualified Contingent Cross Orders. The proposed rule change was published for comment in the Federal Register on June 26, 2009.³ The Commission received two comment letters in response to the proposed rule change⁴ and a comment response letter from the Exchange.⁵ This order grants approval of the proposed rule change.

II. Description of the Proposal

The Exchange is currently a participant in the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage (“Current Plan”).⁶ Subject to certain conditions, the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 60147 (June 19, 2009), 74 FR 30651 (“Notice”).

⁴ See letter from Angelo Evangelou, Assistant General Counsel, Chicago Board Options Exchange (“CBOE”), to Elizabeth M. Murphy, Secretary, Commission, dated July 16, 2009 (“CBOE Letter”) and letter from Gerald D. O’Connell, Chief Compliance Officer, Susquehanna International Group, LLP (“SIG”), to Elizabeth M. Murphy, Secretary, Commission, dated August 10, 2009 (“SIG Letter”).

⁵ See letter from Michael J. Simon, Secretary and General Counsel, ISE, to Elizabeth M. Murphy, Secretary, Commission, dated August 20, 2009 (“ISE Letter”).

⁶ See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (File No. 4-429).

Current Plan provides for a limited trade-through⁷ exemption for “block trades” which are trades that, among other things, consist of 500 or more contracts with a premium value of at least \$150,000.⁸ The Commission recently approved the Order Protection and Locked/Crossed Market Plan (“New Plan”),⁹ which will replace the Current Plan. Unlike the Current Plan, however, the New Plan does not provide an exemption for block trades. The Exchange believes that the loss of the block trade exemption will adversely affect the ability of its members to effect large trades that are tied to stock, and is proposing a new order type, the Qualified Contingent Cross Order,¹⁰ which the Exchange proposes to implement contemporaneously with its New Linkage Rules.

The proposed Qualified Contingent Cross Order would permit an ISE member to cross the options leg of a Qualified Contingent Trade (“QCT”)¹¹ on ISE immediately upon entry if the order is: (i) for at least 500 contracts; (ii) part of a QCT; and (iii) executed at a price at or

⁷ A trade-through is a transaction in a given options series at a price that is inferior to the best price available in the market (“Trade-Through”). See Section 2(21) of the New Plan and Section 2(29) of the Current Plan.

⁸ Current Plan Section 2(3) and 8(c)(i)(C).

⁹ See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546). The Exchange has also proposed revisions to its rules to implement the New Plan (“New Linkage Rules”). See Securities Exchange Act Release No. 60559 (August 21, 2009), 74 FR 44425 (August 28, 1009) (SR-ISE-2009-27).

¹⁰ Proposed ISE Rule 715(j), proposed Supplementary Material .01 to ISE Rule 715, and proposed ISE Rule 721(b).

¹¹ A Qualified Contingent Trade is a transaction consisting of two or more component orders, executed as agent or principal, that satisfy the six elements in the Commission’s order exempting QCTs from the requirements of Rule 611(a) of Regulation NMS under the Act (“Regulation NMS”), which requires trading centers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs. See Securities Exchange Act Release No. 57620 (April 4, 2008) 73 FR 19271 (April 9, 2008) (“QCT Release”). See also Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006).

between the national best bid or offer (“NBBO”).¹² Proposed Supplementary Material .01 to ISE Rule 715 defines a QCT as a transaction composed of two or more orders, executed as agent or principal, where: (i) at least one component is in an NMS stock; (ii) all components are effected with a product or price contingency that either has been agreed to by all the respective counterparties or arranged for by a broker-dealer as principal or agent; (iii) the execution of one component is contingent upon the execution of all other components at or near the same time; (iv) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined by the time the contingent order is placed; (v) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or cancelled; and (vi) the transaction is fully hedged (without regard to any prior existing position) as a result of other components of the contingent trade.¹³

The Exchange represents that it will adopt policies and procedures to ensure that its members use the Qualified Contingent Cross Order properly, including requiring them to properly mark such orders and instituting surveillance procedures to identify that the member executed the stock leg of the transaction at or near the same time as the options leg.

III. Discussion and Commission Findings

After careful review, 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

¹² Qualified Contingent Cross Orders will be automatically canceled if they cannot be executed. Proposed ISE Rule 721(b)(1).

¹³ These requirements are substantively identical to those in the QCT Release, supra note 11.

securities exchange and, in particular, with Section 6(b) of the Act.¹⁴ Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹⁵ which requires, among other things, that the rules of a national securities exchange 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. In addition, the Commission finds that the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act,¹⁶ in which Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure, among other things, the economically efficient execution of securities transactions.

In 2006, the Commission provided an exemption from Rule 611(a) of Regulation NMS for each NMS stock component of contingent trades that satisfied the six requirements for “qualified contingent trades” (“NMS QCT Exemption”).¹⁷ Pursuant to the Commission’s exemption, trade-throughs caused by the execution of orders involving one or more NMS stocks that are components of a QCT are permitted. The Commission stated that QCT transactions that meet the specified requirements could be useful trading tools for investors and other market participants, and could be of benefit to the market as a whole, contributing to the efficient functioning of the securities markets and the price discovery process.¹⁸

¹⁴ 15 U.S.C. 78f(b). In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ 15 U.S.C. 78k-1(a)(1)(C).

¹⁷ See supra note 11.

¹⁸ See QCT Release, supra note 11 at 19273.

As a result of the loss of the Trade-Through exemption for block trades that is available under the Current Plan, but not available under the New Plan, the Exchange has proposed the Qualified Contingent Cross Order, which it believes is necessary to facilitate the execution of large-sized stock-option orders. In particular, the Exchange stated that this proposed Qualified Contingent Cross Order is needed when the components of a stock-option are executed in separate markets, rather than as a package on options exchanges.¹⁹ The Exchange's proposal would provide for a new order type, the Qualified Contingent Cross Order, that would permit a cross of the options leg of a stock-option order that, among other things, met each of the six requirements of the NMS QCT Exemption.

In its comment letter,²⁰ CBOE asserted that the ISE proposal is misleading and has no relevance to the Trade-Through requirements of the New Plan because the proposed Qualified Contingent Cross Order would not violate the NBBO and therefore would not be in conflict with the New Plan. CBOE further questioned ISE's concern over losing the Trade-Through exemption for block trades. In particular, CBOE noted that, as with the Current Plan, the New Plan contains a Trade-Through exception for stock-option orders that are represented at a net price,²¹ and that this exception does not even require a 500-contract size minimum. In addition, CBOE noted that the NMS QCT Exemption, which CBOE believes only applies "to stock-option trades negotiated and represented as a package," is also available to ISE members. Given these available alternatives, CBOE opined that it fails to follow ISE's statement that the proposal would "provide customers with the flexibility needed to achieve their investment objectives."

¹⁹ Both the Current Plan and New Plan include a Trade-Through exception for "complex trades," including stock-option orders represented as a package on options exchanges. See Section 8(c)(iii)(G) of the Current Plan and Section 5(b)(viii) of the New Plan.

²⁰ See CBOE Letter, *supra* note 4.

²¹ *I.e.*, the complex trade exception. See *supra* note 19.

ISE responded to CBOE's comments by affirming the close relationship between its proposal and the implementation of the New Plan because the New Plan does not contain the block trade exemption of the Current Plan. ISE stated the absence of a block trade exemption would make it very difficult for the options component of stock-option transactions to be executed without allowing such orders to be executed at a price that matches the NBBO. In particular, the Exchange explained that, for stock-option orders negotiated on a "net price" basis where such price reflects the total price of both the stock and options legs, "the actual execution price of each component is not as material to the parties as is the net price of the transaction."²² For a stock-option order in which the stock leg meets the requirements of the NMS QCT Exemption, ISE noted that the stock leg can be executed at any price which in turn permits flexibility in the pricing of the options component as well, including allowing the options leg to be priced between the Exchange's BBO. However, ISE noted that when its quotation spread was at the minimum increment, the options component would not be able to trade at a price between the ISE BBO. ISE also believed that its proposed Qualified Contingent Cross Order is more limited than the block trade exemption available under the Current Plan because trades would not be permitted to Trade-Through other markets, and would be limited to orders that meet the requirements of the NMS QCT Exemption.

In addition, the Exchange disputed CBOE's assertion that the NMS QCT Exemption applied only to "stock-option trades negotiated and represented as a package," noting that the NMS QCT Exemption contained no such limitation. Instead, the Exchange stated that stock-option orders, including those exempted from Rule 611(a) of Regulation NMS as qualified contingent trades under the NMS QCT Exemption, are regularly effected in the options markets

²² See ISE Letter, supra note 5.

“without ever representing the legs together as one trade on an options exchange.” The Commission agrees with the Exchange that the application of the NMS QCT Exemption to stock-option trades is not limited to those negotiated and represented as a package. So long as a transaction meets the six specified elements of the NMS QCT Exemption, the exemption is available for use by a trading center.

In its comment letter,²³ SIG stated that, if ISE’s proposal were to be approved such that options legs of stock-option orders could be effected as clean option crosses without auction or exposure and ahead of other orders on ISE’s book, the net result would be that customers would have little assurance that their stock-option orders are effected competitively or receive best execution prices. SIG, noting that ISE’s proposal is modeled off of the NMS QCT Exemption, sought to provide context for which the Regulation NMS exemption was originally sought by the Securities Industry Association (“SIA”) (n/k/a SIFMA).²⁴ SIG stated that SIA’s exemption request presumed that the stock-option net price would be subject to competition (i.e., through the options markets) even if the stock leg were not, though it acknowledges that the Qualified Contingent Trade exemption provided by the Commission under Regulation NMS does not require exposure of such orders as a net trade. If it was envisioned that stock-option orders could be effected pursuant to ISE’s proposal, “with the stock leg at a trade-through price and the option leg at a book-priority price that was never exposed or auctioned,” SIG believed that “the conclusion would probably have been that there would be insufficient price discovery to merit an exemption for the stock leg.” As such, SIG believed that ISE’s proposal would strip away the

²³ See SIG Letter, supra note 4.

²⁴ Letter to Nancy M. Morris, Secretary, Commission, from Andrew Madoff, SIA Trading Committee, SIA, dated June 21, 2006 (“SIA QCT Letter”).

price protections afforded by the options markets for stock-option orders and would result in their executions at non-competitive prices.²⁵

As discussed above, the application of the NMS QCT Exemption to stock-option trades is not limited to those negotiated and represented as a package. In response to SIG, ISE also noted that the SIA's exemption request was focused solely on the need for trade-through relief for the NMS stock components of QCTs. In addition, ISE pointed out that, at the time the Commission granted the NMS QCT Exemption, every option leg of a stock-option transaction of 500 contracts or more was also exempt from trade-through liability based on the application of the Current Plan's block trade exemption. Accordingly, although an option leg of a stock-option QCT would not have had an exception from exchange priority rules, block-sized transactions would have been permitted to trade-through the NBBO. ISE's Qualified Contingent Cross Order, by contrast, would provide intermarket price protection by trading at a price no worse than the NBBO, but would be excepted from intramarket priority rules.

CBOE also argued against the proposal because it believed that the Qualified Contingent Cross Order would be the first time that an options market would be permitted to cross orders "without exposure to market participants and ahead of resting public customer orders," which CBOE argued would be "a significant departure from the established practice of auction and exposure in the options industry." CBOE believed that the Exchange's proposal would

²⁵ SIG also asserted that SIA only requested trade-through relief for one component order of a contingent trade (at least where there are only two legs involved). The Commission notes that the NMS QCT Exemption provides an exemption from Rule 611(a) for any, and not just one, Trade-Through that results from an execution of an order involving on or more NMS stocks that are components of a qualified contingent trade. See QCT Release, supra note 11.

disadvantage resting public customer orders, including large-sized public customer orders, and would be harmful to options market structure.²⁶

In response to this argument, ISE stated that customer orders on its book would not be disadvantaged because they would not be bidding and offering for the contingent trade that is being executed. ISE disputed CBOE's view of the execution of Qualified Contingent Cross Orders as "trading ahead" of customers on its book, and disagreed with what it believed CBOE implied, that an exchange must either maintain customer priority in all circumstances or adopt a market structure that does not provide customer priority in any circumstance, noting that CBOE's own rules permit the execution of one leg of a complex order at the same price as public customers on its book when another leg is executed at an improved price.

The Commission agrees with CBOE that the Exchange's proposal would represent a change in certain long-held principles in the options markets because it would permit the execution of a cross order without requiring exposure or customer priority. The Commission continues to believe that exposure and customer priority play an important role in ensuring competition and price discovery in the options markets. At the same time, as discussed above, the Commission also continues to believe that qualified contingent trades that satisfy the requirements of the NMS QCT Exemption can benefit the market as a whole and contribute to the efficient functioning of the securities markets and the price discovery process.²⁷ The Commission believes that the Exchange's proposal to establish a limited exception to priority and exposure principles is consistent with the Act because it is limited solely to the options legs of stock-option orders that: (1) satisfy the requirements of the NMS QCT Exemption; (2) are for a size of at least 500 contracts; and (3) are executed at or better than the NBBO.

²⁶ See CBOE Letter, *supra* note 4.

²⁷ See QCT Release *supra* note 11.

In its comment letter, CBOE also stated that, while there might be a time and place to discuss special handling treatment for extremely large option orders, such standards should “be considered in a transparent and measured manner with input from all industry participants (as opposed to via a rule filing pretending to adopt some linkage-related functionality).” In this regard, the Commission notes that the proposal was published for public comment as required under Section 19(b) of the Act²⁸ and the rules thereunder, and that the Commission has received and considered the comments of those industry participants that sought to provide input regarding the proposal, including CBOE, a competitor of the Exchange, as well as SIG, a large participant in the options market.

The Commission believes that the Exchange’s proposed new Qualified Contingent Cross Order is consistent with the Act, and will allow Exchange members to retain the flexibility needed to utilize the Commission’s NMS QCT Exemption for qualified stock-option transactions that are not presented as a package on an options exchange, but instead where the options and stock components are executed in separate markets. As noted above, the Commission believes that contingent trades that meet the requirements of the NMS QCT Exemption may be useful trading tools for investors and other market participants, and may be of benefit to the market as a whole, contributing to the efficient functioning of the securities markets and the price discovery process.²⁹ The Commission believes that, given the NMS QCT Exemption, the Exchange’s proposal is consistent with the Act in that it seeks to address the execution of stock-option orders

²⁸ 15 U.S.C. 78s(b).

²⁹ See QCT Release, supra note 11 and accompanying text.

whose legs are executed separately rather than as a package while limiting such orders to QCTs with a size of at least 500 contracts that are executed at or between the NBBO.³⁰

In approving the proposed rule change, the Commission notes the Exchange's representation that it will adopt policies and procedures to ensure that its members use the proposed order type properly, including requiring members to mark all Qualified Contingent Cross Orders as such. In addition, ISE has represented that it will implement surveillance procedures to identify that the member executed the stock leg of the stock-option transaction at or near the same time as the options leg. The Commission emphasizes that these are important measures that should help ensure that the proposed order type is employed properly.

³⁰ The Commission notes that an original single-sided customer order would not otherwise constitute a multi-component, fully-hedged trade for purposes of ISE's proposed Qualified Contingent Cross Order solely by virtue of being hedged by the member representing the order. In such a case, the Commission does not believe that the execution of the options leg would qualify for the proposed Qualified Contingent Cross Order.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³¹ that the proposed rule changes (SR-ISE-2009-35) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³²

Florence E. Harmon
Deputy Secretary

³¹ 15 U.S.C. 78s(b)(2).

³² 17 CFR 200.30-3(a)(12).