

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-65548; File No. SR-ISE-2011-39)

October 13, 2011

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Approving a Proposed Rule Change Relating to Complex Orders

I. Introduction

On July 1, 2011, the International Securities Exchange, LLC (the “Exchange” or the “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 to amend ISE Rule 722, “Complex Orders.” The proposed rule change was published for comment in the Federal Register on July 15, 2011.<sup>3</sup> The Commission received one comment letter regarding the proposed rule change and<sup>4</sup> ISE submitted a response to the comment letter.<sup>5</sup> This order approves the proposed rule change.

II. Description

The ISE proposes to amend ISE Rule 722 to: (1) allow market makers to enter quotations for complex order strategies on the complex order book, provide that such quotations will not execute automatically against bids and offers for the individual legs of the order, and make existing market maker risk management tools available for these quotations; (2) add a size pro rata method of execution priority for bids and offers on the complex order book at the same

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<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. 64853 (July 11, 2011), 76 FR 41850 (“Notice”).

<sup>4</sup> See letter to Elizabeth M. Murphy, Secretary, Commission, from Geva Patz, Principal, Android Alpha Fund, dated July 27, 2011 (“Android Letter”).

<sup>5</sup> See letter to Elizabeth M. Murphy, Secretary, Commission, from Michael J. Simon, Secretary and General Counsel, ISE, dated October 12, 2011 (“ISE Letter”).

price; and (3) provide for an enhanced allocation of complex orders to a market maker that an Electronic Access Member (“EAM”) designates as a “Preferred Market Maker” and that satisfies certain requirements.

A. Quotations for Complex Orders

Currently, ISE market makers may enter quotes for single-leg options orders, but not for complex order strategies.<sup>6</sup> New Supplementary Material .03 to ISE Rule 722 allows market makers to enter quotes for complex order strategies on the complex order book in their appointed options classes and provides that these quotes will not execute automatically against bids and offers for the individual legs of the order.<sup>7</sup> Market makers will continue to have the ability to enter complex orders on the complex order book. ISE represents that it is not aware of any demand from non-market maker participants to quote on the complex order book.<sup>8</sup>

New Supplementary Material .03 to ISE Rule 722 provides that complex order quotes may not be marked for price improvement,<sup>9</sup> nor are market makers required to enter quotes for complex orders. Quotations and executions against complex orders shall not be taken into consideration in determining whether a market maker is meeting, respectively, its quoting obligations under ISE Rule 804 or its obligation under ISE Rule 805 to refrain from executing

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<sup>6</sup> Only market makers may enter quotes. See ISE Rule 804(a) (stating that a quotation only may be entered by a market maker, and only in the options classes to which the market maker is appointed under ISE Rule 802). See also ISE Rule 100(a)(42) (defining “quote” or “quotation” as a bid or offer entered by a market maker that updates the market maker’s previous bid or offer, if any).

<sup>7</sup> Quotes and orders are processed as they are received by the ISE’s trading system. Quotes are not processed more quickly than orders. See Notice at footnote 5.

<sup>8</sup> See Notice, 76 FR at 41852.

<sup>9</sup> In contrast, under ISE Rule 722(b)(3)(iii), complex orders may be marked for price improvement and exposed for up to one second before executing automatically against pre-existing complex orders or bids and offers for the individual legs.

more than a specified percentage of contracts in options classes which it is not appointed..<sup>10</sup>

Under new Supplementary Material .04 to ISE Rule 722, the same risk management tools that currently are available for market maker quotes in the individual leg market will also be available for market makers' complex order quotes.<sup>11</sup>

B. Size Pro Rata Execution Priority

Currently, ISE may designate on a class basis whether complex orders at the same price on the complex order book will execute (A) in time priority; or (B) on a size pro-rata basis after all Priority Customer Orders at the same price have been executed in full.<sup>12</sup> As amended, ISE Rule 722(b)(3)(i) adds a third method of execution priority that will allow ISE to designate on a class basis that bids and offers on the complex order book at the same price may be executed

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<sup>10</sup> Telephone conversation among Kathy Simmons, Deputy General Counsel, ISE, and David Hsu, Assistant Director, Division of Trading and Markets ("Division"), Commission, and Yvonne Fraticelli, Special Counsel, Division, Commission, on October 12, 2011. A Primary Market Maker must, on a daily basis, enter continuous quotations and enter into any resulting transactions in all of the series listed on ISE of the options classes to which the market maker is appointed. A Competitive Market Maker must, on a given day, participate in the opening rotation and make markets and enter into any resulting transactions on a continuous basis in at least 60% of the series listed on ISE of at least 60% of the options classes for the Group to which the Competitive Market Maker is appointed or 40 options classes in the Group, whichever is lesser. See ISE Rule 804(e)(1) and (2). The total number of contracts executed during a quarter by a Competitive Market Maker in options classes in which it is not appointed may not exceed 25% of the total number of contracts traded by such Competitive Market Maker in classes to which it is appointed and with respect to which it was quoting pursuant to ISE Rule 804(e)(2). The total number of contracts executed during a quarter by a Primary Market Maker in options classes to which it is not appointed may not exceed 10% of the total number of contracts traded per each Primary Market Maker Membership. See ISE Rule 805(b)(2) and (3).

<sup>11</sup> ISE Rule 804, Supplementary Material .01 sets forth certain enhanced risk management tools that currently are available for market maker quotes in the individual leg market. See Securities Exchange Act Release No. 63117 (October 15, 2010), 75 FR 65042 (October 21, 2010) (notice of filing and immediate effectiveness of File No. SR-ISE-2010-101).

<sup>12</sup> See ISE Rule 722(b)(3)(i).

pro-rata based on size. Under this priority method, Priority Customer Orders would receive a pro-rata allocation along with all other orders and quotes at the same price.<sup>13</sup>

C. Enhanced Allocation for Complex Orders

New Supplementary Material .05 to ISE Rule 722 provides an enhanced allocation for a market maker quoting at the best price that is designated by the entering EAM as a Preferred Market Maker. The enhanced allocation will be available only for options classes that are allocated pro-rata based on size with Priority Customer Order priority, and a Preferred Market Maker that satisfies the requirements of Supplementary Material .05 will receive an enhanced allocation only after all Priority Customer Orders on the complex order book at the same price have been executed in full.<sup>14</sup> A Preferred Market Maker on the complex order book must satisfy its quoting obligations in the options class in the regular leg market, including the enhanced quoting requirements in ISE Rule 804(e)(2)(ii) applicable to Competitive Market Makers that receive Preferred Orders.<sup>15</sup> Accordingly, a market maker must be quoting at least 90% of the series of an options class in the regular market to receive an enhanced allocation on the complex order book.

After all Priority Customer Orders on the complex order book at the same price have been executed in full, a Preferred Market Maker that satisfies the requirements in ISE Rule 722, Supplementary Material .05 will receive an allocation equal to the greater of: (i) the proportion

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<sup>13</sup> ISE notes that the new execution priority provision does not affect ISE Rule 722(b)(2), which, among other things, provides requirements for executing complex orders when the established bid or offer on ISE for any leg of the complex order consists of a Priority Customer Order. See Notice, 76 FR at 41851.

<sup>14</sup> See ISE Rule 722, Supplementary Material .05.

<sup>15</sup> See ISE Rule 722, Supplementary Material .05. Among other things, ISE Rule 804(e)(2)(ii) requires a Competitive Market Maker to maintain continuous quotations in at least 90% of the series of any options class in which it receives Preferred Orders.

of the total size at the best price represented by the size of the market maker's quote; or (ii) 60% of the contracts to be allocated if there is only one other Professional Order or market maker quotation at the best price, and 40% of the contracts to be allocated if there are two or more other Professional Orders and/or market maker quotes at the best price.<sup>16</sup>

### III. Discussion and Commission's 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 securities exchange.<sup>17</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>18</sup> which requires, among other things, 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 believes that allowing market makers to enter quotations for complex order strategies, as well as complex orders, in the complex order book is consistent with the Act. Allowing market makers to submit complex order quotes could result in additional liquidity for complex orders on ISE, thereby potentially benefitting investors.<sup>19</sup>

The Commission also believes that the limitation on automatic executions of market maker complex order strategy quotations against leg market interest is consistent with the Act. According to the ISE, this limitation is designed to address an operational issue that ISE believes

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<sup>16</sup> See ISE Rule 722, Supplementary Material .05.

<sup>17</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>18</sup> 15 U.S.C. 78f(b)(5).

could discourage market makers from adding liquidity to the complex order book. This operational issue may arise when a market maker updating its complex order strategy quotation inadvertently trades with its own leg market quotations or the leg market quotations of another market maker before the complex order strategy quotation update is processed. By addressing an operational issue that might discourage market makers from adding liquidity to the complex order book, the Commission believes that the limitation on automatic executions against leg market interest could help to increase liquidity in the complex order book, thus benefitting investors seeking to execute complex orders.

The Commission believes that the market maker risk management tools in new Supplementary Material .04 to ISE Rule 722 could assist ISE market makers in effectively managing their complex order strategy quotations. Accordingly, the Commission believes that Supplementary Material .04 to ISE Rule 722 is consistent with the Act.

The proposal also amends ISE Rule 722(b)(3)(i) to provide for executions of complex orders at the same price on a size pro-rata basis.<sup>20</sup> The Commission believes that providing an additional method of execution priority in ISE Rule 722(b)(3)(i) will provide ISE with greater flexibility in determining how complex order bids and offers at the same price may be executed. The Commission notes that the rules of other options exchanges currently permit size pro-rata executions of orders at the same price.<sup>21</sup> In addition, the Commission notes that the addition of this new execution priority method to ISE Rule 722(b)(3)(i) does not affect the complex order

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<sup>19</sup> See ISE Rule 722, Supplementary Material .03.

<sup>20</sup> See ISE Rule 722(b)(3)(i)(C).

<sup>21</sup> See, e.g., CBOE Rule 6.45B(a)(i) and C2 Rule 6.12(a)(2). In approving CBOE direct, a screen-based trading system, the Commission stated that both price-time priority and pro rata priority were consistent with the Act. See Securities Exchange Act Release No. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (order approving File No. SR-CBOE-00-55).

priority provisions in ISE Rule 722(b)(2).<sup>22</sup>

The Commission believes that new Supplementary Material .05 to ISE Rule 722, which permits preferencing of certain complex orders to a market maker with a quote at the best price on the complex order book that the EAM entering the order designates as a “Preferred Market Maker,” is consistent with the Act. The Commission notes that the Chicago Board Options Exchange, Inc. (“CBOE”) currently permits preferencing of complex orders<sup>23</sup> and that the requirements for receiving an enhanced complex order allocation under ISE Rule 722, Supplementary Material .05, are the same as the requirements for receiving an enhanced complex order allocation under CBOE Rule 8.13, Commentary .01. Although the ISE and CBOE rules provide different complex order percentage allocations for Preferred Market Makers, the complex order percentage allocation in ISE Rule 722, Supplementary Material .05 is the same as the enhanced allocation for single options currently provided to Preferred Market Makers under ISE Rule 713, Supplementary Material .03(c), which the Commission previously approved.<sup>24</sup> The

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<sup>22</sup> See Notice, 76 FR at 41851. ISE Rule 722(b)(2) provides that a complex order may be executed at a total net debit or credit price with one other Member without giving priority to bids or offers established in the marketplace that are no better than the bids or offers comprising such total credit or debit, provided that if any of the bids or offers in the marketplace consists of a Priority Customer Order, the price of at least one leg of the complex order must trade at a price that is better than the corresponding bid or offer in the marketplace by at least one minimum trading increment, as defined in ISE Rule 710.

<sup>23</sup> See CBOE Rule 8.13, Interpretation and Policy .01. See also Securities Exchange Act Release No. 60957 (November 6, 2009), 74 FR 58332 (November 12, 2009) (File No. SR-CBOE-2009-070) (approving proposal to establish a participation entitlement for complex orders).

<sup>24</sup> See Securities Exchange Act Release No. 51818 (June 10, 2005), 70 FR 35146 (June 16, 2005) (order approving File No. SR-ISE-2005-18). Under CBOE’s rules, the complex order participation entitlement for a Preferred Market Maker, after equivalent net priced orders in the EBook and equivalent public customer orders resting in the complex order book have been satisfied, is 40% when there are two or more market makers quoting at the best net priced bid/offer execution price, and 50% when there is only one other market maker quoting at the best net priced bid/offer execution price. See CBOE Rule 8.13, Interpretation and Policy .01(b). Under ISE Rules 713, Supplementary Material

Commission also notes ISE's statement that it would be a violation of ISE Rule 400, "Just and Equitable Principles of Trade," for EAMs and Preferred Market Makers to coordinate their action, and ISE's representation that it will proactively conduct surveillance for, and enforce against, such violations.<sup>25</sup> For example, it would be a violation of ISE Rule 400 for an EAM to notify a Preferred Market Maker immediately prior to sending a complex order so that the market maker could post a complex order strategy quotation on the complex order book before the EAM's order arrived.

The Commission received one comment letter regarding the proposed rule change.<sup>26</sup> ISE responded to the commenter letter.<sup>27</sup> The commenter expresses concern that ISE lacks the system capacity to handle the additional volume that market maker complex order quotes could produce.<sup>28</sup> In particular, the commenter notes that ISE's systems incur overhead to create a new instrument whenever a complex order is created for a new spread, regardless of whether any trades occur in that spread.<sup>29</sup> According to the commenter, ISE had indicated that this overhead could become problematic even at the level of a few tens of thousands of spreads.<sup>30</sup> Noting that there are over 24,000,000 valid two-legged spreads alone for options currently traded on ISE, the

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.03(c) and 722, Supplementary Material .05, a Preferred Market Maker has a participation right equal to: (i) the proportion of the total size at the best price represented by the size of its quote; or (ii) 60% of the contracts to be allocated if there is only one other Professional Order or market maker quotation at the best price and 40% if there are two or more other Professional Orders and/or market maker quotes at the best price.

<sup>25</sup> See Notice at footnote 10. See also Securities Exchange Act Release No. 51818 (June 10, 2005), 70 FR 35146 (June 16, 2005) (order approving File No. SR-ISE-2005-18) at footnote 10.

<sup>26</sup> See Android Letter, supra note 4.

<sup>27</sup> See ISE Letter, supra note 5.

<sup>28</sup> See Android Letter, supra note 4, at 1.

<sup>29</sup> See Android Letter, supra note 4, at 1.

<sup>30</sup> See id.

commenter believed that ISE's system would be unable to keep up with the volume of quotations even if ISE market makers chose to quote only a small fraction of these spreads.<sup>31</sup> Accordingly, the commenter believes that the proposal "presents a serious risk of causing an unacceptable degradation of exchange infrastructure to the detriment of all users, both current and potential, of the ISE Complex Order Book," and urged the Commission not approve the proposal "unless and until the ISE is able to provide adequate assurances that its systems will not be adversely affected by the change."<sup>32</sup>

In its response to the commenter's concerns regarding the number of complex order strategies that potentially could trade on ISE, ISE states that the Exchange currently supports 3,000 complex order instruments per options class, for a total of more than 7.2 million instruments on a daily basis.<sup>33</sup> ISE states, further, that far fewer than 3,000 complex order instruments have ever traded across all options class on ISE on a single day.<sup>34</sup> Accordingly, ISE believes that it has more than sufficient capacity to meet investor demand.<sup>35</sup>

In response to the commenter's concerning regarding the potential increase in quotation volume, ISE states that it maintains a rigorous capacity planning program that monitors system performance and projected capacity demands, and that, as a general matter, ISE considers the potential system capacity impact of all new initiatives.<sup>36</sup> ISE represents that it has analyzed the potential for additional message traffic resulting from market makers entering quotes on the complex order book and has concluded that, while quotes may update more frequently than orders,

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<sup>31</sup> See id.

<sup>32</sup> Android Letter, supra note 4, at 2.

<sup>33</sup> See ISE Letter, supra note 5, at 1.

<sup>34</sup> See id.

<sup>35</sup> See id.

it has sufficient system capacity to handle those quotes without degrading the performance of its systems or reducing the number of complex order instruments it currently supports.<sup>37</sup> In addition, ISE states that because market makers are able to update multiple instruments with a single quote change, encouraging market makers to add liquidity to the complex order book through quotations, rather than orders, will require less ISE capacity.<sup>38</sup> For example, ISE notes that ISE market makers currently must enter two separate orders to update a bid and an offer for each complex order instrument.<sup>39</sup> However, market makers will be able to update both the bid and the offer for multiple complex order instruments with one quote change.<sup>40</sup>

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<sup>36</sup> See id.

<sup>37</sup> See ISE Letter, supra note 5, at 1 – 2.

<sup>38</sup> See ISE Letter, supra note 5, at 2.

<sup>39</sup> See id.

<sup>40</sup> See id.

In approving the proposed rule change, the Commission has relied on ISE's representation that it has the necessary systems capacity to implement the proposed changes. The Commission expects ISE to continue to monitor the quoting volume associated with market makers' complex order strategy quotations and its effect on ISE's systems.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>41</sup> that the proposed rule change (SR-ISE-2011-39) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>42</sup>

Elizabeth M. Murphy  
Secretary

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<sup>41</sup> 15 U.S.C. 78s(b)(2).

<sup>42</sup> 17 CFR 200.30-3(a)(12).