

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73973; File No. SR-ISE-2014-43)

December 31, 2014

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change 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”)¹ and Rule 19b-4 thereunder,² a proposed rule change amending its information barrier rules. The proposed rule change was published for comment in the Federal Register on October 6, 2014.³ On November 17, 2014, the Commission extended the time period in which to either approve the Proposal, disapprove the Proposal, or institute proceedings to determine whether to approve or disapprove the proposed rule change to January 2, 2015.⁴ The Commission received one comment letter regarding the proposed rule change⁵ and one response letter from ISE.⁶ This order institutes proceedings under

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 73261 (September 30, 2014), 79 FR 60226 (“Notice”).

⁴ See Securities Exchange Act Release No. 73614 (November 17, 2014), 79 FR 69547 (November 21, 2014).

⁵ See Letter from John Kinahan, Chief Executive Officer, Group One Trading, L.P., dated October 27, 2014 (“Group One Letter”).

⁶ See Letter from Michael J. Simon, Secretary and General Counsel, International Securities Exchange, LLC, dated November 14, 2014 (“ISE Response Letter”).

Section 19(b)(2)(B) of the Act⁷ to determine whether to approve or disapprove the proposed rule change.

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 Electronic Access Member ("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 book⁸ and to use that information to influence routing 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.⁹

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

⁷ 15 U.S.C. 78s(b)(2)(B).

⁸ 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.

⁹ See Notice, supra note 3, 79 FR at 60226.

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 letter¹⁰ opposing the proposed rule change.¹¹ 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.¹² The commenter disagrees with the Exchange's premise that the proposal would not compromise market integrity or cause customer harm.¹³ The commenter also indicates that although other exchanges may interpret their rules to permit 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.¹⁴ 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.¹⁵

¹⁰ See Group One Letter, supra note 5.

¹¹ See ISE Response Letter, supra note 6.

¹² See Group One Letter at 1, supra note 5.

¹³ Id.

¹⁴ Id.

¹⁵ Id. at 2.

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.¹⁶ 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.¹⁷ 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.¹⁸ The commenter also believes that exchange rules should be 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.¹⁹

The ISE responds that the commenter did not raise any new issues and its concerns were addressed in the Notice.²⁰ 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.²¹ 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.²² ISE also represents that it would continue

¹⁶ Id.

¹⁷ Id.

¹⁸ Id.

¹⁹ Id.

²⁰ See ISE Response Letter at 1, supra note 6.

²¹ Id.

²² Id.

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.²³ ISE believes that its surveillance tools will allow it to fulfill its regulatory responsibilities.²⁴ 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.²⁵

IV. Proceedings to Determine Whether to Approve or Disapprove SR-ISE-2014-43 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act²⁶ to determine whether the proposed rule change should be approved or disapproved.²⁷ Institution of such proceedings is appropriate at this time in view of the legal and policy issues that are raised by the proposal and are discussed below. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail below, the Commission seeks and encourages interested persons to comment on the proposal, including the comments received and the Exchange's response, and provide the Commission with additional comment to inform the Commission's analysis whether to approve or disapprove the proposed rule change.

²³ Id.

²⁴ Id.

²⁵ Id. at 2.

²⁶ 15 U.S.C. 78s(b)(2)(B).

²⁷ Section 19(b)(2)(B) of the Act provides that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. The time for conclusion of the proceedings may be extended for up to an additional 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding or if the self-regulatory organization consents to the extension.

Pursuant to Section 19(b)(2)(B) of the Act, the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of, and input from, commenters with regard to the proposed rule change's consistency with Section 6 of the Act, and in particular Sections 6(b)(5).²⁸ Section 6(b)(5) requires that the rules of an exchange be designed, among other things, 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; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.²⁹

V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data and arguments with respect to the concerns identified above, as well as any others they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change is inconsistent with Section 6 or any other provision, of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.³⁰

²⁸ 15 U.S.C. 78f(b)(5).

²⁹ 15 U.S.C. 78f(b)(5).

³⁰ Section 19(b) (2) of the Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

Interested persons are invited to submit written data, views and arguments regarding whether the proposed rule change should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register].

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-2014-43 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-2014-43. 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 office 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 publicly available. All submissions should refer to File Number SR-ISE-2014-43 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. If comments are received, any rebuttal comments should be submitted by [insert date 35 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³¹

Brent J. Fields
Secretary

³¹ 17 CFR 200.30-3(a)(57).