

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73023; File No. SR-ISE-2014-10)

September 9, 2014

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Approving a Proposed Rule Change Related to Limiting Certain Types of Complex Orders from Logging into the Regular Market

I. Introduction

On February 25, 2014, the International Securities Exchange, LLC (the “Exchange” or “ISE”) filed with the Securities and Exchange Commission (the “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 relating to complex orders. The proposed rule change was published for comment in the Federal Register on March 14, 2014.³ On April 23, 2014, the Commission extended the time period in which to either approve the proposal, disapprove the proposal, or to institute proceedings to determine whether to approve or disapprove the proposal, to June 12, 2014.⁴ On June 10, 2014, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule change.⁵ The Commission received five comment letters on proposal.⁶ This order approves the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 71669 (March 10, 2014), 79 FR 14563 (“Notice”).

⁴ See Securities Exchange Act Release No. 72006 (April 23, 2014), 79 FR 24031 (April 29, 2014).

⁵ See Securities Exchange Act Release No. 72359 (June 10, 2014), 79 FR 34387 (June 16, 2014).

⁶ See letters to Elizabeth Murphy, Secretary, Commission, from Kurt Eckert, Principal, Wolverine Trading, LLC, dated July 7, 2014 (“Wolverine Letter”); Ellen Green, Vice President, Financial Services Operations, Securities Industry and Financial Markets Association, dated July 8, 2014 (“SIFMA Letter”); Wouter Stinis, Head of Trading,

II. Description of the Proposal

The Exchange proposes to amend ISE Rule 722 to prohibit certain types of complex orders from legging into the regular market (i.e., executing against individual quotes for each of the legs of the complex order in the regular market).⁷ Specifically, ISE proposes that complex orders with two option legs where both legs are buying or both legs are selling and both legs are calls or both legs are puts will only trade against other complex orders in the complex order book and will not be permitted to leg into the regular market.⁸ ISE also proposes that complex orders with three option legs where all legs are buying or all legs are selling, regardless of whether the options are a calls or puts, will only trade against other complex orders in the complex order book and will not be permitted to leg into the regular market.⁹ ISE describes these types of two and three leg complex order strategies as “atypical” complex order strategies in that they are geared toward an aggressive directional capture of volatility.¹⁰

Optiver US, LLC, dated July 9, 2014 (“Optiver Letter”); letter to Kevin M O’Neill, Deputy Secretary, Commission, from John Kinahan, Interim-CEO, Group One Trading, L.P., dated July, 7, 2014 (“Group One Letter”); letter to the Office of the Secretary, Commission, from Martha Redding, Chief Counsel and Assistant Corporate Secretary, NYSE, Inc. dated July 10, 2014 (“NYSE Letter”).

⁷ See Notice, supra note 3, at 14564. ISE Rule 722(b)(3)(ii) rule states that complex orders up to a maximum number of legs (determined by the Exchange on a class basis as either two legs or three legs) will be automatically executed against bids and offers on the Exchange for the individual legs of the complex order provided the complex order can be executed while maintaining a permissible ratio by such bids and offers.

⁸ See Notice, supra note 3, at 14564. The Exchange offers some examples of such strategies as follows: (i) Buy Call 1, Buy Call 2; (ii) Sell Call 1, Sell Call 2; (iii) Buy Put 1, Buy Put 2; (iv) Sell Put 1, Sell Put 2. See id.

⁹ See id. The Exchange offers some examples of such strategies as follows: (i) Buy Call 1, Buy Call 2, Buy Put 1; (ii) Buy Put 1, Buy Put 2, Buy Put 3; (iii) Buy Call 1, Buy Call 2, Buy Call 3; (iv) Buy Put 1, Buy Put 2, Buy Call 3; (v) Sell Put 1, Sell Put 2, Sell Call 1. See id.

¹⁰ See id. Hereinafter these two and three legged complex order strategies that are the subject of this proposal will be referred to as “directional complex orders.” ISE states that most traditional complex order strategies used by retail or professional investors,

The Exchange further proposes to amend ISE Rule 722 to prevent legging orders¹¹ from being generated on behalf of the two-legged complex orders where both legs are buying or both legs are selling and both legs are calls or both legs are puts.¹² According to the Exchange, preventing the generation of legging orders for these types of two-legged complex orders is necessary to effectuate the proposed limitation to exclude these types of complex orders from trading in the regular market.¹³

In addition, the Exchange proposes to amend Supplemental Material .08 to ISE Rule 716 (Facilitation Mechanism and Solicited Order Mechanism) and Supplemental Material .10 to ISE Rule 723 (Price Improvement Mechanism) to ensure that directional complex orders do not leg into the regular market through an auction.¹⁴ ISE represents that, under its current rules, if an improved net price for a complex order in the Exchange's auctions can be achieved from bids and offers for the individual legs of the complex order in the regular market, the complex order would receive that better net price.¹⁵ ISE proposes to prevent directional complex orders from interacting with the regular market during an auction in connection with the Exchange's proposal

unlike directional complex orders, seek to hedge the potential move of the underlying security or to capture a premium from an anticipated market event. See id.

¹¹ ISE Rule 715(k) defines a legging order as a limit order on the regular limit order book that represents one side of a complex order that is to buy or sell an equal quantity of two options series resting on the Exchange's complex order book.

¹² See Notice, supra note 3, at 14565. The Exchange notes that legging orders cannot be generated for complex orders with three options legs, and, therefore, is not proposing to prevent the generation of legging orders for complex orders with three option legs where all legs are buying or all legs are selling, regardless of whether the options are calls or puts. See id.

¹³ See id.

¹⁴ See id.

¹⁵ See id.

in order to prevent directional complex orders from executing against the regular market.¹⁶

Accordingly, the Exchange proposes to amend Supplemental Material .08 to ISE Rule 716 and Supplemental Material .10 to ISE Rule 723 to provide that if an improved net price can be achieved from bids and offers for the individual legs for directional complex orders during an auction, ISE will cancel the auction at the end of the auction's exposure period.¹⁷

According to the Exchange, the proposed rule amendments are designed to prevent directional complex orders from bypassing the Exchange's market maker risk parameters for the regular market.¹⁸ ISE states that the market maker risk parameters are designed to automatically remove a market maker's quotes in all series of an options class when any of four parameter settings established by the market maker are triggered.¹⁹ ISE describes these market maker risk parameters as a functionality that allows market makers to provide liquidity across many different options series without being at risk of executing the full cumulative size of all of their quotes before being given adequate opportunity to adjust their quotes.²⁰ According to ISE, when a complex order legs into the regular market, all of the legs of a complex order are considered as a single transaction for purposes of the market maker risk parameters, and not as a series of individual transactions.²¹ Thus, the trading system performs the market maker risk parameter calculations after the entire complex order executes against interest in the regular market.

According to the Exchange, the manner in which complex orders leg into the regular market may

¹⁶ See Notice, supra note 3, at 14565.

¹⁷ See id.

¹⁸ See id. at 14564 and ISE Rule 804(g) (Automated Quotation Adjustments). See also Supplemental Material .04 to ISE Rule 722 (Automated Spread Quotation Adjustments).

¹⁹ See Notice, supra note 3, at 14564.

²⁰ See id.

²¹ See id.

cause market makers to trade above limits set in their market maker risk parameters.²² As a result, the Exchange believes that market makers may alter their trading behavior to account for the additional risk by widening quotes, hurting the Exchange's quality of markets and the quality of markets in general.²³ Further, according to ISE, directional complex orders that bypass market makers' risk parameters may result in artificially large transactions that distort the market for related instruments, including the underlying security or related options series.²⁴ The Exchange believes that the potential risk to market makers of allowing directional complex orders to execute against market makers' quotes in the regular market outweighs the potential benefit of allowing directional complex orders to execute against interest in the regular market.²⁵ By limiting directional complex orders from legging into the regular market, the Exchange believes that market makers will post tighter and more liquid markets for regular orders and traditional complex orders, while reducing the frequency and size of related market distortions.²⁶

Finally, ISE represents that directional complex orders may trade against other complex orders in the ISE complex order book and may rest on the ISE complex order book until they are traded or canceled by the member that entered them.²⁷

III. Summary of Comment Letters

As previously noted, the Commission received five comment letters.²⁸ All of the commenters support the proposal and believe the Commission should approve it.

²² See id.

²³ See id.

²⁴ See id.

²⁵ See Notice, supra note 3, at 14565. ISE notes that the number of directional complex orders is small relative to the total number of complex orders executed on the Exchange on a given day. See id.

²⁶ See id.

²⁷ See id.

Several commenters state that they rely on market maker risk parameter mechanisms to prevent them from exceeding a set amount of risk without having the opportunity to update the price or size of their quotes to better reflect the state of the current market.²⁹ One commenter, a national securities exchange, states that market makers and other participants who contribute to price discovery by posting displayed bids and offers incur significant risk of taking on large options positions on the same side of the market, potentially causing a liquidity provider to accumulate unacceptable risk levels very quickly.³⁰ This commenter states that, because of this, options exchanges make available to their market makers and other market participants risk protection tools that restrict the amount of risk a liquidity provider can accumulate per unit time before their quotes or orders are disabled.³¹ Another commenter, a market maker, states that it relies on the exchange-level market maker risk parameter mechanisms to ensure that its quotes are removed from the market when its risk tolerance is exceeded.³² According to this commenter, it is because of these market maker risk parameters that market makers are able to quote tight spreads and deep liquidity.³³

²⁸ See supra note 6.

²⁹ See e.g., Group One Letter, supra note 6, at 1; Wolverine Letter, supra note 6, at 1.

³⁰ See NYSE Letter, supra note 6, at 1.

³¹ See id.

³² See Group One Letter, supra note 6, at 1. See also Wolverine Letter, supra note 6, at 1 (stating that market makers are reliant on exchange-level market maker risk parameters mechanisms to protect market makers from assuming undue risk if multiple resting quotes are executed in rapid succession).

³³ See Group One Letter, supra note 6, at 1. See also Wolverine Letter, supra note 6, at 1 (stating that market makers are able to provide tight, deep, competitive markets based on the understanding that they can, to a reasonable degree, control the amount of risk they assume within a single trade or sequence of trades before being able to recalculate and republish their quotes).

Commenters generally agree that directional complex orders allow market participants to circumvent a market-maker's risk parameters.³⁴ Several commenters assert that directional complex orders are not traditional complex orders used by retail and professional investors.³⁵ One commenter notes that, while any complex order, traditional or directional, legging into the market could circumvent a market-maker's risk parameters, such circumvention is justifiable for traditional complex orders but not directional complex orders.³⁶ This commenter explains that traditional complex orders, such as spreads or straddles, are designed to provide some degree of directional protection, where gains in one leg may be at least partially offset by losses in another, which, according to the commenter, renders the risk of these traditional complex orders executing as a single transaction more tolerable.³⁷ However, according to this commenter, directional complex orders often increase the net directional exposure because they consist of all bullish or bearish positions where no one leg hedges any other, as is the case for traditional complex orders.³⁸

Generally, all of the commenters agree that directional complex orders restrict market-makers' ability to mitigate their risk and, in turn, their ability to quote in larger sizes with tighter

³⁴ See Wolverine Letter, supra note 6, at 2; Optiver Letter, supra note 6, at 2; Group One Letter, supra note 6, at 1; NYSE Letter, supra note 6, at 2; and SIFMA Letter, supra note 6, at 3.

³⁵ See e.g., Wolverine Letter, supra note 6, at 2; Optiver Letter, supra note 6, at 1-2; and Group One Letter, supra note 6, at 2.

³⁶ See Wolverine Letter, supra note 6, at 1-2. See also NYSE Letter, supra note 6, at 2.

³⁷ See Wolverine Letter, supra note 6, at 1.

³⁸ See Wolverine Letter, supra note 6, at 2. See also NYSE Letter, supra note 6, at 2 (noting that most complex orders "...are 'self-hedged,' i.e., comprising one or more 'long' sides offset by one or more 'short' sides").

spreads across many different options series.³⁹ One commenter states that without the protection offered by the market maker risk parameters, its only remaining controls at its disposal to protect against the risk of directional complex orders are to widen quoted spreads and/or reduce the size of its quotes in the single leg market.⁴⁰ This commenter also notes that it may even cancel all its quotes in related instruments on other exchanges where the commenter provides liquidity in response to an execution of a directional complex order against its quotes, or may even stop quoting altogether on venues where directional complex orders are permitted to circumvent a market maker's risk parameters.⁴¹ One commenter states that these directional complex orders may force market makers to hedge their position more urgently than for other transactions, which hedging may cause a larger, temporary, market impact in the underlying securities than normal hedging activity does.⁴² One commenter states that it would be able to provide larger published quotes and/or tighter spreads if the proposal is approved.⁴³

³⁹ See Wolverine Letter, supra note 6, at 2; Optiver Letter, supra note 6, at 4; Group One Letter, supra note 6, at 1-2; NYSE Letter, supra note 6, at 1-2; and SIFMA Letter, supra note 6, at 4-5.

⁴⁰ See Optiver Letter, supra note 6, at 3.

⁴¹ See Optiver Letter, supra note 6, at 3-4.

⁴² See SIFMA Letter, supra note 6, at 4. This commenter also notes that retail investors' limit orders may also be adversely impacted by directional complex orders because such orders can result in large price swings, which may result in stop orders being triggered. Id.

⁴³ See Wolverine Letter, supra note 6, at 2. See also Group One letter, supra note 6, at 2 (noting that by allowing market makers to rely on the Exchange's market maker risk parameters, "market makers can continue to provide large size quotes with tight spreads"); and Optiver Letter, supra note 6, at 5 (asserting that approval would "further allow tighter markets and increased liquidity for both complex orders and the regular market").

Two commenters state that they believe that the number of directional complex orders is small relative to the total number of complex orders executed on the Exchange in a given day.⁴⁴ Some commenters note that most directional complex orders come from market makers.⁴⁵ One commenter states that, according to one market participant, 95% of directional complex orders that executed against that participant's quotes over the last year originated from the market making desk of one firm.⁴⁶ According to this commenter, of the complex order flow received by that same market participant from institutional and retail customers over the past year, zero directional complex orders came from institutional customers and just 0.1% of retail complex orders were directional.⁴⁷ Another commenter notes that the average trade number of contracts executed in traditional complex orders against the commenter's quotes in 2014 was 14.8 contracts per trade, which is, according to the commenter, generally consistent with the Options Clearing Corporation's data indicating an average number of contracts per average transaction of 15.6 contracts on the Exchange.⁴⁸ The commenter then notes that the average number of contracts per transaction against the commenter's quotes for directional complex orders was 157.3 contracts.⁴⁹

⁴⁴ See SIFMA Letter, supra note 6, at 5; Optiver Letter, supra note 6, at 4 (noting that it believes 3-legged directional complex orders represents less than 1% of total orders).

⁴⁵ See SIFMA Letter, supra note 6, at 3; Optiver Letter, supra note 6, at 2 (noting that, in the commenter's experience, "these [directional] order types are overwhelmingly used by market makers").

⁴⁶ See SIFMA Letter, supra note 6, at 3.

⁴⁷ See id. Two commenters state that they believe that the number of directional complex orders is small relative to the total number of complex orders executed on the Exchange in a given day.

⁴⁸ See Optiver Letter, supra note 6, at 3.

⁴⁹ See id.

Two commenters state that they believe that the potential benefits of preventing directional complex orders from legging into the regular market under the Exchange's proposal outweighs any benefits of continuing to allow directional complex orders to leg into the regular market.⁵⁰ One commenter asserts that market maker risk protections in the regular market must have priority over directional complex orders that leg into that same regular market.⁵¹ Another commenter states that it believes that approval of the proposal will deter potentially nefarious activity without reducing liquidity for regular orders or traditional complex orders.⁵²

IV. 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 securities exchange.⁵³ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁵⁴ 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 notes that directional complex orders may continue to trade against other complex orders on the Exchange's complex order book, and

⁵⁰ See SIFMA Letter, supra note 6, at 5; Optiver Letter, supra note 6, at 5.

⁵¹ See Optiver Letter, supra note 6, at 5.

⁵² See Group One Letter, supra note 6, at 2. Two commenters also express support for the part of the Exchange's proposal that would require that an auction be canceled at the end of the auction's exposure period if an improved net price can be achieved from the bids and offers for the individual legs of a directional complex order during an auction. See SIFMA Letter, supra note 6, at 3; Optiver Letter, supra note 6, at 2.

⁵³ 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).

⁵⁴ 15 U.S.C. 78f(b)(5).

that market participants may submit the individual legs of a directional complex order separately to the regular market for execution should they so choose. The Commission also notes that all five commenters expressed support for the proposal.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵⁵ that the proposed rule change (SR-ISE-2014-10) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵⁶

Kevin M. O'Neill
Deputy Secretary

⁵⁵ 15 U.S.C. 78s(b)(2).

⁵⁶ 17 CFR 200.30-3(a)(12).