

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73147; File No. SR-ISE-2014-09)

September 19, 2014

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Approving Proposed Rule Change Related to Market Maker Risk Parameters

I. Introduction

On March 10, 2014, 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”),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend ISE Rules 722 and 804 to mitigate market maker risk by adopting an Exchange-provided risk management functionality. The proposed rule change was published for comment in the Federal Register on March 26, 2014.³ The Commission received no comments on the proposal. On May 7, 2014, pursuant to Section 19(b)(2) of the Act,⁴ the Commission designated a longer period within which to either approve the proposed rule change, disapprove the proposed rule changes, or institute proceedings to determine whether to disapprove the proposed rule change.⁵ On June 24, 2014, the Commission instituted proceedings

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 71759 (March 20, 2014), 79 FR 16850 (March 26, 2014) (SR-ISE-2014-09) (“Notice”).

⁴ 15 U.S.C. 78s(b)(2).

⁵ See Securities Exchange Act Release No. 72117, 79 FR 27360 (May 13, 2014). The Commission determined that it was appropriate to designate a longer period within which to take action on the proposed rule change so that it would have sufficient time to consider the proposed rule change. Accordingly, the Commission designated June 24, 2014, as the date by which it should approve, disapprove, or institute proceedings to determine whether to disapprove the proposed rule change.

to determine whether to approve or disapprove the proposed rule change.⁶ In response to the Order Instituting Proceedings, the Commission received five comment letters on the proposal.⁷

This order approves the proposed rule change.

II. Description of the Proposal

The Exchange proposes to amend ISE Rule 722 and ISE Rule 804 to enhance its risk management offering for market maker quotes.⁸

Currently, there are four parameters that can be set by market makers on a class-by-class basis. These parameters are available for market maker quotes in single options series and in complex instruments on the complex order book. Market makers establish a time frame during which the system calculates: (1) the number of contracts executed by the market maker in an options class; (2) the percentage of the total size of the market maker's quotes in the class that has been executed; (3) the absolute value of the net between contracts bought and sold in an

⁶ See Securities Exchange Act Release No. 72455, 79 FR 36849 (Jun. 30, 2014) (“Order Instituting Proceedings”). In the Order Instituting Proceedings, the Commission noted, among other things, that questions remains as to whether the Exchange’s proposal is consistent with the requirements of Section 6(b)(5) of the Act, 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 perfect the mechanism of a free and open market and a national market system, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Additionally, the Commission questioned whether the proposal is consistent with Section 6(b)(8) of the Act, which requires that the rules of a national securities exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

⁷ See Letters to the Commission from Andrew Killion, Chief Executive Officer, Akuna Securities LLC, dated July 24, 2014 (“Akuna Letter”); Brent Hippert, President/CCO, Hardcastle Trading USA LLC, dated July 28, 2014 (“Hardcastle Letter”); John Kinahan, Chief Executive Officer, Group One Trading, L.P., dated July 29, 2014 (“Group One Letter”); Sebastiaan Koeling, Chief Executive Officer, Optiver US LLC, dated July 29, 2014 (“Optiver Letter”); and Andrew Stevens, General Counsel, IMC Chicago, LLC d/b/a IMC Financial Markets, dated August 18, 2014 (“IMC Letter”).

⁸ For a more complete description of the proposal, see Notice, supra note 3.

options class, and (4) the absolute value of the net between (a) calls purchased plus puts sold, and (b) calls sold plus puts purchased. Once the limits for each of the four parameters are exceeded within the prescribed time frame, the market maker's quotes in all series of that class are automatically removed or curtailed. Additionally, ISE's rules provide that if a specified number of curtailment events are exceeded within the prescribed time period, the market maker quotes in all classes will be automatically removed from ISE's trading system.⁹ The Exchange now proposes to implement functionality to allow market maker quotes to be removed from the trading system if a specified number of curtailment events occur across both ISE and ISE Gemini, LLC ("ISE Gemini").

To the extent that a market maker utilizes the offered functionality, ISE and ISE Gemini's trading systems will count the number of times a market maker's pre-set curtailment events occur on each exchange and aggregate them. Once a market maker's specified number of curtailment events across both markets is reached, the trading systems will remove the market maker's quotes in all classes on both ISE and ISE Gemini. The Exchange will then reject any quotes sent by the market maker after the parameters across both exchanges have been triggered until the market maker notifies the market operations staff of the Exchange that it is ready to come out of its curtailment. Once notified by the market maker, the Exchange will reactivate the market maker's quotes on the Exchange.

The Exchange believes that the proposal will enhance the Exchange's current risk management offering by allowing market makers to manage their risk across ISE and ISE Gemini. The Exchange also provides that the proposal will protect market makers from

⁹ See Securities Exchange Act Release Nos. 70132 (August 7, 2013), 78 FR 49311 (August 13, 2013) (SR-ISE-2013-38) and 71446 (January 30, 2014), 79 FR 6951 (February 5, 2014) (SR-ISE-2014-04).

inadvertent exposure to excessive risk and thereby allow them to quote aggressively and provide more liquidity with greater size to both markets. The Exchange further represents that its proposal will operate consistently with the firm quote obligations of a broker-dealer pursuant to Rule 602 of Regulation NMS and that the functionality is not mandatory.

III. Summary of Comment Letters

As noted above, the Commission received five comment letters in response to the Order Instituting Proceedings.¹⁰ All of the commenters support the proposal. Three of the five commenters are registered options market makers on ISE,¹¹ while the other two are registered options market makers on both ISE and ISE Gemini.¹²

The commenters note that, while the current risk protections on the Exchange help manage risk, systems and other issues that trigger such risk parameters are normally not confined to a member firm's activity on a single exchange.¹³ Accordingly, the commenters believe that the Exchange's proposal to aggregate curtailment events across both ISE and ISE Gemini would allow market makers to more effectively manage risk.¹⁴ The commenters state that the proposed rule change would allow market makers to continue to actively provide liquidity, while facilitating effective management of the risks associated with quoting a large number of option series across multiple exchanges.¹⁵ Further, the commenters believe that allowing market

¹⁰ See supra note 7.

¹¹ See Akuna Letter; Hardcastle Letter; and Group One Letter, supra note 7.

¹² See Optiver Letter and IMC Letter, supra note 7.

¹³ See Akuna Letter; Group One Letter, Hardcastle Letter; IMC Letter; and Optiver Letter, supra note 7.

¹⁴ See, e.g., Akuna Letter at 2; Hardcastle Letter at 2; and Optiver Letter, supra note 7.

¹⁵ See Optiver Letter and IMC Letter, supra note 7.

makers to better manage their risk would benefit the broader market, as it would reduce disruptive trading events.¹⁶

Two commenters who are registered market makers on ISE but not on ISE Gemini also believe that the proposal is not unfairly discriminatory in violation of Section 6(b)(5) of the Act.¹⁷ These two commenters note that the proposal is optional to market makers and is not unfairly discriminatory to firms who simply have no need for the proposal's additional protections by virtue of only trading on either ISE or ISE Gemini.¹⁸

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.¹⁹ Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,²⁰ 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, not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission believes that the proposal could assist ISE market makers manage and reduce inadvertent exposure to excessive risk across both ISE and ISE Gemini. The Commission

¹⁶ See Akuna Letter at 2; Hardcastle Letter at 2; and Optiver Letter, supra note 7.

¹⁷ See Akuna Letter at 2 and Hardcastle Letter at 2, supra note 7.

¹⁸ Id. One commenter also states that it does not believe the proposal places any undue burden on competition between options exchanges. See Group One Letter at 2, supra note 7.

¹⁹ 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).

²⁰ 15 U.S.C. 78f(b)(5).

notes that the proposed functionality is not mandatory and must operate consistent with the firm quote obligations of Rule 602 of Regulation NMS. The Commission also notes that all five commenters expressed support for the proposal.

For the foregoing reasons, the Commission believes that the proposed rule change is consistent with the Act.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act²¹ that the proposed rule change (SR-ISE-2014-09) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²²

Kevin M. O'Neill
Deputy Secretary

²¹ 15 U.S.C. 78s(b)(2).

²² 17 CFR 200.30-3(a)(12).