SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60014; File No. SR-ISE-2009-27)

June 1, 2009

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Proposed Rule Change to Adopt Rules to Implement the Options Order Protection and Locked/Crossed Market Plan

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on May 11, 2009, the International Securities Exchange, LLC ("ISE" or "Exchange"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The ISE proposes to adopt rules to implement the Options Order Protection and Locked/Crossed Market Plan (the "Plan"). The text of the proposed rule change is available on the ISE's website (http://www.ise.com), at the principal office of the ISE, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b-4.

it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to adopt rules to implement the Plan. These rules will replace current Chapter 19 of the ISE's rules in their entirety. The proposed rules also will amend various other rules to accommodate the Plan.

Background to the Plan and the Implementing Rules

The ISE filed the current version of the Plan on November 7, 2008.[3] The Plan would replace the current Plan for the Purpose of Creating and Operating an Intermarket Option Linkage ("Old Plan"). The Old Plan requires its participant exchanges to operate a stand-alone system or "Linkage" for sending order-flow between exchanges to limit trade-throughs. The Options Clearing Corporation ("OCC") operates the Linkage system. The Linkage rules provide for unique types of Linkage orders, with a complicated set of requirements as to who may send such orders and under what conditions.

While the Linkage largely has operated satisfactorily, it is under significant strain. When the Commission approved the Linkage Plan in 2000, average daily volume ("ADV") in the options market was approximately 2.6 million contracts across all exchanges. Now the ADV has increased

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[3] The November 7th filing was Amendment No. 3 to the Plan. The ISE initially filed the Plan on September 12, 2007, filed Amendment No. 1 on December 10, 2007, and filed Amendment No. 2 on April 16, 2008.

to more than 10 million contracts, putting added strain on the ability of market makers to comply with the complex Linkage rules. At the same time, the options markets have been moving towards quoting in pennies, and are quoting in pennies options representing over half the total industry volume. This greatly increases the number of price changes in an option, giving rise to greater chances of trade-throughs and missing markets as market makers send Linkage orders and have to wait for a response.

Experience in the equities markets shows that there is a more efficient way to provide price protection in options. When first implemented, the Linkage represented a vast improvement over the then-current equities price-protection system, which depended on the operation of the Intermarket Trading System ("ITS"). The plan governing ITS imposed long waiting times for filling ITS commitments and a cumbersome method for satisfying trade-throughs. Learning from the shortcomings of ITS, the options Linkage has shorter waiting periods and more efficient trade-through protections.

The equity price-protection mechanisms have now leapfrogged the options Linkage. By adopting Regulation NMS in 2005 the Commission effectively terminated ITS, replacing it with a rules-based price-protection system.[4] The key to Regulation NMS's price-protection provisions is the Intermarket Sweep Order, or ISO. Each equity exchange must adopt rules "reasonably designed to prevent trade-throughs."[5] Exempted from trade-through liability is an ISO, which is an order a member sends to an exchange displaying a price inferior to the national best bid and

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4 Release No. 34-51808 (June 9, 2005), 70 F.R. 37496 (June 29 2005).

5 Regulation NMS Rule 611(a).

offer ("NBBO"), while simultaneously sending orders to trade against the full size of any other exchange that is displaying the NBBO.[6]

The Regulation NMS rules-based price-protection system is working well. It requires neither a central linkage mechanism nor a complex set of operating rules. It also has eliminated the need for achieving unanimity to change even the most minor aspects of a linkage mechanism. A simple prohibition against most trade-throughs, coupled with the ISO mechanism, has given the equities markets a straight-forward system to provide customers with price protection in a fast-moving, high-volume market that is quoted in pennies. The ISE and the other options exchange participants in the Plan intend for the Plan, and the implementing rules, to bring the efficiencies of Regulation NMS to the options market.

Operation of the Plan

The Plan effectively would apply the Regulation NMS price-protection provisions to the options markets. Similar to Regulation NMS, the Plan would require participants to adopt rules "reasonably designed to prevent Trade-Throughs," while exempting ISOs from that prohibition.[7] The definition of an ISO is essentially the same as under Regulation NMS,[8] and there are a number of additional exceptions to the trade-through prohibition. Like Regulation NMS, [9] the Plan requires participating exchanges to take reasonable steps to establish that ISOs meet the requirements of the Plan.

With respect to locked and crossed markets, similar to Regulation NMS the Plan requires its participants to adopt, maintain and enforce rules requiring members: to avoid displaying

6 Regulation NMS Rule 600(b)(30).

7 Sections 5(a)(i) and 5(b)(iv) of the Plan.

8 Section 2(9) of the Plan.

9 Regulation NMS Rule 611(c) and Section 5(c) of the Plan.

locked and crossed markets; to reconcile such markets; and to prohibit members from engaging in a pattern or practice of displaying locked and crossed markets. [10] With respect to locked markets, the Plan differs from Regulation NMS in that it specifically permits exceptions to the locked market prohibitions "as contained in the rules of a Participant approved by the Commission."[11]

Description of the Implementing Rules

This proposed rule change would delete the ISE's current Linkage rules in Chapter 19 of the ISE's rule book and replace those rules with a new Chapter 19 entitled "Order Protection; Locked and Crossed Markets." New Chapter 19 contains the following rules:

Rule 1900 – Definitions

This proposed rule incorporates all the operative definitions from the Plan into the ISE's rulebook. With one exception, the parties to the Plan derived all such definitions either from the Old Plan[12] or Regulation NMS.[13] The one exception is the definition of "complex trade" in Rule 1900(d). A "complex trade" is exempt from trade-through liability. The exemption in the Old Plan simply refers to complex trades "as that term may be defined by the Operating Committee from time to time." Based on that provision, the ISE adopted current Rule 1900(3), which is substantially identical among all the options exchanges. We propose to carry that definition into new Chapter 19 unchanged.

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10 Section 6 of the Plan.

11 Id.

12 See, e.g., the definitions of "Broker-Dealer" in Rule 1900(c), NBBO in Rule 1900(j), Non-Firm in Rule 1900(k), OPRA Plan in Rule 1900(l), and Participant in Rule 1900(m).

13 See, e.g., the definitions of "Best Bid"/"Best Offer" in Rule 1900(a), "Bid"/"Offer" in Rule 1900(b), "Intermarket Sweep Order ("ISO")" in Rule 1900(h), and "Quotation" in Rule 1900(p).

Rule 1901 – Order Protection

Paragraph (a) of Rule 1901 provides that, subject to specified exceptions, ISE Members shall not effect trade-throughs. Paragraph (b) provides for the following trade-through exceptions:

- System Issues: Rule 1901(b)(1) implements Section 5(b)(i) of the Plan by establishing an exception for trade-throughs due to system-failures. This is akin to the exception in Regulation NMS for equity securities and permits trading through an Eligible Exchange that is experiencing system problems.[14] The ISE is proposing "self-help" rules similar to its equity Rule 2107(c)(1), adopted pursuant to Regulation NMS.
- Trading Rotations: Rule 1901(b)(2) implements Section 5(b)(ii) of the Plan and carries forward the current trade-through exception in the Old Plan[15] and current Rule 1902(b)(5) related to the opening of markets. It is the options equivalent to the single price opening exception in Regulation NMS for equity securities.[16] We use a trading rotation to open an option for trading, or to reopen an option after a trading halt. The rotation is effectively a single price auction to price the option and there are no practical means to include prices on other exchanges in that auction.
- Crossed Markets: Rule 1901(b)(3) implements Section 5(b)(iii) of the Plan and is the functional equivalent to ISE Rule 2107(c)(3) for equity securities. If the best intermarket bid is higher than the best intermarket offer, it indicates that there is

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14 See Regulation NMS Rule 611(b)(1).

15 See Old Plan Section 8(c)(iii)(E).

16 See Regulation NMS Rule 611(b)(3) under the Securities Exchange Act of 1934, as amended ("Act").

some form of market dislocation or inaccurate quoting. Permitting transactions to be executed without regard to trade-throughs in a Crossed Market will allow the market quickly return to equilibrium.

- Intermarket Sweep Orders ("ISOs"): Rule 1901(b)(4) is the ISO exemption and implements Sections 5(b)(iv) and (v) of the Plan. Section 5(b)(iv) of the Plan permits a Participant to execute orders it receives from other Participants or members that are marked as ISO even when it is not at the NBBO.[17] Section 5(b)(v) of the Plan allows a Participant to execute inbound orders when it is not at the NBBO, provided it simultaneously "sweeps" all better-priced interest displayed by Eligible Exchanges. These provisions are the options equivalents of the corresponding Regulation NMS equity rules.[18]

- Quote Flickering: Rule 1901(b)(5) implements Section 5(b)(vi) of the Plan and corresponds to the flickering quote exception in Regulation NMS for equity securities.[19] Options quotations change as rapidly, if not more rapidly, than equity quotations. Indeed, they track the price of the underlying security and thus change when the price of the underlying security changes. This exception provides a form

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17 Supplementary Material .01 to Rule 1901 specifies that all ISOs routed to the ISE from other exchanges on behalf of public customers will be represented as Priority Customer Orders. Priority Customer Orders are executed prior to Professional Orders on the ISE. ISE Rule 100(37A) defines Priority Customer Orders as orders for persons who do not place more than 390 orders in listed options per day on average during a calendar month. The other options exchanges have not adopted this distinction between Priority Customer and Professional Orders. Thus, we do not believe it is practical or appropriate to require ISOs sent to us from other exchanges, representing customer orders from such exchanges, to be marked as Professional Orders.

18 See Regulation NMS Rules 611(b)(5) and (6).

19 See Regulation NMS Rule 611(b)(8).

of "safe harbor" to market participants to allow them to trade through prices that have changed within a second of the transaction causing a nominal trade-through.

- <u>Non-Firm Quotes</u>: Rule 1901(b)(6) implements Section 5(b)(vii) of the Plan and carries forward the current non-firm quote trade-through exception in the Old Plan.[20] By definition, an exchange's quotations may not be firm for automatic execution during this trading state and thus should not be protected from trade-throughs. In effect, these quotations are akin to "manual quotations" under Regulation NMS.

- <u>Complex Trades</u>: Rule 1901(b)(7) implements Section 5(b)(viii) of the Plan and carries forward the current complex trade exception in the Old Plan.[21] Complex trades consist of multiple transactions ("legs") effected at a net price, and it is not practical to price each leg at a price that does not constitute a trade-through. This exemption will apply to executions in the Exchange's Complex Order Mechanism.[22]

- <u>Customer Stopped Orders</u>: Rule 1901(b)(8) implements Section 5(b)(ix) of the Plan and corresponds to the customer stopped order exception in Regulation NMS for equity securities.[23] It permits broker-dealers to execute large orders over time at a price agreed upon by a customer, even though the price of the option may change before the order is executed in its entirety.

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20 <u>See</u> Old Plan Section 8(c)(iii)(C).

21 <u>See</u> Old Plan Section 8(c)(iii)(G).

22 <u>See</u> ISE Rule 722.

23 <u>See</u> Regulation NMS Rule 611(b)(9).

- Stopped Orders and Price Improvement: Rule 1901(b)(9) implements Section 5(b)(x) of the Plan and would apply if an order is stopped at price that did not constitute a trade-through at the time of the stop. This exception will facilitate the use of the ISE's "Price Improvement Mechanism," by which members could seek price improvement for that order, even if the market moves in the interim, and the transaction ultimately is effected at a price that would trade through the then currently-displayed market.[24]
- Benchmark Trades: Rule 1901(b)(10) implements Section 5(b)(xi) of the Plan and would cover trades executed at a price not tied to the price of an option at the time of execution, and for which the material terms were not reasonably determinable at the time of the commitment to make the trade. An example would be a volume-weighted average price trade, or "VWAP." This corresponds to a trade-through exemption in Regulation NMS for equity trades.[25] The ISE does not currently permit these types of options trades, and any transaction-type relying on this exemption would require the ISE to adopt implementing rules, subject to Commission review and approval.

Rule 1902 – Locked and Crossed Markets

Proposed Rule 1902 implements Section 6 of the Plan, which requires Plan participants to establish, maintain and enforce rules that: require their members reasonably to avoid displaying locked and crossed markets; are reasonably deigned to assure reconciliation of locked and crossed markets; and prohibit their members from engaging in a pattern or practice of displaying locked

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[24] See ISE Rule 723.

[25] See Regulation NMS Rule 611(b)(7).

and crossed markets. Section 6 of the Plan further allows an exchange to provide exceptions to these limitations as "contained in the rules of a Participant approved by the Commission."

Proposed Rule 1902(a) contains the general prohibition that ISE members shall reasonably avoid displaying, and shall not engage in a pattern or practice of displaying, any quotations that lock or cross the best bid or offer of another exchange. We propose four exceptions to this general prohibition.[26]

The first exception would apply when we are experiencing system issues, and is similar to the systems issues exception to the trade-through rule. The second exception applies when there is a crossed market, and also is similar to the corresponding trade-through exception. Also similar to the trade-through exception, the third exception applies when a member simultaneously routes an ISO to execute against the full displayed size of any locked or crossed protected bid or offer. The fourth proposed exception applies to locked markets in the following circumstances:

- Neither the locking or locked quote represents, in whole or in part, a customer order; or
- A customer enters a bid or offer that locks a non-customer quotation on another market, and the customer, on a case-by-case basis, authorizes the locking of the other market's quotation.[27]

This fourth exemption recognizes an important distinction between the equities and options markets. Options market makers compete for order flow by disseminating quotations in multiple series with respect to each underlying security, distributing liquidity over a much greater universe of products than in the equity markets. As a result, the options markets are more reliant

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[26] See email from Michael Simon, General Counsel, ISE, to David Liu, Assistant Director, Division of Trading and Markets, Commission, dated May 29, 2009.

[27] See id.

on market maker quotations to provide liquidity, with fewer customer orders in each series than in each underlying security, where liquidity is concentrated in one product.[28]

With market makers on multiple exchanges constantly updating their quotations in all these series based on mathematical formulae there is a greater likelihood of market maker quotations locking. We believe that in most cases locked market maker quotations are good for the investing public. Effectively locked markets provide a "zero spread," allowing market participants to buy and sell an option at the same price. On the ISE these quotations are firm, and are fully executable on an automated basis.

We recognize that locked markets are more complicated where one or both of the locking quotations represents a customer order. Where there is contra-side market interest willing to trade with a customer, the customer order should be filled. Thus, we would not exempt from the locked market prohibition situations involving customer orders unless the customer entering the locking order specifically authorizes the lock on a case-by-case basis.[29]

As proposed, the ISE will not permit a member to lock another exchange's quotation unless the ISE can establish that the quotation on the other exchange is not for the account of a customer. The options exchanges currently are working on a method to so identify customer quotations through the Options Price Reporting Authority. Absent the ability to identify a customer quote as part of an exchange's BBO, the ISE will assume that the quote represents, in whole or in part, a customer order. That is, the ISE will not permit its members to avail themselves of this exemption unless another exchange has informed the ISE that it will designate all customer orders as such in OPRA, and such exchange's quotation does not contain such

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28 See id.

29 We can envision a customer authorizing a lock when the fees associating with trading against the locked market make the execution price uneconomical to the customer.

designation. If an exchange opts not to identify its customer quotations, the ISE will treat all of that exchange's quotations as customer orders and, absent application of another exception, will not permit locks of such quotations.

Temporary Rule 1903 – Phase Out of Intermarket Linkage Rules

When the Plan and implementing rules become operative it is possible that not all the options exchanges will be functionally able to operate pursuant to the Plan. Thus, in order to ensure there is full intermarket trade-through protection during this interim period, we propose to retain certain minimum trade-through rules governing the operation of the Linkage until all the options exchanges are operating pursuant to the Plan. When that occurs we will file a rule change with the Commission to delete Temporary Rule 1903.

Temporary Rule 1903 provides that the ISE will continue to accept Principal Acting as Agent ("P/A") and Principal Orders from options exchanges that use such orders to address trade-throughs. The handling of these orders will be subject to rules that parallel the operation of the Linkage under the Old Plan.

Amendment of other ISE Rules to Accommodate the Plan

We propose to amend six ISE rules outside of Chapter 19:

- First, Rule 701, entitled "Trading Rotations," describes the initiation of trading in an options series. That rule currently permits an ISE Primary Market Maker ("PMM") to send various Linkage orders prior to the opening of trading on the Exchange. With the termination of the Linkage such provision no longer will be necessary and we thus propose to delete this provision.

- Second, Rule 714 governs when we provide automatic execution for orders we receive. We propose to amend that rule to reflect the terminology in the Plan and the implementing rules. We propose no substantive changes to that rule.
- Third, we propose to amend the Supplementary Material Rule 716, entitled "Block Trades," to delete Supplementary Material .07 which implements the block exception in the Old Plan, which no longer will be in effect.
- Fourth, Rule 803(c) and the Supplementary Material govern the obligations of PMMs, including the PMMs' obligation to address customer orders when there is a better market displayed on another exchange. We propose to amend this rule to specify that ISE will discharge its obligations under the Plan to "establish, maintain and enforce written policies and procedures . . . reasonably designed to prevent Trade-Throughs"[30] by requiring PMMs to address customer orders when there is a better market away. This is similar to PMMs' obligations under the Old Plan. However, PMMs would meet this obligation via the use of ISOs rather than Linkage orders.[31] ISE will conduct surveillance of PMMs' trading activities to ensure that they comply with this obligation.

  PMMs will comply with their obligation (i) by executing a customer order at a price that at least matches the best price displayed or (ii) by sending ISO(s) as agent for the customer to any other exchange(s) displaying a superior price and,

30 Section 5(a) of the Plan.

31 The routing of Public Customer orders to another exchange when the ISE is not at the best price is, in effect, voluntary. A customer can avoid such route-outs by entering an Immediate or Cancel ("IOC," <u>see</u> ISE Rule 715(b)(3)) or Fill or Kill ("FOK," <u>see</u> ISE Rule 715(b)(2)) order. If the Exchange cannot immediately execute such orders, it will cancel all of the order (FOK orders) or the unexecuted portion of the order (IOC orders) without routing such orders to another exchange.

with respect to any remaining portion of the customer order, either (a) releasing the remaining portion of the order for execution in the Exchange's auction market or (b) executing the remaining portion of the order at a price superior to the best price in the Exchange's auction market.

The amended rule further specifies that: (i) in addressing customer orders that are not automatically executed because there is a displayed bid or offer on another exchange trading the same options contract that is better than the best bid or offer on the Exchange, the Exchange will act in compliance with its rules and with the provisions of the Act and the rules thereunder, including, but not limited to, the requirements in Section (6)(b)(4) and (5) of the Act that the rules of national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers; and (ii) all orders entered on the Exchange and routed to another exchange via an ISO pursuant to the Rule, and that result in an execution, are binding.

- Fifth, Rule 810 governs "informational barriers" that ISE market makers must maintain within their firms. These barriers restrict the flow of information between personnel handling market making activities, on the one hand, and personnel performing other functions, including the acting as agency [sic] for customer orders, on the other hand. Under the Old Plan, when there is a better market on another exchange, a PMM can send a P/A Order to that exchange in an attempt to access that better price for the customer. This is consistent with Rule 810 because a

Under the Plan and these proposed rules, PMMs will send ISOs representing the underlying customer orders, rather than P/A Orders, when there is a better market away. Because these ISOs technically will be orders on behalf of a Public Customer current Rule 810 would prohibit a PMM from sending such an order. We propose a narrow carve-out to Rule 810 that would permit a PMM to send ISOs solely to comply with its obligation under Rule 803 to address Public Customer orders when there is a better market on another exchange. PMMs will act as agent in these circumstances, and will send the ISOs from the market making side of the information barrier. In all other respects PMMs will be subject to Rule 810.

- Sixth, Rule 811(b) governs Directed Orders and currently states that ISE market makers may act as agent for customer orders only when handling directed orders. We propose to amend that rule to reflect the ability of Primary Market Makers to act as agent when sending ISOs under Rule 803.

2. Statutory Basis

The basis under the Act for this proposed rule change is found in Section 6(b)(5),[32] in that the proposed rule change is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system and, in general, to protect investors and the public interest. In particular, the Exchange believes that adopting rules that implement the Plan will facilitate the trading of options in a

[32] 15 U.S.C. 78f(b)(5).

national market system by establishing more efficient protection against trade-throughs and locked and crossed markets.

B. Self-Regulatory Organization's Statement on Burden on Competition

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) by order approve the proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. 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 No. SR-ISE-2009-27 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-ISE-2009-27. 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 Web site (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 inspection and copying in the Commission's Public Reference Room, 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 available publicly. All submissions should refer to File Number SR-ISE-2009-27 and should be submitted on or before [insert date 21 days from the date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[33]

Florence E. Harmon
Deputy Secretary

[33] 17 CFR 200.30-3(a)(12).