

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69782; File No. SR-ISE-2013-38)

June 18, 2013

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Proposed Rule Change Related to Market Maker Risk Parameters and Complex Orders

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 June 5, 2013, the International Securities Exchange, LLC (the "Exchange" or the "ISE") 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 Exchange proposes to mitigate market maker risk by requiring market makers to enter values in the Exchange-provided risk parameters and by limiting the types of complex orders that can leg-into the regular market. The text of the proposed rule change is available on the Exchange's Web site www.ise.com, at the principal office of the Exchange, 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 Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B and C below, of the most significant aspects of such statements.

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

1. Purpose

On [sic] Pursuant to ISE Rule 722 and 804, the Exchange currently provides functionality that will automatically remove a market maker's quotes in all series of an options class when certain parameter settings are triggered. Specifically, 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 for market maker quotes 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 contracts sold in an options class, and the absolute value of the net between (a) calls purchased plus puts sold, and (b) calls sold plus puts purchased. The market maker establishes limits for each of these four parameters, and when the limits are exceeded within the prescribed time frame, the market makers quotes are removed.³

³ The Exchange is proposing certain non-substantive changes to the text of Rules 722 and 804 for clarity. The changes shorten the first sentence in Rule 804 by deleting "if the market maker trades, in the aggregate across all series of an options class during a specified time period" and to delete "(established by the market maker), within a time frame specified by the market maker" as the text might be confusing in its current form and is redundant with other text within the Rule. To assure clarity, the Exchange also proposes to specify that the first parameter is a number of "total" contracts "in the class," and to specify that the fourth parameter is a net value based on puts and calls purchased and sold "in the class." Finally, the Exchange proposes to use a uniform construction of "the specified . . ." for each of the four parameters. The same clarifying changes are also proposed with respect to Rule 722, as the language in both rules is identical except for the fact that Rule 722 applies to market maker quotes for complex orders. The Exchange is

The purpose of this functionality is to allow market makers to provide liquidity across potentially hundreds of options series without being at risk of executing the full cumulative size of all such quotes before being given adequate opportunity to adjust their quotes. For example, if a market maker can enter quotes with a size of 20 contracts in 150 series of an options class, its total potential exposure is 3000 contracts in the options class. To mitigate the risk of executing all 3000 contracts without evaluating its positions, the market maker risk functionality will automatically remove its quotes in all series of the options class after it has executed a specified number of contracts (e.g., 100) in series of that options class during a specified time period (e.g., 5 seconds).

To assure that all quotations are firm for their full size, the parameter calculations occur after an execution against a market maker's quote takes place. For example, if a market maker has set a parameter of 100 contracts during a 5 second interval for an options class, and has executed a total of 95 contracts in the options class within the previous 3 seconds, a quote in a series of that class with a size of 20 contracts continues to be firm for all 20 contracts. In this example, an incoming order could execute all 20 contracts of the quote, and following the execution, the total size parameter would add 20 contracts to the running total of 95. Since the total size executed within the 5 second time frame exceeds the 100 contracts established by the market maker for the options class, all of the market maker's quotes in the options class would be removed. The market maker would then enter new quotes in the class.

Use of these risk management tools has always been voluntary under the rules. Similarly, from a technical perspective, market makers currently do not need to enter any values into the

not proposing to alter the operation of the functionality, other than to make use of the parameters mandatory.

applicable fields, and thus effectively can choose not to use these tools. The Exchange proposes to amend the rule to make it mandatory for market makers to enter values into all four of the quotation risk management parameters for all options classes in which it enters quotes. The purpose of the rule change is to prevent market makers from inadvertently entering quotes without risk-management parameters. In this respect, the Exchange notes that all ISE market makers currently use the parameters when entering quotes. However, it is possible that a market maker could inadvertently enter quotes without populating one or more of the risk parameters, resulting in the member being exposed to much more risk than it intended. Accordingly, ISE market makers have requested that the Exchange modify the trading system to reject quotes if there are any missing risk management values for the options class.

While entering values into the quotation risk parameters will be mandatory to prevent an inadvertent exposure to risk, the Exchange notes that market makers who prefer to use their own risk-management systems can enter values that assure the Exchange-provided parameters will not be triggered.⁴ Accordingly, the proposal does not require members to manage their risk using the Exchange-provided tools.

The Exchange also proposes to amend Rule 722 to limit a potential source of unintended market maker risk related to how the market maker risk parameters under Rule 804 are calculated when complex orders leg-into the regular market.⁵ As discussed above, by checking

⁴ For example, a market maker could set the value for the total number of contracts executed in a class at a level that exceeds the total number of contracts the market maker actually quotes in an options class.

⁵ Pursuant to ISE Rule 722(b)(3)(ii), complex orders may be 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.

the risk parameters following each execution in an options series, the risk parameters allow market makers to provide liquidity across multiple series of an options class without being at risk of executing the full cumulative size of all such quotes. This is not the case, however, when a complex order legs-into the market. Because the execution of each leg is contingent on the execution of the other legs, the execution of all the legs in the regular market is processed as a single transaction, not as a series of individual transactions.

For example, if individual orders to buy 10 contracts for the Jan 30 call, Jan 35 call, Jan 40 call, Jan 45, and Jan 50 calls are entered, each is processed as it is received and the market maker quotation parameters are calculated following the execution of each 10-contract order. However, if a complex order to buy all five of these strikes ten times is entered and is executed against bids and offers for the individual series, the market maker parameters for quotes in the regular market are calculated following the execution of all 50 contracts. In the example discussed previously, when the market maker had set a limit of 100 contracts for the options class and had executed 95 contracts, the amount by which the next transaction might exceed 100 is limited to the largest size of its quote in a single series of the options class. In that example, since the largest size the market maker was quoting in any one series was 20 contracts, the market maker could not have exceeded the 100 contract trigger by more than 15 contracts ($95 + 20 = 115$). With respect to a complex order with five legs 20 times, the next transaction against the market maker's quotes potentially could be as large as 100 contracts (depending upon whether there are other market participants same price), creating the potential in this example that the market maker could exceed the 100 contract limit by 95 contracts ($95 + 100 = 195$) instead of 15.

As the example demonstrates, the legging-in of complex orders presents higher risk to market makers as compared to regular orders being entered in multiple series of an options class in the regular market as it allows market makers to exceed their parameters by a greater number of contracts. Because this risk is directly proportional to the number of legs associated with a complex order, ISE market makers have requested that the Exchange prevent complex orders from legging into the market if they have a large number of legs. The Exchange therefore proposes to limit the legging functionally to complex orders with no more than either two or three legs, as determined by the Exchange on a class basis.⁶ The Exchange notes in this respect that over 85% of all complex orders have only two legs and that very few complex orders are entered with more than three legs. The Exchange believes that the potential risk to market makers in the regular market of allowing orders with more than three legs (in some cases more than two legs) to leg-into the market, far out-weighs the potential benefit of offering such functionality to a very limited number of orders.

Complex orders with more than three legs (in some cases more than two legs) that could leg into the market except for the proposed limitation will be available for execution on the complex order book. The Exchange notes in this respect that the execution priority rules contained in ISE Rule 722(b)(2) often prevent the execution of complex orders that might otherwise be executable. Specifically, Rule 722(b)(2) provides that the legs of a complex order cannot be executed at the same price as a Priority Customer Order in the regular market unless another leg of the order is executed at a price that is better than the best price in the regular

⁶ The Exchange will issue a circular to members identifying the options classes for which legging is limited to complex orders with two legs and those for which legging is limited to complex order with three legs. The Exchange will provide members with reasonable notice prior to change the limit applicable to an options class.

market.⁷ In other words, if there is a Priority Customer Order on the book in one or more of the series of a complex order, the net price of the complex order has to improve upon the price that would be available if the complex order legged-into the market. Thus, currently there can be complex orders resting on the book that cannot leg-into the market because the permissible ratio cannot be satisfied by the bids and offers in the regular market or because there are Priority Customer Orders in the regular market in one or more of the series of the complex order that prevent its execution. Accordingly, the Exchange believes that preventing orders with more than three legs (in some cases more than two legs) from legging-into the market does not create any unusual circumstances on the complex order book. The Exchange further notes that priority of complex orders on the complex order book is not impacted by the proposed rule change.⁸

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the the [sic] Act⁹ in general, and furthers the objectives of Section 6(b)(5) of the Act¹⁰ in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest.

⁷ Pursuant to ISE Rule 100(a)(37A) and (37B), a Priority Customer Order is an order for the account of a person or entity that (i) is not a broker or dealer in securities, and (ii) does not place more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s).

⁸ For example, if there are multiple complex orders for the same strategy at the same price with four or more legs, they will be executed pursuant to Rule 722(b)(3) (*i.e.*, in time priority or pro-rata bases on size (with or without Priority Customer priority)).

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

The Exchange believes that requiring market makers to enter values into the risk parameters provided by the Exchange will not be unreasonably burdensome, as all ISE market makers currently utilize the functionality. Moreover, the Exchange is proposing this rule change at the request of its market makers to reduce their risk of inadvertently entering quotes without populating the risk parameters. As discussed above, the Exchange will be modifying the trading system to automatically reject quotations unless the parameters are populated with values, which will protect market makers from inadvertent exposure to excessive risk. Reducing such risk will enable market makers to enter quotations with larger size, which in turn will benefit investor through increased liquidity for the execution of their orders. Such increased liquidity benefits investors because they receive better prices and because it lowers volatility in the options market.

The Exchange also believes it is reasonable to limit the types of complex orders that are eligible to leg-into the market. In this respect, the Exchange notes that the vast majority of complex orders consist of only two legs, which will be unaffected by this rule change. Moreover, the Exchange believes that the potential risk of continuing to offer legging functionality for complex orders with more than three legs (in some cases with more than two legs) limits the amount of liquidity that market makers are willing to provide in the regular market. In particular, market makers may reduce the size of their quotations in the regular market because they are at risk of executing the cumulative size of their quotations across multiple options series without an opportunity to adjust their quotes. Accordingly, reducing market maker risk in the regular market by limiting the legging functionality to orders with no more than three legs (in some cases with no more than two legs) will benefit investors by encouraging additional liquidity in the regular market. This benefit to investors far exceeds the

small amount of potential liquidity provided by the few complex orders that have more than three legs (in some case more than two legs).

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

The proposed rule change does not impose any burden on competition. The proposed rule change to make it mandatory for market makers to populate the quotation risk management parameters is being made at the request of ISE market makers to prevent the inadvertent entry of quotes without risk-management parameters. Market makers who prefer to use their own risk-management systems can enter out-of-range values so that the Exchange-provided parameters will not be triggered. Accordingly, the proposal does not require members to manage their risk using an Exchange-provided tool. The proposed change to limit legging functionality to complex orders of no more than three legs (in some cases no more than two legs) will reduce risk to market makers that are quoting in the regular market. As such, the proposal may encourage market makers to increase the size of their quotations, thereby adding liquidity on the Exchange.

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 45 days of the publication date of this notice or within such longer period (1) as the Commission may designate up to 45 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (2) as to which the self-regulatory organization consents, the Commission will:

- (a) by order approve or disapprove such 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 Number SR-ISE-2013-38 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-ISE-2013-38. 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 ISE. 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-2013-38 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹¹

Kevin M. O'Neill
Deputy Secretary

¹¹ 17 CFR 200.30-3(a)(12).