

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-79665; File No. SR-ISE-2016-27)

December 22, 2016

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Amend the Exchange's Rules Regarding Routing of Orders, Cancellation of Orders, and Handling of Error Positions, and Permit Nasdaq Execution Services, LLC to become an Affiliated Member of the Exchange to Perform Certain Routing and Other Functions

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 9, 2016, the International Securities Exchange, LLC ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change. On December 20, 2016, the Exchange filed Amendment No. 1 to the proposed rule change, which amended and replaced the original filing in its entirety. The proposed rule change, as modified by Amendment No. 1, is 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, as modified by Amendment No. 1, from interested persons.

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

The Exchange proposes to (1) permit the Exchange to receive inbound orders in options routed through Nasdaq Execution Services, LLC ("NES") from certain affiliated exchanges, as described in detail below, by establishing procedures designed to prevent potential informational advantages resulting from the affiliation with NES; (2) route outbound orders through NES either directly or through a third party routing broker-dealer; (3) grant the Exchange an exemption to permit NES, an affiliate of the Exchange, to become a Member of the Exchange in

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

order to perform certain routing and [sic] other functions on behalf of the Exchange; and (4) adopt a rule regarding the cancellation of orders and the maintenance of a NES error account.

The text of the proposed rule change is available on the Exchange's Website at [www.ise.com](http://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 in Item IV below. The Exchange 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 the Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the filing is to permit ISE to receive inbound orders in options routed through Nasdaq Execution Services, LLC ("NES") from certain affiliated exchanges, as described herein and establish procedures designed to prevent potential informational advantages resulting from the affiliation between ISE and NES. The Exchange requests approval to permit NES, an affiliate of the Exchange, to become a Member of the Exchange in order to perform certain routing and other functions on behalf of the Exchange. First, the Exchange requests that NES be permitted to route orders inbound to the Exchange in its capacity as a facility of the Affiliated Entities as defined below. Also, this proposal is to permit ISE to route outbound

orders through NES either directly or indirectly through a third party routing broker-dealer<sup>3</sup> to other market centers. Additionally, the Exchange proposes to add a rule regarding the cancellation of orders and the maintenance of a NES error account.<sup>4</sup>

### **Restriction on Affiliation**

NES is a broker-dealer owned and operated by Nasdaq, Inc. NES is affiliated with ISE, ISE Gemini LLC (“ISE Gemini”), ISE Mercury LLC (“ISE Mercury”),<sup>5</sup> Nasdaq PHLX LLC (“Phlx”), The Nasdaq Options Market LLC (“NOM”) and Nasdaq BX, Inc. (“BX”). For purposes of this filing the term “Affiliated Entities” shall refer to ISE Gemini, ISE Mercury, Phlx, NOM and BX. Currently, NES is a member of Phlx, NOM and BX (collectively “Nasdaq Exchanges”) and provides all options routing functions for Phlx, NOM and BX.<sup>6</sup>

Today, Phlx Rule 985 (Affiliation and Ownership Restrictions), The NASDAQ Stock Market LLC (“Nasdaq”) Rule 2160 (Restrictions on Affiliation)<sup>7</sup> and BX Rule 2140 (Restrictions on Affiliation) currently prohibit the Nasdaq Exchanges [sic] or any entity with which it is affiliated from, directly or indirectly, acquiring or maintaining an ownership interest in, or engaging in a business venture with, a Nasdaq Exchange member or an affiliate of a Nasdaq Exchange member in the absence of an effective filing under 19(b) of the Act. Specifically, in connection with prior filings, the Commission has expressed concern that the

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<sup>3</sup> The ability to route orders to other exchanges using either the Exchange’s affiliated broker-dealer (NES) or a third party unaffiliated broker-dealer, which the Exchange may choose to use, is for efficiency and potential cost savings.

<sup>4</sup> The Exchange notes that the amendments to the Chapter 19 rules noted herein will also impact ISE Gemini an ISE Mercury rules which are cross-referenced to Chapter 19 in the ISE Rulebook

<sup>5</sup> ISE, ISE Gemini and ISE Mercury are collectively referred to as “ISE Exchanges.”

<sup>6</sup> See Phlx Rule 1080(m) and Nasdaq and BX Rules at Chapter VI, Section 11.

<sup>7</sup> NOM is a facility of Nasdaq.

affiliation of an exchange with one of its members raises the potential for unfair competitive advantage and potential conflicts of interest between an exchange's self-regulatory obligations and its commercial interests.<sup>8</sup> NES performs similar functions for the Nasdaq Exchanges and is a member of those three markets respectively.<sup>9</sup>

Similarly, NES would be prohibited from becoming an ISE member pursuant to ISE Rule 312, titled "Limitation on Affiliation between the Exchange and Members," without Commission approval. Specifically, a Member or non-member owner may not become an affiliate of the Exchange, or any facility of the Exchange, or any entity with which the Exchange or any facility of the Exchange is affiliated such as the Affiliated Entities. This rule change requests permission from the Commission to allow NES, an affiliate of ISE, to become a Member of ISE for the

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<sup>8</sup> Securities Exchange Act Release Nos. 71416 (January 28, 2014), 79 FR 6244 (February 3, 2014) (SR-Phlx-2014-05); 71419 (January 28, 2014), 79 FR 6247 (February 3, 2014) (SR-NASDAQ-2014-007); and 714121 (January 28, 2014), 79 FR 6264 (February 3, 2014) (SR-BX-2014-003).

<sup>9</sup> See Securities Exchange Act Release Nos. 59721 (April 7, 2009), 74 FR 17245 (April 14, 2009) (SR-Phlx-2009-32); 59779 (April 16, 2009) 74 FR 18600 (April 23, 2009) (SR-Phlx-2009-32, Amendment No. 1) notice of filing of proposed rule change relating to enhanced electronic trading platform for options); 61667 (March 5, 2010), 75 FR 11964 (March 12, 2010)(SR-Phlx-2010-36)(notice of filing and immediate effectiveness of proposed rule changes to establish procedures to prevent information advantages resulting from the affiliation between Phlx and NES); and 71416 (January 28, 2014), 79 FR 6244 (February 3, 2014) (SR-Phlx-2014-05)(notice of filing and immediate effectiveness of proposed rule change to inbound routing of options orders). Nasdaq Options Services was the affiliated broker-dealer prior to a rule change to utilize NES, another affiliated broker-dealer of Nasdaq. See also Securities Exchange Act Release Nos. 63769 (January 25, 2011), 76 FR 5423 (January 31, 2011) (SR-BX-2011-003); 63859 (February 7, 2011), 76 FR 8391 (February 14, 2011) (SR-BX-2011-007) (notice of filing of proposed rule change relating to permanent approval of the BX and NES inbound routing relationship); 71420 (January 28, 2014), 79 FR 6256 (February 3, 2014)(SR-BX-2014-004)(notice of filing and immediate effectiveness of proposed rule change to inbound routing). See also Securities Exchange Act Release Nos. 65554 (October 13, 2011), 76 FR 65311 (October 20, 2011)(SR-NASDAQ-2011-142); 71418 (January 28, 2014), 79 FR 6262 (February 3, 2014)(SR-NASDAQ-2014-008)(notice of filing and immediate effectiveness of proposed rule change to inbound routing).

purpose of performing certain functions, including receiving inbound orders from one of the Affiliated Entities. The Exchange proposes adopting language at proposed ISE Rule 312(c), adding references to paragraphs “a” and “b” within Rule 312. Proposed paragraph 312(c) is similar to Phlx Rule 985(c)(2).

In order for NES to be a Member of ISE, the Exchange proposes to permit the acceptance of inbound orders that NES routes in its capacity as a facility of the Affiliated Exchanges<sup>10</sup> subject to certain limitations and conditions as follows:

- First, ISE shall maintain a Regulatory Services Agreement (“RSA”) with FINRA, as well as an agreement pursuant to Rule 17d–2 under the Act (“17d–2 Agreement”).<sup>11</sup> Pursuant to the RSA and the 17d–2 Agreement, FINRA will be allocated regulatory responsibilities to review NES’s compliance with certain Exchange rules.<sup>12</sup> Pursuant to the RSA, however, ISE retains ultimate responsibility for enforcing its rules with respect to NES.

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<sup>10</sup> The Exchange notes that ISE, [sic] ISE Gemini and ISE Mercury are each separately filing rule changes to permit NES to be a Member of ISE Gemini and ISE Mercury for the purpose of performing certain routing and other functions, including, but not limited to receiving inbound orders from other entities that are affiliated with NES such as the Affiliated Entities. See SR-ISEGemini-2016-16 and SR-ISEMercury-2016-22 (both not published).

<sup>11</sup> 17 CFR 240.17d-2. FINRA will review NES’ compliance for certain common rules. The RSA with FINRA specifies the types of business activities that NES may undertake and it also indicates the obligations to which NES is subject under the RSA. Among other things, NES must maintain a certain amount of net capital pursuant to SEC Rule 15c3-1(a)(1)(ii) and operate pursuant to SEC Rule 15c3-3(k)(2)(ii). NES is permitted to route orders in options to the appropriate market center for execution in accordance with member order and requirements.

<sup>12</sup> NES is also subject to independent oversight by FINRA, its designated examining authority, for compliance with financial responsibility requirements.

- Second, FINRA will monitor NES for compliance with the Exchange’s trading rules, and will collect and maintain certain related information.<sup>13</sup>
- Third, FINRA will provide a report to the Exchange’s chief regulatory officer (“CRO”), on a quarterly basis, that: (i) quantifies all alerts (of which the Exchange or FINRA is aware) that identify NES as a participant that has potentially violated Commission or Exchange rules, and (ii) lists all investigations that identify NES as a participant that has potentially violated Commission or Exchange rules.
- Fourth, ISE has in place Rule 312, which the Exchange proposes to amend into paragraphs (a) and (b) and adopt a new paragraph (c) which states that Nasdaq, Inc., as the holding company owning ISE and NES, shall establish and maintain procedures and internal controls reasonably designed to ensure that NES does not develop or implement changes to its system, based on non-public information obtained regarding planned changes to ISE’s system, obtained as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange Members, in connection with the provision of inbound order routing to the Exchange.<sup>14</sup>

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<sup>13</sup> Pursuant to the RSA, both FINRA and ISE shall collect and maintain all alerts, complaints, investigations and enforcement actions in which NES (in its capacity as a facility of the Affiliated Entities) is identified as a participant that has potentially violated applicable Commission or Exchange rules. The Exchange and FINRA shall retain these records in an easily accessible manner in order to facilitate any potential review conducted by the Commission’s Office of Compliance Inspections and Examinations.

<sup>14</sup> Similarly, Phlx Rule 985 also prohibits a Phlx member from being or becoming an affiliate of Phlx, or an affiliate of an entity affiliated with Phlx, in the absence of an effective filing under Section 19(b). See Phlx Rule 985(b)(1)(B) [sic]. Phlx filed a rule proposal and received approval based on meeting the four conditions specified above to protect the independence of the Exchange’s regulatory responsibility with respect to NES,

## **Inbound Routing**

This new rule text provides that Nasdaq, Inc. which owns NES and ISE, shall establish and maintain procedures and internal controls reasonably designed to ensure that NES does not develop or implement changes to its system on the basis of non-public information regarding planned changes to the Exchange's systems, obtained as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members in connection with the provision of inbound routing to the Exchange.

By meeting the conditions above under Restriction on Affiliation, ISE will have set up mechanisms that protect the independence of ISE's regulatory responsibilities, with respect to NES, as well as demonstrate that NES cannot use any information advantage it may have because of its affiliation with ISE.

The Exchange has approval from Financial Regulatory Authority ("FINRA")<sup>15</sup> and The Options Clearing Corporation ("OCC")<sup>16</sup> for NES to perform these inbound routing functions.

The Exchange notes that each of the Nasdaq Exchanges are also separately filing rule changes to permit NES to route orders inbound from ISE to the Nasdaq Exchanges.<sup>17</sup>

## **Outbound Routing**

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and has demonstrated that NES cannot use any information advantage it may have because of its affiliation with the Exchange.

<sup>15</sup> The Membership Agreement as between NES and FINRA, dated January 15, 2014, provides that NES may "[e]ngage in the following types of business: Route orders in equities and options to the appropriate market center for execution in accordance with member order and requirements."

<sup>16</sup> On December 5, 2013, OCC provided NES membership approval.

<sup>17</sup> See SR-NASDAQ-2016-169, SR-Phlx-2016-120 and SR-BX-2016-068 (not published).

Today, ISE utilizes Linkage Handlers<sup>18</sup> to route orders. These Linkage Handlers are unaffiliated with ISE. The Exchange proposes to have NES route, either directly to other options exchanges or indirectly through third-party routing brokers on behalf of ISE. Regardless of whether a third-party routing broker is utilized, all options routing will go through NES, however the Exchange could determine to direct NES to route orders to certain exchanges through a routing broker rather than routing an order directly. In those cases, orders are submitted to the third-party routing broker through NES, and the third-party routing broker would route the orders to the routing destination in its name. These rules are similar to Phlx Rule 1080(m). As part of this proposal, the Exchange will remove references to Linkage Handlers in Rule 705, the Supplementary Material to Rule 1901 and Rule 1903, including the Supplementary Material to Rule 1903. Rule 1904, which includes references to Linkage Handlers is being replaced in its entirety and Rule 1905, which contains references to Linkage Handlers is being reserved.

The Exchange proposes to amend the current Rule 1903 to adopt new language similar to Phlx Rule 1080(m). The Exchange proposes to maintain the first part of this rule which specifies that the Exchange may automatically route ISOs to other exchanges under certain circumstances, including pursuant to Supplementary Material .02 to Rule 1901 which describes trade throughs. This provision, although not specified directly within Phlx Rule 1080(m) is also true today for Phlx orders. The Exchange believes this language adds more context to the Rule.

Proposed Rule 1903(a), which is similar to Phlx Rule 1080(m)(iii)(A) would provide that the Exchange shall route orders in options via NES, a broker-dealer that is a member of an

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<sup>18</sup> A Linkage Handler is a broker that is unaffiliated with the Exchange with which the Exchange has contracted to provide Routing Services, as that term is defined in Rule 1903, by routing ISO(s) to other exchange(s) as agent on behalf of Public Customer and Non-Customer Orders according to the requirements of Rule 1901 (prohibition on trade-throughs) and Rule 1902 (prohibition on locked and crossed markets). See Supplementary Material .03 to ISE Rule 1901.



unaffiliated SRO which is the designated examining authority for the broker-dealer. NES would serve as the Routing Facility of the Exchange (the “Routing Facility”). The sole use of the Routing Facility by the system would route orders in options listed and open for trading on the system to away markets either directly or through one or more third-party unaffiliated routing broker-dealers pursuant to Exchange rules on behalf of the Exchange. The Routing Facility would be subject to regulation as a facility of the Exchange, including the requirement to file proposed rule changes under Section 19 of the Securities Exchange Act of 1934, as amended. Similar to Phlx, this rule describes the affiliation to NES and indicates the sole use for NES to route orders either directly or indirectly. This is the current practice on Phlx today.

Proposed Rule 1903(b), which is similar to Phlx Rule 1080(m)(iii)(B), describes that routing is optional. Parties that do not desire to use NES must designate orders as Do-Not-Route-Orders as described in Rule 715(m).

Proposed Rule 1903(c), similar to Phlx Rule 1080(m)(iii)(C) states that the Exchange shall establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange and the Routing Facility, and any other entity, including any affiliate of the Routing Facility; or, where there is a routing broker, the Exchange, the Routing Facility and any routing broker, and any other entity, including any affiliate of the routing broker (and if the routing broker or any of its affiliates engages in any other business activities other than providing routing services to the Exchange, between the segment of the routing broker or affiliate that provides the other business activities and the segment of the routing broker that provides the routing services). Thus this provision would extend to the routing broker, if one is used. This is the current practice on Phlx today.

The Exchange proposes to state at Rule 1903(c)(1), the books, records, premises, officers, directors, agents, and employees of the Routing Facility, as a facility of the Exchange, shall be deemed to be the books, records, premises, officers, directors, agents, and employees of the Exchange for purposes of and subject to oversight pursuant to the Act. The books and records of the Routing Facility, as a facility of the Exchange, shall be subject at all times to inspection and copying by the Exchange and the Commission. This provision is similar to Phlx Rule 1080(m)(iii)(D).

The Exchange proposes to add language at Rule 1903(c)(2), similar to Phlx Rule 1080(m)(iii)(F) that states that the Exchange and NES may not use a routing broker for which the Exchange or any affiliate of the Exchange is the designated examining authority. This provision is intended to prevent any conflicts of interest which may arise wherein a regulatory oversight entity is privy to trades conducted on ISE.

The Exchange proposes to add language in Rule 1903(d), similar to Phlx Rule 1080(m)(iii)(E) to provide language related to Market Access. Specifically, the rule text addresses NES' obligations pursuant to Rule 15c3-5 under the Act to implement certain tests designed to mitigate risks associated with providing the Exchange's Members with access to away trading centers. Pursuant to the policies and procedures developed by NES to comply with Rule 15c3-5, if an order or series of orders are deemed to be violative of applicable pre-trade requirements of Rule 15c3-5, the order will be rejected prior to routing and/or NES will seek to cancel any orders that have been routed.

The Exchange also proposes to expressly state in Rule 1903(e), similar to Phlx Rule 1080(m)(iii)(G), that the Exchange will determine the logic that provides when, how, and where orders are routed away to other exchanges. In addition, the routing broker(s) cannot change the

terms of an order or the routing instructions, nor does the routing broker have any discretion about where to route an order. The Exchange may determine to use a different routing broker by destination exchange, depending upon the costs and technological efficiencies involved by indirectly routing to that broker through NES. The proposal is intended to allow the Exchange to structure its routing arrangements accordingly. At a minimum, the Exchange anticipates using a routing broker to access certain markets where the Exchange finds that the costs of maintaining a membership, for NES, and/or the costs of connectivity and execution do not make sense in light of the number or types of orders the Exchange typically routes to that particular market. These costs necessarily determine the ultimate costs to the Exchange of routing to a market, and, in turn, affect how the Exchange chooses to recoup those costs through its own transaction fees.<sup>19</sup> Sometimes, it will not make economic sense for NES to access an exchange directly. Accordingly, the Exchange would route the order through NES to another routing broker where the Exchange determines that it is appropriate. In addition to costs, the Exchange will also consider ease of connectivity and execution as well as general reliability in selecting a routing broker.

The Exchange proposes to replace Rule 1903(f) with a provision similar to Phlx Rule 1080(m)(ii), which provides that entering Members whose orders are routed to away markets shall be obligated to honor such trades that are executed on away markets to the same extent they would be obligated to honor a trade executed on the Exchange. This is the case today for all

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<sup>19</sup> For these reasons, today, transaction fees for orders vary depending on the market where an order is ultimately executed.

orders entered on ISE today pursuant to current ISE Rule 1903(f).<sup>20</sup> The Exchange is simply conforming the rule text to Phlx's rule.

Finally, the Exchange is amending the Supplementary Material to Rule 1903 to address citations to a "Linkage Handler." In Supplementary Material .01 to Rule 1903 the Exchange is replacing the term Linkage Handler with references to NES or third-party unaffiliated routing broker dealers used by NES. In Supplementary Material .02 to Rule 1903 the Exchange is replacing the term Linkage Handler with NES in describing the case where routing services cannot be provided by the today (Linkage Handler) and now proposed NES. The Exchange is amending Supplementary Material .03 to Rule 1903 the Exchange is replacing the term "Linkage Handler" with "NES."

### **Other Corresponding Changes**

The Exchange proposes to amend ISE Rule 705 to remove the rule text in Rule 705(d)(4) which provides an exception to the limits on compensation in Rule 705(d) for Members to the extent that such Members are acting as Linkage Handlers, as defined in Supplementary .03 to Rule 1901. NES is replacing the Linkage Handlers for purposes of routing options orders from the ISE Exchanges. Today, Phlx does not have a similar provision and ISE is removing it from this rule. Unlike NES, Linkage Handlers are not affiliated with ISE and therefore the Exchange does not believe that this provision is necessary.

The Exchange proposes to amend the Supplementary Material to Rule 1901 to replace the term "Linkage Handler" with "NES" and amend the cross-reference to define NES.

Supplementary Material .02(d) has a reference to "Linkage Handler" which is being changed to

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<sup>20</sup> ISE Rule 1903(f) currently states, "Any bid or offer entered on the Exchange routed to another exchange via a Linkage Handler that results in an execution shall be binding on the Member that entered such bid/offer."

“NES” and a cross-reference to the Linkage Handler definition in Supplementary Material .03 to Rule 1901, which is being deleted, is proposed to be replaced with a reference to proposed Rule 1903. Finally, the reference to “Linkage Handler” in Supplementary Material .05 is being replaced with “NES.”

### **Cancellation of Orders and Error Accounts**

The Exchange is amending Rule 1904 entitled “Order Cancellation/Release” to retitle the rule “Cancellation of Orders and Error Account.” The Exchange is replacing the current rule text with rule text similar to Phlx Rule 1080(m)(v). The Exchange is also removing and reserving Rule 1905, entitled “Routing Service Error Accounts.”

Today ISE Rule 1904 provides the Exchange may cancel orders as it deems to be necessary to maintain fair and orderly markets if a technical or systems issue occurs at the Exchange, a Linkage Handler in connection with the Routing Service provided under Rule 1903, or another exchange to which an Exchange order has been routed. A Linkage Handler may only cancel orders being routed to another exchange based on the Exchange’s standing or specific instructions or as otherwise provided in the Exchange Rules. The Exchange shall provide notice of the cancellation of the Members’ original order to affected Members as soon as practicable.<sup>21</sup> Further, the Exchange may release orders being held on the Exchange awaiting an away exchange execution as it deems necessary to maintain fair and orderly markets if a technical or systems issue occurs at the Exchange, a Linkage Handler, or another exchange to which an Exchange order has been routed.<sup>22</sup>

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<sup>21</sup> See Rule 1904(a).

<sup>22</sup> See Rule 1904(b).

Today, ISE Rule 1905 permits each Linkage Handler to maintain, in the name of the Linkage Handler, one or more accounts for the purpose of liquidating unmatched trade positions that may occur in connection with the Routing Service provided under Rule 1903 (“error positions”). Errors to which this Rule applies include any action or omission by the Exchange, a Linkage Handler, or another exchange to which an Exchange order has been routed, that results in an unmatched trade position due to the execution of an order that is subject to the away market Routing Service and for which there is no corresponding order to pair with the execution (each a “routing error”). Such routing errors would include, without limitation, positions resulting from determinations by the Exchange to cancel or release an order pursuant to Rule 1904. An error position will be liquidated in a Linkage Handler’s error account.

A Linkage Handler utilizing its own account to liquidate error positions, shall liquidate the error positions as soon as practicable. The Linkage Handler shall: (i) establish and enforce policies and procedures reasonable [sic] designed to (1) adequately restrict the flow of confidential and proprietary information associated with the liquidation of the error positions in accordance with Rule 1903, and (2) prevent the use of information associated with other orders subject to the Routing Services when making determinations regarding the liquidation of error positions; and (ii) make and keep records associated with the liquidation of such Linkage Handler error positions and shall maintain such records in accordance with Rule 17a-4 under the Exchange Act. Finally, the Exchange shall make and keep records to document all determinations to treat positions as error positions under this Rule and shall maintain such records in accordance with Rule 17a-1 under the Exchange Act

The Exchange proposes to adopt language similar to Phlx Rule 1080(m)(v). This rule provides general authority for Phlx or NES to cancel orders in order to maintain fair and orderly

markets when technical and systems issues are occurring, and Rule 1080(m)(v) also sets forth the manner in which error positions may be handled by the Exchange or NES.<sup>23</sup> NES, as the proposed routing broker of the Exchange, would be subject to the conditions listed in this proposed Rule 1903. The Exchange, pursuant to this proposal, would rely on NES to provide outbound routing services from itself to routing destinations of NES (“routing destinations”). When NES routes orders to a routing destination, it would do so by sending a corresponding order in its own name to the routing destination. In the normal course, routed orders that are executed at routing destinations are submitted for clearance and settlement in the name of NES, and NES arranges for any resulting securities positions to be delivered to the member that submitted the corresponding order to the Exchange. From time to time, however, the Exchange

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<sup>23</sup> See Securities Exchange Act Release No. 68393 (December 10, 2012), 77 FR 74520 (December 14, 2012)(SR-Phlx-2012-134). Accordingly, pursuant to proposed ISE Rule 1904, the Exchange is responsible for filing with the Commission rule changes and fees relating to NES’s functions. In addition, the Exchange is using the phrase “NES or the Exchange” in this rule filing to reflect the fact that a decision to take action with respect to orders affected by a technical or systems issue may be made in the capacity of NES or the Exchange depending on where those orders are located at the time of that decision. From time to time, the Exchange may use non-affiliate third-party broker-dealers to provide outbound routing services (i.e., third-party Routing Brokers). In those cases, orders are submitted to the third-party Routing Broker through NES, the third-party Routing Broker routes the orders to the routing destination in its name, and any executions are submitted for clearance and settlement in the name of NES so that any resulting positions are delivered to NES upon settlement. As described above, NES normally would arrange for any resulting securities positions to be delivered to the member that submitted the corresponding order to the Exchange. If error positions (as defined in proposed ISE Rule 1904(b)) result in connection with the Exchange’s use of a third-party Routing Broker for outbound routing, and those positions are delivered to NES through the clearance and settlement process, NES would be permitted to resolve those positions in accordance with proposed ISE Rule 1904. If the third-party Routing Broker received error positions in connection with its role as a routing broker for the Exchange, and the error positions were not delivered to NES through the clearance and settlement process, then the third-party Routing Broker would resolve the error positions itself, and NES would not be permitted to accept the error positions, as set forth in proposed ISE Rule 1904(b)(2).

and NES encounter situations in which it becomes necessary to cancel orders and resolve error positions.<sup>24</sup>

### **Examples of Circumstances That May Lead to Canceled Orders**

A technical or systems issue may arise at NES, a routing destination, or the Exchange that may cause the Exchange or NES to take steps to cancel orders if the Exchange or NES determines that such action is necessary to maintain a fair and orderly market. The examples set forth below describe some of the circumstances in which the Exchange or NES may decide to cancel orders.

**Example 1.** If NES or a routing destination experiences a technical or systems issue that results in NES not receiving responses to immediate or cancel (“IOC”) orders that it sent to the routing destination, and that issue is not resolved in a timely manner, NES or the Exchange would seek to cancel the routed orders affected by the issue.<sup>25</sup> For instance, if NES experiences a connectivity issue affecting the manner in which it sends or receives order messages to or from routing destinations, it may be unable to receive timely execution or cancellation reports from the routing destinations, and NES or the Exchange may consequently seek to cancel the affected

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<sup>24</sup> The examples described in this filing are not intended to be exclusive. Proposed Rule 1904 would provide general authority for the Exchange or NES to cancel orders in order to maintain fair and orderly markets when technical and systems issues are occurring, and Rule 1904 also would set forth the manner in which error positions may be handled by the Exchange or NES. The proposed rule change is not limited to addressing order cancellation or error positions resulting only from the specific examples described in this filing.

<sup>25</sup> In a normal situation (*i.e.*, one in which a technical or systems issue does not exist), NES should receive an immediate response to an IOC order from a routing destination, and would pass the resulting fill or cancellation on to the Exchange member. After submitting an order that is routed to a routing destination, if a member sends an instruction to cancel that order, the cancellation is held by the Exchange until a response is received from the routing destination. For instance, if the routing destination executes that order, the execution would be passed on to the member and the cancellation instruction would be disregarded.



routed orders. Once the decision is made to cancel those routed orders, any cancellation that a member submitted to the Exchange on its initial order during such a situation would be honored.<sup>26</sup>

**Example 2.** If the Exchange experiences a systems issue, the Exchange may take steps to cancel all outstanding orders affected by that issue and notify affected members of the cancellations. In those cases, the Exchange would seek to cancel any routed orders related to the members' initial orders.

### **Examples of Circumstances That May Lead to Error Positions**

In some instances, the technical or systems issue at NES, a routing destination, the Exchange, or a non-affiliate third party Routing Broker may also result in NES acquiring an error position that it must resolve. The examples set forth below describe some of the circumstances in which error positions may arise.

**Example A.** Error positions may result from routed orders that the Exchange or NES attempts to cancel but that are executed before the routing destination receives the cancellation message or that are executed because the routing destination is unable to process the cancellation message. Using the situation described in Example 1 above, assume that the Exchange seeks to cancel orders routed to a routing destination because it is not receiving timely execution or cancellation reports from the routing destination. In such a situation, NES may still receive executions from the routing destination after connectivity is restored, which it would not then allocate to members because of the earlier decision to cancel the affected routed orders. Instead,

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<sup>26</sup> If a member did not submit a cancellation to the Exchange, however, that initial order would remain “live” and thus be eligible for execution or posting on the Exchange, and neither the Exchange nor NES would treat any execution of that initial order or any subsequent routed order related to that initial order as an error.

NES would post those positions into its error account and resolve the positions in the manner described below.

**Example B.** Error positions may result from an order processing issue at a routing destination. For instance, if a routing destination experienced a systems problem that affects its order processing, it may transmit back a message purporting to cancel a routed order, but then subsequently submit an execution of that same order (i.e., a locked-in trade) to OCC for clearance and settlement. In such a situation, the Exchange would not then allocate the execution to the member because of the earlier cancellation message from the routing destination. Instead, NES would post those positions into its error account and resolve the positions in the manner described below.

**Example C.** Error positions may result if NES receives an execution report from a routing destination but does not receive clearing instructions for the execution from the routing destination. For instance, assume that a member sends the Exchange an order to buy 100 contracts overlying ABC stock, which causes NES to send an order to a routing destination that is subsequently executed, cleared, and closed out by that routing destination, and the execution is ultimately communicated back to that member. On the next trading day (T+1), if the routing destination does not provide clearing instructions for that execution, NES would still be responsible for settling that member's purchase, but would be left with a short position in its error account.<sup>27</sup> NES would resolve the position in the manner described below.

**Example D.** Error positions may result from a technical or systems issue that causes orders to be executed in the name of NES that are not related to NES's function as the Exchange's routing broker and are not related to any corresponding orders of members. As a

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<sup>27</sup> To the extent that NES incurred a loss in covering its short position, it would submit a reimbursement claim to that routing destination.

result, NES would not be able to assign any positions resulting from such an issue to members. Instead, NES would post those positions into its error account and resolve the positions in the manner described below.

**Example E.** Error positions may result from a technical or systems issue through which the Exchange does not receive sufficient notice that a member that has executed trades on the Exchange has lost the ability to clear trades through OCC. In such a situation, the Exchange would not have valid clearing information, which would prevent the trade from being automatically processed for clearance and settlement on a locked-in basis. Accordingly, NES would assume that member's side of the trades so that the counterparties can settle the trades. NES would post those positions into its error account and resolve the positions in the manner described below.

**Example F.** Error positions may result from a technical or systems issue at the Exchange that does not involve routing of orders through NES. For example, a situation may arise in which a posted quote/order was validly cancelled but the system erroneously matched that quote/order with an order that was seeking to access it. In such a situation, NES would have to assume the side of the trade opposite the order seeking to access the cancelled quote/order. NES would post the position in its error account and resolve the position in the manner described below.

In the circumstances described above, neither the Exchange nor NES may learn about an error position until T+1, either: (1) during the clearing process when a routing destination has submitted to OCC a transaction for clearance and settlement for which NES never received an execution confirmation; or (2) when a routing destination does not recognize a transaction submitted to OCC for clearance and settlement. Moreover, the affected members' trade may not

be nullified absent express authority under Exchange rules.<sup>28</sup> As noted, the Exchange or NES would be expressly authorized to cancel orders as may be necessary to maintain fair and orderly markets if a technical or systems issue occurred at the Exchange, NES, or a routing destination.<sup>29</sup> The Exchange or NES would be required to provide notice of the cancellation to affected members as soon as practicable.

NES would be required to maintain an error account for the purpose of addressing positions that result from a technical or systems issue at NES, the Exchange, a routing destination, or a non-affiliate third-party Routing Broker that affects one or more orders (“error positions”). For purposes of this Rule 1904 an error position shall not include any position that results from an order submitted by a Member to the Exchange that is executed on the Exchange and automatically processed for clearance and settlement on a locked-in basis. Except as provided in Rule 1904(b)(3), NES shall not (i) accept any positions in its error account from an account of a Member, or (ii) permit any Member to transfer any positions from the Member's account to NES' error account.<sup>30</sup> If a technical or systems issue results in the Exchange not

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<sup>28</sup> See, e.g., ISE Rule 720.

<sup>29</sup> Such a situation may not cause the Exchange to declare self-help against the routing destination pursuant to Rule 1901(b)(1)(i). If the Exchange or NES determines to cancel orders routed to a routing destination under proposed Rule 1904, but does not declare self-help against that routing destination, the Exchange would continue to be subject to the trade-through requirements in the Options Order Protection and Locked/Crossed Markets Plan and Rule 1901 with respect to that routing destination.

<sup>30</sup> The purpose of this provision is to clarify that NES may address error positions under the proposed rule that are caused by a technical or systems issue, but that NES may not accept from a member positions that are delivered to the member through the clearance and settlement process, even if those positions may have been related to a technical or systems issue at NES, the Exchange, a routing destination of NES, or a non-affiliate third-party Routing Broker. This provision would not apply, however, to situations like the one described in Example C in which NES incurred a short position to settle a member's purchase, as the member did not yet have a position in its account as a result of the purchase at the time of NES's action (i.e., NES's action was necessary for the purchase to settle into the member's account). Similarly, the provision would not apply

having valid clearing instructions for a Member to a trade, NES may assume that Member's side of the trade so that the trade can be automatically processed for clearance and settlement on a locked-in basis.<sup>31</sup>

In connection with a particular technical or systems issue, NES or the Exchange shall either (i) assign all resulting error positions to Members, or (ii) have all resulting error positions liquidated. Any determination to assign or liquidate error positions, as well as any resulting assignments, shall be made in a nondiscriminatory fashion. NES or the Exchange shall assign all error positions resulting from a particular technical or systems issue to the Members affected by that technical or systems issue if NES or the Exchange:

(i) determines that it has accurate and sufficient information (including valid clearing information) to assign the positions to all of the Members affected by that technical or systems issue;

(ii) determines that it has sufficient time pursuant to normal clearance and settlement deadlines to evaluate the information necessary to assign the positions to all of the Members affected by that technical or systems issue; and

(iii) has not determined to cancel all orders affected by that technical or systems issue in accordance with Rule 1904(a).<sup>32</sup>

For example, a technical or systems issue of limited scope or duration may occur at a routing destination, and the resulting trades may be submitted for clearance and settlement by

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to situations like the one described in Example F, where a system issue caused one member to receive an execution for which there was not an available contra-party, in which case action by NES would be necessary for the position to settle into that member's account.

<sup>31</sup> See proposed Rule 1904(b).

<sup>32</sup> See proposed Rule 1904(c).

such routing destination to OCC. If there were a small number of trades, there may be sufficient time to match positions with member orders and avoid using the error account.

If NES or the Exchange is unable to assign all error positions resulting from a particular technical or systems issue to all of the affected Members, or if NES or the Exchange determines to cancel all orders affected by the technical or systems issue in accordance with Rule 1904(a), then NES shall liquidate the error positions as soon as practicable. NES shall: (i) provide complete time and price discretion for the trading to liquidate the error positions to a third-party broker-dealer and shall not attempt to exercise any influence or control over the timing or methods of such trading;<sup>33</sup> and (ii) establish and enforce policies and procedures that are reasonably designed to restrict the flow of confidential and proprietary information between the third-party broker-dealer and NES/the Exchange associated with the liquidation of the error positions.<sup>34</sup>

For example, in some cases, the volume of questionable executions and positions resulting from a technical or systems issue might be such that the research necessary to determine which members to assign those executions to could be expected to extend past the normal settlement cycle for such executions. Furthermore, if a routing destination experiences a technical or systems issue after NES has transmitted IOC orders to it that prevents NES from receiving responses to those orders, NES or the Exchange may determine to cancel all routed

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<sup>33</sup> This provision is not intended to preclude NES from providing the third-party broker with standing instructions with respect to the manner in which it should handle all error account transactions. For example, NES might instruct the broker to treat all orders as “not held” and to attempt to minimize any market impact on the price of the stock being traded.

<sup>34</sup> See proposed Rule 1904(c)(B).

orders affected by that issue. In such a situation, NES or the Exchange would not pass on to the members any executions on the routed orders received from the routing destination.<sup>35</sup>

NES and the Exchange would be required to make and keep records to document all determinations to treat positions as error positions and all determinations for the assignment of error positions to Members or the liquidation of error positions, as well as records associated with the liquidation of error positions through the third-party broker-dealer.<sup>36</sup>

### Implementation

The Exchange intends to begin implementation of the proposed rule changes in Q2 2017 in tandem with a technology migration to Nasdaq INET architecture. The migration will be on a symbol by symbol basis, and the Exchange will issue an alert to members to provide notification of the symbols that will migrate and the relevant dates.

The Exchange notes that with respect to the Rules in Chapter 19, Rules 1901, 1903, 1904 and 1905, these rules impact not only the ISE market but also ISE Gemini and ISE Mercury because Chapter 19 is incorporated by reference into those rulebooks. As noted above, ISE Gemini and ISE Mercury have filed to propose that NES may be an affiliated Member of those exchanges to similarly perform the specified functions pursuant to the specified conditions. ISE rule changes, if approved, will be implemented in Q2 2017 on a symbol by symbol basis, as noted above. ISE Gemini rule changes, if approved, will be implemented in Q1 2017 on a symbol by symbol basis. ISE Mercury rule changes, if approved, will be implemented in Q3 2017 on a symbol by symbol basis.

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<sup>35</sup> If NES determines in connection with a particular technical or systems issue that some error positions can be assigned to some affected members but other error positions cannot be assigned, NES would be required under the proposed rule to liquidate all such error positions (including those positions that could be assigned to the affected members).

<sup>36</sup> See proposed Rule 1904(d).

The Exchange will add notations in the rulebook to cross reference the amended rule text and make clear the implementation date in each rulebook.

## 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act,<sup>37</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>38</sup> in particular, in that it is designed 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, because the proposed rule change will allow the Exchange to receive inbound orders from each Affiliated Entity through NES, acting in its capacity as a facility of the respective Affiliated Entity, in a manner consistent with prior approvals and established protections. The Exchange believes that these conditions establish mechanisms that protect the independence of the Exchange's regulatory responsibility with respect to NES, as well as ensure that NES cannot use any information it may have because of its affiliation with the Exchange to its advantage.

Further, the Exchange notes that its proposal is designed 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 because ISE will have set up mechanisms that protect the independence of ISE's regulatory responsibilities, with respect to NES, as well as demonstrate that NES cannot use any information advantage it may have because of its affiliation with ISE. The Exchange will not be granting any preferential access to information from the Exchange's Order Book to NES. As an affiliated routing broker, NES would not be treated differently than any other unaffiliated routing broker.

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<sup>37</sup> 15 U.S.C. 78f(b).

<sup>38</sup> 15 U.S.C. 78f(b)(5).



The proposal should remove impediments to and perfect the mechanism of a free and open market and a national market system by providing customer order protection and by facilitating trading at away exchanges so customer orders trade at the best market price. The proposal should also protect investors and the public interest by fostering compliance with the Options Order Protection and Locked/Crossed Market Plan. In addition, the Exchange believes that the proposal is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, because of the specific protections pertaining to the routing broker, in light of the potential conflict of interest where the member routing broker could have access to information regarding other members' orders or the routing of those orders. These protections include the Exchange's control over all routing logic as well as the confidentiality of routing information.<sup>39</sup>

The Exchange believes that its proposal related to the cancellation of orders and error account is consistent with the Act because NES's or the Exchange's ability to cancel orders during a technical or systems issue and to maintain an error account facilitates the smooth and efficient operations of the market. Specifically, the Exchange believes that allowing NES or the Exchange to cancel orders during a technical or systems issue would allow the Exchange to maintain fair and orderly markets. Moreover, the Exchange believes that allowing NES to assume error positions in an error account and to liquidate those positions, subject to the conditions set forth in the proposed amendments to Rule 1904 would be the least disruptive means to correct these errors, except in cases where NES can assign all such error positions to all affected members of the Exchange. Overall, the proposed amendments are designed to ensure full trade certainty for market participants and to avoid disrupting the clearance and settlement

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<sup>39</sup> See proposed Rule 1903(e).

process. The proposed amendments are also designed to provide a consistent methodology for handling error positions in a manner that does not discriminate among members. The proposed amendments are also consistent with Section 6 of the Act insofar as they would require NES to establish controls to restrict the flow of any confidential information between the third-party broker and NES/the Exchange associated with the liquidation of error positions.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Receiving orders through NES does not raise any issues of intra-market competition because it involves inbound routing from an affiliated exchange. This proposal provides that Nasdaq, which owns NES and the Exchange, shall establish and maintain procedures and internal controls reasonably designed to ensure that NES does not develop or implement changes to its system on the basis of non-public information regarding planned changes to the Exchange's systems, obtained as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members and member organizations in connection with the provision of inbound routing to the Exchange. Utilizing NES as the routing broker does not create any undue burden on inter-market competition because NES cannot use any information advantage it may have because of its affiliation with ISE. The Exchange will not be granting any preferential access to information from the Exchange's Order Book to NES. As an affiliated routing broker, NES would not be treated differently than any other unaffiliated routing broker.

The proposal does not result in a burden on competition among exchanges, because there are many competing options exchanges that provide routing services, including through an affiliate. Further, the proposal does not raise issues of intra-market competition, because the

Exchange's decision to route through a particular routing broker would impact all participants equally.

With respect to the proposal to establish error accounts, the Exchange's proposal does not result in a burden on competition among exchanges because NES' or the Exchange's ability to cancel orders during a technical or systems issue and to maintain an error account facilitates the smooth and efficient operations of the market for all impacted members. The proposals regarding assumption of error positions and [sic] to liquidation of those positions ensures certainty for all impacted market participants. The proposal does not discriminate among Members.

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

No written comments were either solicited or received.

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

Within 45 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 shall: (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, as modified by Amendment No. 1, 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](mailto:rule-comments@sec.gov). Please include File Number SR-ISE-2016-27 on the subject line.

Paper comments:

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-ISE-2016-27. 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 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 available publicly. All submissions should refer to File Number SR-ISE-2016-27, 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.<sup>40</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>40</sup> 17 CFR 200.30-3(a)(12).