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SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-70132; File No. SR-ISE-2013-38)

August 7, 2013

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

I. Introduction

On June 5, 2013, the International Securities Exchange, LLC (the "Exchange" or the "ISE") filed with the Securities and Exchange Commission (the "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change related to market maker risk parameters and complex orders. The proposed rule change was published for comment in the Federal Register on June 24, 2013.[3] The Commission received no comments on the proposal. This order approves the proposed rule change.

II. Description of the Proposal

The Exchange proposes to amend ISE Rule 722 and ISE Rule 804 to make it mandatory for market makers to enter values into all four of the quotation risk management parameters for all options classes in which they enter quotes. These risk management 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 may 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

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 69782 (June 18, 2013), 78 FR 37870 (June 24, 2013) (SR-ISE-2013-38) (the "Notice").

has been executed; (3) the absolute value of the net between contracts bought and contracts sold in an options class, and (4) 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.

The Exchange notes that all ISE market makers currently use the risk management parameters when entering quotes but may inadvertently enter quotes without populating one or more of the parameters, and thereby be exposed to more financial risk than intended. The Exchange indicates that, in order to forestall such an occurrence, ISE market makers requested that the trading system be modified to reject a quote if a value for any of the four risk management parameters for the options class is missing. While entering values into the quotation risk parameters would be mandatory to prevent an inadvertent exposure to financial risk, the Exchange notes that market makers that prefer to use their own risk-management systems could simply enter values that assure the Exchange-provided parameters will not be triggered.[4] Accordingly, the proposal requires that the fields for the quotation risk management parameters be populated, but does not require that members substantively or qualitatively manage their risk using the Exchange-provided tools.

The Exchange also proposes to amend ISE Rule 722 to limit a market maker's financial risk exposure as it relates to the calculation of the aforementioned ISE Rule 804 risk parameters and complex orders legging-into the regular market.[5] Specifically, the Exchange proposes to

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[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

limit the legging functionality to complex orders with no more than either two or three legs, as determined by the Exchange on a class basis.[6] In the Notice, the Exchange explains that because the execution of each leg of a complex order is contingent on the execution of the other legs and the execution of all the legs in the regular market is processed as a single transaction, not as a series of individual transactions, the legging-in of complex orders presents higher risk to market makers compared to regular orders being entered in multiple series of an options class in the regular market and may cause market makers to exceed the established risk parameters by a greater number of contracts. The Exchange also notes that because the potential to exceed the intended risk parameters 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 believes that because 85% of all complex orders have only two legs, and very few complex orders are entered with more than three legs, the potential risk to market makers in the regular market far out-weighs the potential benefit of offering such functionality to a very limited number of orders.

The Exchange also notes that 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 states that the execution priority rules contained in ISE Rule 722(b)(2) often prevent the execution of complex orders that might otherwise be executable because legs of a complex order cannot be executed at the same

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complex order can be executed while maintaining a permissible ratio by such bids and offers.

[6] The Exchange states that it 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 also states that it will provide members with reasonable notice prior to changing the limit applicable to an options class.

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 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. The Exchange believes that preventing orders with more than three legs (in some cases more than two legs) from legging-into the market would not create any unusual circumstances on the complex order book. The Exchange also notes that the priority of complex orders on the complex order book will not be impacted by the proposed rule change.[8]

In the Notice, the Exchange states that checking the risk management parameters following each execution in an options series allows market makers to provide liquidity across multiple series of an options class while mitigating the risk of executing the full cumulative size of all such quotes; however this is not the case when a complex order legs-into the market.

III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national

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[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)).

securities exchange.[9] In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,[10] which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers or dealers.

The Commission believes the proposal is designed to provide market makers with a risk management tool to assist managing the financial exposure of market makers which in turn could enhance the integrity of trading on the securities markets and help to assure the stability of the financial system. The Commission believes that greater assurances related to the management of financial risk exposure could enable market makers to enter quotations with larger size, which in turn could benefit investors through increased liquidity for the execution of their orders, and that such increased liquidity could benefits investors by improving prices and lowering volatility in the options market.

As discussed above, the proposed rule change is designed to protect market makers from exposure to inadvertent, excessive risk by modifying the trading system to automatically reject quotations unless values are entered for all four risk management parameters for all options classes in which quotes are entered. ISE asserts that all market makers currently utilize the Exchange provided risk management tool; and the catalyst for the instant proposal was a request from market makers that the entry of values into all four risk management parameters be made

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[9] In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

[10] 15 U.S.C. 78f(b)(5).

mandatory to avoid inadvertent error that could result in unintended financial exposure during quote entry. In addition, while market makers must populate the all risk management parameters in order to have their quotations accepted by the trading system, they may enter values in the parameters which effectively permit them to bypass the Exchange provided risk management tool in favor of a different, preferred risk management solution.

In addition, the proposed rule change is designed to mitigate the financial risk associated with complex orders that leg-into the regular market. Specifically, the proposed rule change would limit the legging functionality to complex order with no more than two or three legs, as determined by the Exchange on a class basis. The Exchange represents that it will provide reasonable prior notice via a circular to members that identifies the applicable 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 notes that 85% of all complex orders only have two orders and very few complex orders have more than three legs, thus the vast majority of complex orders would be unaffected by this limitation. The Exchange also opined that market maker liquidity in the regular market may be limited as a result of the potential risk of offering legging functionality for complex orders with more than three legs (in some cases with more than two legs). In particular, the Exchange notes that market makers may reduce the size of their quotations in the regular market because of the risk of executing the cumulative size of their quotations across multiple options series without an opportunity to adjust their quotes. Thus, the Exchange posits that limiting the legging functionality to orders with no more than three legs (in some cases with no more than two legs) could encourage market makers to add liquidity to the regular market which would in turn benefit investors.

Accordingly, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act.[11]

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[12] that the proposed rule change (SR-ISE-2013-38) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[13]

Kevin M. O'Neill
Deputy Secretary

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[11] 15 U.S.C. 78f(b)(5)

[12] 15 U.S.C. 78s(b)(2).

[13] 17 CFR 200.30-3(a)(12).