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Invested in America

July 8, 2014

By Electronic Mail (rule-comments@sec.gov)
Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: ISE Request for Comment on SEC File No. SR-ISE-2014-10

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the above-referenced filing, which is a proposed rule change filed by the International Securities Exchange, LLC ("ISE") with the Securities and Exchange Commission ("Commission")[2]. ISE has filed a proposed rule change to "amend ISE Rule 722, to prohibit certain types of complex orders from legging into the regular market (i.e. executing against individual quotes for each of the legs of the complex orders in the regular market). Specifically, ISE proposes that complex orders with two option legs where both legs are buying or both legs are selling and both legs are calls or both legs are puts will only trade against other complex orders in the complex order book and will not be permitted to leg into the regular market. ISE also proposes that complex orders with three option legs where all legs are buying or all legs are selling and both legs are calls or both legs are puts will only trade against other complex orders in the complex order book and will not be permitted to leg into the regular market. ISE describes these types of two and three leg complex order strategies as 'atypical' complex order strategies in that they are geared toward an aggressive directional capture of volatility."[3] For the reasons outlined below, SIFMA strongly agrees with ISE's proposal to amend ISE Rule 722 since it eliminates a loop hole that allows market maker quotes to trade beyond their risk mitigation settings in the regular market.

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[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] See Securities Exchange Act Release No. 34-71669 (March 14, 2014), 79 FR 14563 (March 14, 2014).

[3] See Securities Exchange Act Release No. 34-72359 (June 16, 2014), 79 FR 34387 (June 16, 2014).

ISE Rules 722 and 804 govern the functionality which ISE offers that automatically removes a market maker's quotes in all series of an options class when certain parameter settings are triggered. The Exchange offers four parameters that are mandatory for market maker quotes which are based on a time frame during which the system calculates various metrics to limit the number of executions which can occur against a market maker. Once the limits of the parameters are triggered, the market makers quotes are removed. The purpose of this functionality is to allow market makers to provide liquidity across potentially hundreds of option series without being at risk of executing the full cumulative size of all such quotes before being given adequate opportunity to adjust their quotes.[4]

The risk protections provided to market makers pursuant to Rules 722 and 804, check the risk parameters following each execution in an options series, allowing market makers to manage their risk. Standard complex orders can contain up to eight (8) legs in the trading system on ISE, while complex orders with a stock component can contain up to eight (8) option legs and a stock leg. However, when a complex order legs into the regular 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. Thus, market maker's quotes in the regular market can be hit up to 8 instruments at a time by a complex order.[5]

ISE articulates in their filing that "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 can result in market makers exceeding their parameters by a greater number of contracts."[6] To manage risk in the complex order book, ISE limits the legging functionality to complex orders with no more than either two or three legs, as determined by the Exchange, on a class by class basis. However, despite the current limitations, market participants can continue to use "atypical multi-leg strategies (2 or more legs) to trade with multiple quotes from a single market maker thereby causing the single leg market maker to trade far more than its limit allows. Although the market maker can use the Exchange's risk parameters, the market maker's quotes are not removed until after a trade is executed. As a result, because of the way complex orders leg into the regular market as a single transaction, market makers end up trading more than the limitations they have set and are therefore exposed to greater risk. In turn, market makers are forced to change their trading behavior to account for the additional risk by widening their quotes, hurting the Exchange's quality of markets and the quality of markets in general available for trading."[7]

SIFMA's Listed Options Trading Committee supports ISE's effort to further minimize the impact to single leg market makers by amending Rule 722 to limit a potential source of unintended market maker risk when certain types of complex orders leg into the regular market. To substantiate our position, SIFMA addresses below a series of questions posed

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[4] *See* 79 FR at 14564.

[5] *Id.*

[6] *Id.*

[7] *Id.*

by the SEC on June 10, 2014, when the Commission issued an order to institute proceedings under Section 19(b)(2)(B)[8] of the Act to determine whether to approve or disapprove the proposal.[9]

Questions and Answers:

1. What are commenters' views on ISE's proposal to limit directional complex orders from legging into the regular market?

SIFMA is in favor of ISE's proposal. Committee members are in agreement that the proposal will no longer allow Market Maker quotes to trade beyond their Risk Mitigation settings.

a. What are commenters' views on ISE's proposal to prevent legging orders from being generated on behalf of directional complex orders? Please explain.

SIFMA is in favor of ISE's proposal to prevent legging orders from being generated on behalf of directional complex orders.

b. What are commenters' views on ISE's proposal to cancel an auction at the end of the auction's exposure period if an improved net price can be achieved from bids and offers for the individual legs of a directional complex during an auction? Please explain.

SIFMA is in favor of ISE's proposal.

2. Do commenters' agree with ISE's assertion that complex orders with two options legs where both legs are buying or both legs are selling and both legs are calls or both legs are puts and complex orders with three options legs where all legs are buying or all are selling, regardless of whether the options are calls or puts, are not traditional complex order strategies used by retail or professional investors? Why or why not?

SIFMA agrees that since complex orders, and specifically, complex order books, became available, professional volatility traders began utilizing them to circumvent market maker risk mitigation parameters. One firm shared that "over the last year, 95% of these directional complex orders that have legged in against our quotes on ISE originated from the market-making desk of one firm. Of the remaining 5%, 2% were from that firm's proprietary/away market maker and 2.5% were from one floor broker. This means that two firms were responsible for 99.5% of these order types. During the same time frame, in the complex order flow that we have received from institutional and retail customers, 0% (zero) directional complex orders came from institutional customers and 0.1% from retail."

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[8] 15 U.S.C. 78s(b)(2)(B).

[9] *See* 79 FR at 34387.

Do commenters' agree with ISE's assertion that such complex orders are primarily geared towards an aggressive directional capture of volatility? Why or why not?

Yes, SIFMA is in agreement that such directional complex orders are primarily geared towards aggressive capture of different types of risk, not only volatility but also delta.

3. According to the Exchange, to account for the additional risk presented by the execution of directional complex orders, market makers in the regular market may change their trading behavior by widening quotes. Do commenters' agree with ISE's assertion that market makers in the regular market would alter their trading behavior by widening their quotes to account for the risk presented by the execution of directional complex orders? Why or why not? Are market makers currently altering their trading behavior in such a manner? Please explain, and, to the extent possible, provide supporting data.

Market-makers adjust the width of their quotes and the displayed sizes for a multitude of factors. The additional risk presented by these directional complex orders is responsible for a detrimental effect on market quality since it is forcing market-makers to widen their quotes and lower their quoted sizes on the ISE.

4. Do commenters' agree with ISE's assertion that market makers in the regular market would reduce the size of their quotations across multiple options series in the regular market because they are at risk of executing the cumulative size of their quotations without an opportunity to adjust their quotes? Please explain, and, to the extent possible, provide supporting data.

SIFMA is in agreement that liquidity has suffered as a result of these aggressive order types. A firm commented that "if our risk protections are being bypassed, the inevitable result is that we'll have to lower our exposure in the only other way possible, which is to reduce the sizes of our quotes.

5. Do commenters' agree with ISE's assertion that the execution of directional complex orders could result in artificially large transactions that distort the market for other related instruments, including the underlying security or related options series? Why or why not? Please explain, and, to the extent possible, provide supporting data.

SIFMA agrees that executions of artificially large transactions may force market-makers to hedge their positions more urgently than for regular transactions, which causes a larger, temporary, market impact in the underlying securities than normal hedging activity.

6. According to the Exchange, the proposed rule change is designed to limit a market maker's risk against executions of directional complex orders. Please provide data, if available, showing how the execution of such complex orders against market maker quotes in the regular market affects a market maker's risk exposure.

7. Do commenters' agree with ISE's assertion that the number of directional complex orders is small relative to the total number of complex orders executed on ISE on a given day? Why or why not? Please explain, and, to the extent possible, provide supporting data.

SIFMA is in agreement with this statement. These trades occur infrequently relative to total complex orders, but the risk and impact on liquidity is substantial. Statistically, one market participant shared that less than 0.1% of complex orders received from retail customers are directional complex orders.

8. Do commenters' agree with ISE's assertion that the potential risk to market makers in the regular market of allowing directional complex orders to leg into the regular market outweighs the potential benefits of continuing to allow directional complex orders to interact with the regular market? Why or why not? Please explain, and, to the extent possible, provide supporting data.

SIFMA agrees with the ISE's assertions and would like to reference the risks to market maker described in earlier questions. A firm shared that based on their data; one firm is responsible for 97%, and two firms for 99.5%, of all directional complex orders. This implies that the only "risk" is to those firms.

9. Do commenters' agree with ISE's assertion that the proposed rule change would encourage market makers to provide tighter and more liquid markets on the Exchange? Why or why not? Please explain, and, to the extent possible, provide supporting data.

ISE's proposed rule change would remove a significant barrier to market-makers providing tighter and more liquid markets. Per our answer to Question 3, there are many factors that drive liquidity, and the proposed rule would encourage market makers to provide better markets on the Exchange.

10. Do commenters' believe that any potential benefits to investors resulting from ISE's proposal would exceed any benefits of continuing to allow directional complex orders to interact with the regular market? Why or why not? Please explain, and, to the extent possible, provide supporting data.

SIFMA is in agreement that the potential benefits from ISE's proposal will far outweigh the benefits of continuing to allow directional complex orders to interact with quotes. Directional complex orders are not typically used by the general public and almost exclusively, are used by a single counterparty. Since these complex strategies pose significant risk to market-makers, the discontinuation of this order type would benefit the general public through tighter markets and larger quoted sizes, and would also reduce the impact on the primary market due to the need to urgently hedge large risk in the underlying market.

In addition to harming market makers, and in turn liquidity, retail investors' limit orders may also be adversely impacted by these aggressive order types, since these trades can result in large price swings which may result in stop orders being triggered.

For the reasons set forth above, SIFMA strongly agrees with ISE's request to modify Rule 722, in order to further minimize the impact to single leg market makers to limit a potential source of unintended market maker risk when certain types of complex orders leg into the regular market. As a result, SIFMA believes it is appropriate that the Commission approve SR-ISE 2014-10.

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SIFMA greatly appreciates the SEC's consideration of SIFMA's comments in reference to the above. If you have any questions, please do not hesitate to contact me at (212) 313-1287 or egreene@sifma.org.

Respectively Submitted,

Ellen Greene

Ellen Greene
Vice President
Financial Services Operations

cc: Mary Jo White, Chairman
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