8011-01p
SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-70787; File No. SR-ISE-2013-42]

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1, to List Options on the Nations VolDex Index

October 31, 2013.

I. Introduction

On July 17, 2013, the International Securities Exchange, LLC ("Exchange" or "ISE") filed with the Securities and Exchange Commission ("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 to list options on the Nations VolDex Index ("Index"). The proposed rule change was published for comment in the Federal Register on August 2, 2013.[3] The Commission received one comment letter on the proposed rule change.[4] On September 10, 2013, the Commission extended the time period for Commission action to October 31, 2013.[5] On October 29, 2013, ISE submitted a response to the comment letter.[6] On October 30, 2013, ISE submitted Amendment No. 1 to the proposed rule change. This order institutes proceedings

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 70059 (July 29, 2013), 78 FR 47041 ("Notice").

4 See letter to Elizabeth M. Murphy, Secretary, Commission, from Edward T. Tilly, Chief Executive Officer, Chicago Board Options Exchange, Incorporated ("CBOE"), dated August 23, 2013 ("CBOE Letter").

5 See Securities Exchange Act Release No. 70362, 78 FR 56955 (September 16, 2013).

6 See letter to Elizabeth M. Murphy, Secretary, Commission, from Michael J. Simon, Secretary and General Counsel, ISE, dated October 29, 2013 ("ISE Letter").

under Section 19(b)(2)(B) of the Act[7] to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposal

The Exchange proposes to list and trade cash-settled, European-style options on the Index, which measures changes in implied volatility of the SPDR S&P 500 Exchange-Traded Fund ("SPY").[8]

The Index is calculated using a methodology developed by NationsShares, which uses published real-time bid/ask quotes of SPY options.[9] The Index will be calculated and maintained by a calculation agent acting on behalf of NationsShares. The Index will be updated on a real-time basis on each trading day beginning at 9:30 a.m. and ending at 4:15 p.m. (New York time).[10] Values of the Index also will be disseminated every 15 seconds during the Exchange's regular trading hours to market information vendors such as Bloomberg and Thomson Reuters. In the event the Index ceases to be maintained or calculated, or its values are not disseminated every 15 seconds by a widely available source, the Exchange will not list any additional series

7 15 U.S.C. 78s(b)(2)(B).

8 According to the Exchange, SPY is historically the largest and most actively-traded exchange-traded fund in the United States as measured by its assets under management and the value of shares traded. Specifically, the Exchange states that, according to State Street Global Advisor, the Trustee of SPY, as of June 20, 2013, the net assets under management in SPY was approximately $106.8 billion; the weighted average market capitalization of the portfolio components was approximately $106 billion; the smallest market capitalization was approximately $2.1 billion (Apollo Group Inc., ticker: APOL), and the largest was approximately $395.9 billion (ExxonMobil, ticker: XOM). Further, according to the Exchange, for the three months ending on June 20, 2013, the average daily volume in SPY shares was 137 million, and the average value of shares traded was $22.1 billion. According to the Exchange, for the same period, the average daily volume in SPY options was approximately 2.8 million contracts and open interest in SPY options was approximately 25.2 million contracts. See Notice, supra note 3, at 47042.

9 See id. (describing in more detail the calculation methodology for the Index).

10 If the current published value of a component is not available, the last published value will be used in the calculation.

for trading and will limit all transactions in such options to closing transactions only for the purpose of maintaining a fair and orderly market and protecting investors.

The Exchange proposes that the standard trading hours for index options (9:30 a.m. to 4:15 p.m., New York time) will apply to options on the Index. Options on the Index will expire on the Wednesday that is thirty days prior to the third Friday of the calendar month immediately following the expiration month. Trading in expiring options on the Index will normally cease at 4:15 p.m. (New York time) on the Tuesday preceding an expiration Wednesday. The exercise and settlement value will be calculated on Wednesday at 9:30 a.m. (New York time) using the mid-point of the NBBO for the SPY options used in the calculation of the Index at that time. The exercise-settlement amount is equal to the difference between the settlement value and the exercise price of the option, multiplied by $100. Exercise will result in the delivery of cash on the business day following expiration.

In Amendment No. 1, the Exchange expresses its view that manipulation of the Index would be very difficult, particularly around the time when the settlement value is determined. According to the Exchange, the Index options will be settled using a calculation based on the mid-point NBBO of the input components, a methodology unlike how other index settlement values are determined, as most of those are calculated based on transaction prices of the individual index components. The Exchange believes that manipulating the Index settlement value will be difficult based on the dynamics of a quote-based calculation methodology as opposed to a single transaction price and because the option prices themselves would make such an endeavor cost prohibitive. Further, according to the Exchange, the vast liquidity of SPY options as well as the underlying SPY shares ensures a multitude of market participants at any given time – at least 19 market makers actively traded SPY options on ISE during September

2013 on any given day, and there are now 12 options exchanges that list SPY options. Due to the high level of participation among market makers that can enter quotes in SPY options series, the Exchange believes it would be very difficult for a single participant to alter the NBBO width across multiple series in any significant way without exposing the would-be manipulator to regulatory scrutiny and financial costs.

The Exchange proposes to adopt minimum trading increments for options on the Index to be $0.05 for series trading below $3, and $0.10 for series trading at or above $3. The Exchange also proposes to set the minimum strike price interval for options on the Index at $1 or greater when the strike price is $200 or less, and $5 or greater when the strike price is greater than $200. Currently, when new series of index options with a new expiration date are opened for trading, or when additional series of index options in an existing expiration date are opened for trading as the current value of the underlying index moves substantially from the exercise prices of series already opened, the exercise prices of such new or additional series must be reasonably related to the current value of the underlying index at the time such series are first opened for trading.[11] The Exchange, however, proposes to eliminate this range limitation that would otherwise limit the number of $1 strikes that may be listed in options on the Index. The Exchange's proposal to eliminate this range limitation is identical to strike price intervals adopted by CBOE for the CBOE Volatility Index ("VIX").[12]

The Exchange proposes to list options on the Index in the three consecutive near-term

---

11 See ISE Rule 2009(c)(3). The term "reasonably related to the current index value of the underlying index" means that the exercise price is within thirty percent of the current index value. See ISE Rule 2009(c)(4).

12 See Securities Exchange Act Release No. 63155 (October 21, 2010), 75 FR 66402 (October 28, 2010) (SR-CBOE-2010-096).

expiration months plus up to three successive expiration months in the March cycle.[13] In addition, long-term option series having up to sixty months to expiration,[14] Short Term Option Series,[15] and Quarterly Options Series[16] may also be traded. Options on the Index will be quoted and traded in U.S. dollars.[17]

The Exchange believes that the Index is a broad-based index, as that term is defined in ISE Rule 2001(k).[18] The Exchange proposes that the Index should be treated as a broad-based index for purposes of position limits, exercise limits, and margin requirements. Accordingly, the Exchange proposes no position or exercise limits for options on the Index[19] and the Exchange proposes to apply margin requirements that are identical to those applied for its other broad-based index options.

In addition, the Exchange proposes that the trading of options on the Index will be subject to the same rules that currently govern the trading of Exchange index options, including sales practice rules and trading rules. Trading of options on the Index will also be subject to the

---

13 See ISE Rule 2009(a)(3).

14 See ISE Rule 2009(b)(1).

15 See ISE Rule 2009, Supplementary Material .01.

16 See ISE Rule 2009, Supplementary Material .02.

17 See ISE Rule 2009(a)(1).

18 ISE Rule 2001(k) defines the terms "market index" and "broad-based index" to mean an index designed to be representative of a stock market as a whole or of a range of companies in unrelated industries.

19 The Exchange believes that because the Index will settle using published quotes of SPY options and there are currently no position limits for SPY options, it is appropriate not to impose position or exercise limits for options on the Index. The Exchange notes that because the size of the market underlying SPY options is so large, it should dispel concerns regarding market manipulation. The Exchange believes that the same reasoning applies to options on the Index since the value of options on the Index is derived from the volatility of SPY, as implied by SPY options. The Exchange also notes that VIX options are not subject to any position or exercise limits. See Notice, supra note 3, at 47043.

trading halt procedures applicable to other index options traded on the Exchange.[20] Further, Chapter 6 of the Exchange's rules, which is designed to protect public customer trading, will apply to trading in options on the Index.[21] A trading license issued by the Exchange will also be required for all market makers to effect transactions as market makers in the Index options in accordance with ISE Rule 2013.

The Exchange represents that it has an adequate surveillance program in place for options on the Index and intends to apply those same program procedures that it applies to the Exchange's other options products. Further, in Amendment No. 1, the Exchange states that it will monitor for any potential manipulation of the Index settlement value both according to its current procedures and additional surveillance measures.[22] Additionally, the Exchange notes that

---

20 See ISE Rule 2008(c).

21 The Exchange notes that ISE Rules 608(a) and (b) prohibit Members from accepting a customer order to purchase or write an option, including options on the Index, unless such customer's account has been approved in writing by a designated Options Principal of the Member. In addition, ISE's Rule 610, regarding suitability, is designed to ensure that options, including options on the Index, are only sold to customers capable of evaluating and bearing the risks associated with trading in this instrument. Further, ISE Rule 611 permits members to exercise discretionary power with respect to trading options, including options on the Index, in a customer's account only if the Member has received prior written authorization from the customer and the account had been accepted in writing by a designated Options Principal. According to the Exchange, ISE Rule 611 also requires designated Options Principals or Representatives of a Member to approve and initial each discretionary order, including discretionary orders for options on the Index, on the day the discretionary order is entered. Finally, ISE Rule 609, Supervision of Accounts, Rule 612, Confirmation to Customers, and Rule 616, Delivery of Current Options Disclosure Documents and Prospectus, will also apply to trading in options on the Index. See Notice, supra note 3, at 47043-44.

22 The Exchange represents that it will review the opening ISE BBO ("IBBO") for the input options components to determine if the IBBO had an effect on the NBBO for these options series. If it did, the Exchange can determine which member entered the IBBO quote and review the member's position and quoting activity to determine if the quote may have been entered to impact the NBBO. The Exchange also represents that it will compare the Index settlement value to the subsequent disseminated value. If the difference between these two values is significant, the Exchange will review the opening quotes used in the calculation of the Index across all marketplaces to determine which

it is a member of the Intermarket Surveillance Group, through which it can coordinate surveillance and investigative information sharing in the stock and options markets with all of the U.S. registered stock and options markets. The Exchange also represents that it has the necessary system capacity to support additional quotations and messages that will result from the listing and trading of options on the Index.

III. Comment Letters

As noted above, the Commission received one comment letter regarding the proposed rule change.[23] In its comment letter, CBOE argues that the Index should not be treated as a broad-based security index for regulatory purposes.[24] Specifically, CBOE notes that the spot calculation of the Index would be comprised of a total of four component SPY put options and that the settlement value for the Index option would be calculated using the opening NBBO quotations of those component options.[25] CBOE states that the component weights of the four put options used to calculate the Index can become highly concentrated in just one or two component options, depending on the time to expiration and the relationship of the forward SPY price to the strike prices of the component options.[26] In this regard, CBOE questions the Exchange's proposal not to impose position limits for options on the Index.[27] In particular, CBOE asserts that, although the Commission has permitted some broad-based security index options to have no position limits, the same rationale should not apply to the proposed Index

---

exchange(s) contributed to opening NBBO quote(s) and contact the exchange(s) that entered the quote(s).

23 See CBOE Letter, supra note 4.

24 See id., at 1-2.

25 See id., at 1.

26 See id.

27 See id., at 2-3.

options because they are not options on a broad-based security index.[28] CBOE argues that the more analogous comparison for position limit treatment is the Alpha Index options that trade on NASDAQ OMX PHLX LLC ("Phlx").[29] According to CBOE, Alpha Index options are cash-settled index options that measure the relative performance of two securities (a target component and a benchmark component), and all approved Alpha Index pairs include SPY as the benchmark component.[30] CBOE notes that Alpha Index options where the target component is an exchange-traded fund have a position limit of 15,000 contracts, and Alpha Index options where the target component is a single stock have a position limit of 60,000 contracts.[31]

In its response letter, ISE draws an analogy between the Index and the VIX.[32] ISE argues that, as with the VIX, designating the Index as a broad-based index should not be based only on the number of components that the index contains, but rather, on the economic exposure that the underlying reference seeks to provide.[33] ISE states that, according to CBOE, the VIX is a key measure of the market expectations of near-term volatility conveyed by options on the S&P 500 Index.[34] ISE asserts that the Index provides a similar economic exposure as exposure to the VIX because it measures changes in implied volatility of SPY, which is a broad-based exchange-traded fund based on the price and yield of the stocks held in the SPY portfolio.[35] ISE therefore concludes that the Index should similarly be treated as broad-based by looking through to the

---

28 See id., at 2.

29 See id.

30 See id.

31 See id.

32 ISE notes that CBOE sought to designate the VIX as a broad-based index. See ISE Letter, supra note 6, at 1.

33 See id., at 2.

34 See id.

35 See id.

exposure provided by the underlying reference.[36]

In its response letter, ISE also argues that the proposed Index options are not analogous to Alpha Index options.[37] In particular, ISE points out that Phlx's Alpha Index options involve the pairing of a single equity security or an exchange-traded fund that has a position limit against the SPY that has no position limit.[38] ISE believes that, because the pairing includes one security that has position limits, it does not follow that the combined new index should have no position limits.[39] In contrast, ISE believes that its proposal to apply no position limits to the Index options is appropriate.[40] Further, as discussed above, in Amendment No. 1, the Exchange provides additional information regarding the potential for manipulation of the settlement value of the Index and the additional surveillance measures that the Exchange will undertake with respect to the Index options.

IV. Proceedings to Determine Whether to Approve or Disapprove SR-ISE-2013-42 and Grounds for Disapproval under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B)[41] of the Act to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the

---

36 See id.

37 See id.

38 See id.

39 See id.

40 See id., at 2-3. See also supra note 19. In its response letter, ISE also states that ISE members are bound by the initial and maintenance margin requirements of either CBOE or the New York Stock Exchange. See ISE Letter, supra note 6, at 3. ISE clarifies that although CBOE has margin rules designed for individual stock- or ETF-based volatility index options, its proposal intends to require compliance with CBOE's margin rules applicable to broad-based index options rather than its specialized rules adopted for specified individual stock- or ETF-based volatility index options. See id. See also text accompanying supra note 19.

41 15 U.S.C. 78s(b)(2)(B).

proposed rule change. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail below, the Commission seeks and encourages interested persons to provide additional comment on the proposed rule change to inform the Commission's analysis of whether to approve or disapprove the proposed rule change.

Pursuant to Section 19(b)(2)(B),[42] the Commission is providing notice of the grounds for disapproval under consideration. The section of the Act applicable to the proposed rule change that provides the grounds for the disapproval (or approval) under consideration is Section 6(b)(5),[43] which requires that the rules of an exchange be designed, among other things, 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.

As discussed above, the proposed rule change would allow ISE to list and trade cash-settled, European-style options on the Index, which measures changes in implied volatility of the SPY. As proposed, the Index options would be treated as broad-based index options for purposes of position limits, exercise limits, and margin. Accordingly, ISE proposes no position or exercise limits for the Index options. In addition, the exercise and settlement value will be calculated on expiration Wednesday at 9:30 a.m. using the mid-point of the NBBO for the SPY options that compose the Index, a methodology that ISE states is unlike how other index settlement values are determined, as most of those are calculated based on transaction prices of the individual index components.[44] In Amendment No. 1, ISE asserts that manipulation of the

---

42 15 U.S.C. 78s(b)(2)(B).

43 15 U.S.C. 78f(b)(5).

44 See Amendment No. 1.

Index would be very difficult, particularly around the time when the settlement value is determined.[45] The Exchange believes that manipulating the Index settlement value will be difficult based on the dynamics of a quote-based calculation methodology as opposed to a single transaction price and because the option prices themselves would make such an endeavor cost prohibitive. In addition, the Exchange contends that its surveillance procedures currently in place, coupled with the additional measures proposed in Amendment No. 1, would allow for adequate surveillance for any potential manipulation in the trading of the Index options.[46]

The Commission believes that questions remain as to whether the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act, including whether the proposed rules to allow the listing and trading of the Index options are designed to protect investors and the public interest and to prevent fraudulent and manipulative acts and practices. Thus, the Commission believes the issues raised by the proposed rule change can benefit from additional consideration and evaluation in light of the requirements of Section 6(b)(5) of the Act.

V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any others they may have identified with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change is consistent with Section 6(b)(5) or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval which would be facilitated by

---

45 See id.

46 See id.

an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.[47]

Interested persons are invited to submit written data, views, and arguments regarding whether the proposed rule change should be approved or disapproved by [INSERT DATE 21 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register].

The Commission is asking that commenters address the merit of ISE's statements in support of the proposal. Specifically, the Commission is requesting comment on the following:

- What are commenters' views regarding whether the terms of the proposal sufficiently mitigate concerns about potential manipulation and potential market disruption to support trading this product without position limits?
- What are commenters' views regarding the settlement methodology for the Index options and the additional information the Exchange has provided to support its contention that manipulation of the Index would be very difficult, particularly around the time when the settlement value is determined?

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

---

47 Section 19(b)(2) of the Act, as amended by the Securities Acts Amendments of 1975, Public Law 94-29, 89 Stat. 97 (1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-ISE-2013-42 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 20549-1090.

All submissions should refer to File Number SR-ISE-2013-42. 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 the 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-2013-42 and should be submitted on or before [INSERT DATE 21 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Rebuttal comments should be submitted by [INSERT DATE 35 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[48]

Kevin M. O'Neill,
Deputy Secretary.

[FR Doc. 2013-26552 Filed 11/05/2013 at 8:45 am; Publication Date: 11/06/2013]

48 17 CFR 200.30-3(a)(57).