



8011-01p
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71365; File No. SR-ISE-2013-42)

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Granting Approval of Proposed Rule Change, as Modified by Amendment No. 1, to List Options on the Nations VolDex Index

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. On October 31, 2013, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.⁷ The Commission subsequently received one

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 I”).

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”).

⁷ See Securities Exchange Act Release No. 70787, 78 FR 66798 (November 6, 2013).

additional comment letter on the proposed rule change.⁸ This order grants approval of the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposed Rule Change

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”).⁹

The Index is calculated using a methodology developed by NationsShares, which uses published real-time bid/ask quotes of SPY options.¹⁰ 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).¹¹ 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 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

⁸ See letter to Elizabeth M. Murphy, Secretary, Commission, from Edward T. Tilly, Chief Executive Officer, CBOE, dated November 27, 2013 (“CBOE Letter II”).

⁹ 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. See Notice, supra note 3, at 47042.

¹⁰ See id. (describing in more detail the calculation methodology for the Index).

¹¹ If the current published value of a component is not available, the last published value will be used in the calculation.

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 settlement value calculation for the Index, which is based on the mid-point NBBO of the input components, is a methodology unlike how other index settlement values are determined, as most 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. For example, ISE notes that 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.¹² 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").¹³

The Exchange proposes to list options on the Index in the three consecutive near-term expiration months plus up to three successive expiration months in the March cycle.¹⁴ In addition, long-term option series having up to sixty months to expiration,¹⁵ Short Term Option Series,¹⁶ and Quarterly Options Series¹⁷ may also be traded. Options on the Index will be quoted

¹² 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).

¹³ See Securities Exchange Act Release No. 63155 (October 21, 2010), 75 FR 66402 (October 28, 2010) (SR-CBOE-2010-096).

¹⁴ See ISE Rule 2009(a)(3).

¹⁵ See ISE Rule 2009(b)(1).

¹⁶ See ISE Rule 2009, Supplementary Material .01.

and traded in U.S. dollars.¹⁸

The Exchange believes that the Index is a broad-based index, as that term is defined in ISE Rule 2001(k).¹⁹ The Exchange proposes that the Index should be treated as a broad-based index for purposes of position limits, exercise limits, and margin requirements.²⁰ Accordingly, the Exchange proposes no position or exercise limits for options on the Index²¹ 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 trading halt procedures applicable to other index options traded on the Exchange.²² Further,

¹⁷ See ISE Rule 2009, Supplementary Material .02.

¹⁸ See ISE Rule 2009(a)(1).

¹⁹ 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.

²⁰ In its response letter, ISE 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.

²¹ 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.

²² See ISE Rule 2008(c).

Chapter 6 of the Exchange's rules, which is designed to protect public customer trading, will apply to trading in options on the Index. 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 notes that it will monitor for any potential manipulation of the Index settlement value both according to its current procedures and additional enhanced surveillance measures.²³ Additionally, the Exchange notes that 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. Discussion and Commission Findings

The Commission finds that the proposed rule change is consistent with the requirements

²³ Specifically, 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 exchange(s) contributed to opening NBBO quote(s) and contact the exchange(s) that entered the quote(s). See Amendment No. 1.

of the Act and the rules and regulations thereunder applicable to a national securities exchange.²⁴ Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,²⁵ 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. Specifically, the Commission believes that the proposed Index options provide investors with an additional trading and hedging mechanism.

As noted above, the Commission received two comment letters regarding the proposed rule change.²⁶ In its comment letters, CBOE argues that the Index should not be treated as a broad-based security index for regulatory purposes.²⁷ 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.²⁸ 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.²⁹ In this regard, CBOE questions the

²⁴ 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).

²⁵ 15 U.S.C. 78f(b)(5).

²⁶ See CBOE Letter I, supra note 4 and CBOE Letter II, supra note 8.

²⁷ See CBOE Letter I, supra note 4 at 1-2.

²⁸ See CBOE Letter I, supra note 4 at 1 and CBOE Letter II, supra note 8 at 1.

²⁹ See CBOE Letter I, supra note 4 at 1 and CBOE Letter II, supra note 8 at 1.

Exchange’s proposal not to impose position limits for options on the Index.³⁰ 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 options because they are not options on a broad-based security index.³¹ CBOE argues that the more analogous comparison for position limit treatment is the Alpha Index options that trade on NASDAQ OMX PHLX LLC (“Phlx”).³² 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.³³ 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.³⁴

In its response letter, ISE draws an analogy between the Index and the VIX.³⁵ 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.³⁶ 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.³⁷ ISE asserts that the Index provides a similar economic exposure as exposure to the VIX

³⁰ See CBOE Letter I, supra note 4 at 2-3 and CBOE Letter II, supra note 8 at 1.

³¹ See CBOE Letter I, supra note 4 at 2.

³² See CBOE Letter I, supra note 4 at 2 and CBOE Letter II, supra note 8 at 1-2.

³³ See CBOE Letter I, supra note 4 at 2 and CBOE Letter II, supra note 8 at 2.

³⁴ See CBOE Letter I, supra note 4 at 2 and CBOE Letter II, supra note 8 at 2.

³⁵ ISE notes that CBOE sought to designate the VIX as a broad-based index. See ISE Letter, supra note 6, at 1.

³⁶ See id., at 2.

³⁷ See id.

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.³⁸ ISE therefore concludes that the Index should similarly be treated as broad-based by looking through to the exposure provided by the underlying reference.³⁹

ISE also argues that the proposed Index options are not analogous to Alpha Index options.⁴⁰ 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.⁴¹ 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.⁴² In contrast, ISE believes that its proposal to apply no position limits to the Index options is appropriate.⁴³

Further, as discussed above, in Amendment No. 1, ISE asserts that there is a low potential for manipulation of the settlement value of the Index due to the quote-based calculation methodology used, high cost that would result from any attempted manipulation, and the vast liquidity and high level of participation among market participants making manipulation very difficult.⁴⁴ In addition, while ISE notes that manipulation of the Index settlement value is unlikely, it represents that in addition to its current surveillance procedures, it will undertake

³⁸ See id.

³⁹ See id.

⁴⁰ See id.

⁴¹ See id.

⁴² See id.

⁴³ See id., at 2-3. See also supra note 21 and accompanying text.

⁴⁴ See Amendment No. 1.

certain additional surveillance measures with respect to the Index options.⁴⁵

The Commission believes that the Exchange's proposal to impose no position limits on the Index options is appropriate and consistent with the Act.⁴⁶ As noted above, the Index is calculated using published real-time bid/ask quotes of SPY options and measures changes in the implied volatility of the SPY. The Commission notes that SPY options are the most actively-traded options in terms of average daily volume. The Commission believes that because the options composing the Index are extremely liquid, the potential manipulation and potential market disruption concerns that position limits are designed to address are mitigated in the case of this product.⁴⁷ Moreover, the Commission believes that having no position limits for the proposed Index options may benefit investors by bringing additional depth and liquidity to these Index options without raising significant concerns about potential manipulation or potential market disruption.

The Commission also believes that permitting \$1.00 strike price intervals if the strike price is equal to or less than \$200 will provide investors with added flexibility in the trading of these options and will further the public interest by allowing investors to establish positions that are better tailored to meet their investment objectives. As noted above, the Exchange proposes to provide an exception for the proposed Index options from the existing requirement that exercise prices of new or additional series must be reasonably related to the current value of the Index at the time such series are first opened for trading.⁴⁸ The Commission believes that this

⁴⁵ See supra note 23 and accompanying text.

⁴⁶ In approving this proposed rule change to list and trade options on the Index, the Commission is not determining whether the Index is a "narrow-based" security index as that term is defined in the Act. See 15 U.S.C. 78c(a)(55)(B).

⁴⁷ See also Amendment No. 1.

⁴⁸ See supra notes 12-13 and accompanying text.

change is consistent with the Act because it should provide investors added flexibility to meet their investment objectives.⁴⁹ The Commission also notes that the Exchange has represented that it has the necessary systems capacity to handle the additional traffic associated with the listing and trading of this new product and it expects that the Exchange considered this expansion of the permissible range of strike prices in making such a representation.⁵⁰

The Commission also believes that it is consistent with the Act to apply margin requirements to the proposed Index options that are otherwise applicable to options on broad-based indexes.⁵¹ The Commission further believes that the Exchange's proposed minimum trading increment, series openings, and other aspects of the proposed rule change are appropriate and consistent with the Act.

As a national securities exchange, the Exchange is required, under Section 6(b)(1) of the Act,⁵² to enforce compliance by its members and persons associated with its members with the provisions of the Act, Commission rules and regulations thereunder, and its own rules. In this regard, the Commission notes that trading of options on the Index will be subject to the same rules that currently govern the trading of other index options on the Exchange.⁵³ In addition, as noted above, the Exchange has asserted that manipulation of the Index settlement value will be difficult.⁵⁴ Moreover, the Exchange has represented that it has an adequate surveillance program in place for options traded on the Index, and will monitor for any potential manipulation of the

⁴⁹ The Commission notes that CBOE recently eliminated the band that limited the number of \$1 strikes that could be listed on VIX options. See Securities Exchange Act Release No. 63155 (October 21, 2010), 75 FR 66402 (October 28, 2010) (SR-CBOE-2010-096).

⁵⁰ See Notice, supra note 3, at 47044.

⁵¹ See supra note 20.

⁵² 15 U.S.C. 78f(b)(1).

⁵³ See supra note 22 and accompanying text.

⁵⁴ See Amendment No. 1.

Index settlement value according to its current surveillance procedures and additional surveillance measures.⁵⁵ In approving the proposed listing and trading of the Index options, the Commission has also relied on ISE's representation that it has the necessary systems capacity to support the new options series that will result from this proposal.⁵⁶

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵⁷ that the proposed rule change (SR-ISE-2013-42), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵⁸

Kevin M. O'Neill
Deputy Secretary

[FR Doc. 2014-01510 Filed 01/27/2014 at 8:45 am; Publication Date: 01/28/2014]

⁵⁵ See Notice, supra note 3, at 47044 and Amendment No. 1.

⁵⁶ See Notice, supra note 3, at 47044.

⁵⁷ 15 U.S.C. 78s(b)(2).

⁵⁸ 17 CFR 200.30-3(a)(12).