



8011-01p
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-79994; File No. SR-ISE-2016-27)

February 9, 2017

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Granting Approval 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

I. Introduction

On December 9, 2016, the International Securities Exchange, LLC ("ISE" or "Exchange") 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 related to the routing of orders, cancellation of orders, and handling of error positions. The proposed rule change would also permit Nasdaq Execution Services, LLC ("NES") to become an affiliated Member³ of the Exchange to perform certain routing and other functions. 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, was published for comment in the Federal Register on December 29, 2016.⁴ The Commission received no comments on the proposed rule change. This order grants approval of the proposed rule change, as modified by Amendment No. 1.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ A "Member" is an organization that has been approved to exercise certain trading rights on the Exchange. See ISE Rule 100(a)(23).

⁴ See Securities Exchange Act Release No. 79665 (December 22, 2016), 81 FR 96092 ("ISE Notice").

II. Background

On June 21, 2016, the Commission approved a proposed rule change relating to a corporate transaction in which Nasdaq, Inc. would become the ultimate parent of ISE, ISE Gemini, LLC (“ISE Gemini”), and ISE Mercury, LLC (“ISE Mercury” and, together with ISE and ISE Gemini, the “ISE Exchanges”).⁵ The transaction closed on June 30, 2016.⁶ Nasdaq, Inc. is also the ultimate parent of NASDAQ BX, Inc. (“BX”), The NASDAQ Stock Market LLC (“Nasdaq”), and NASDAQ PHLX LLC (“Phlx” and, together with Nasdaq and BX, the “Nasdaq Exchanges”).⁷ Nasdaq, Inc. is also the ultimate parent of NES,⁸ a broker-dealer that is a member, and affiliate, of each of the Nasdaq Exchanges.⁹ As a result of this transaction, the ISE Exchanges and the Nasdaq Exchanges became affiliates,¹⁰ and NES became an affiliate of the

⁵ See Securities Exchange Act Release No. 78119 (June 21, 2016), 81 FR 41611 (June 27, 2016) (SR-ISE-2016-11; SR-ISE Gemini-2016-05; SR-ISE Mercury-2016-10) (order approving Nasdaq, Inc.’s acquisition of ISE, ISE Gemini, and ISE Mercury) (“Nasdaq Acquisition Order”).

⁶ See <http://ir.nasdaq.com/releasedetail.cfm?releaseid=977785> (Nasdaq press release announcing completion of its acquisition).

⁷ See Nasdaq Acquisition Order, supra note 5, at 41611.

⁸ See Securities Exchange Act Release No. 69233 (March 25, 2013), 78 FR 19352 (March 29, 2013) (SR-NASDAQ-2013-028) (order approving a proposed rule change to make permanent a pilot program to permit Nasdaq to accept inbound orders routed by NES from the BX Equities market and PSX) at 19352 n.6 and accompanying text (“BX Equity Routing Approval”). See also ISE Notice, supra note 4, at 96093.

⁹ See Securities Exchange Act Release Nos. 79661 (December 22, 2016), 81 FR 96100 (December 29, 2016) (SR-BX-2016-068) at 96100; 79662 (December 22, 2016), 81 FR 96087 (December 29, 2016) (SR-NASDAQ-2016-169) at 96087; and 79660 (December 22, 2016), 81 FR 96060 (December 29, 2016) (SR-Phlx-2016-120) at 96061. See also ISE Notice, supra note 4, at 96093.

¹⁰ See Nasdaq Acquisition Order, supra note 5, at 41611 n.8. The Nasdaq Exchanges, together with ISE Gemini and ISE Mercury, are referred to herein as ISE’s “Affiliated Exchanges.”

ISE Exchanges.¹¹

The Exchange has now proposed a rule change to amend its rules relating to order routing, cancellation of orders, and handling of error positions, and to permit NES to become a Member of the Exchange to perform certain routing and other functions. ISE's proposed rules are similar to rules of Phlx,¹² as well as the other Nasdaq Exchanges.¹³ Specifically, and as described in more detail below, the Exchange proposed to: (1) route outbound orders in options listed and open for trading on the Exchange's system to away markets through NES, either directly or through a third-party routing broker-dealer; (2) permit the Exchange to receive inbound orders in options routed through NES from the Affiliated Exchanges, pursuant to certain limitations and conditions; (3) adopt rules regarding the cancellation of orders and the handling of certain error positions, including maintenance by NES of an error account; and (4) make related conforming changes.¹⁴ In addition, the Exchange requested that the Commission approve its proposal to permit NES to become a Member of the Exchange, as required by ISE Rule 312,¹⁵ to perform certain functions relating to the outbound routing of orders to away markets, routing orders inbound from the Affiliated Exchanges, cancellation of orders, and the maintenance of an error account.

¹¹ See generally ISE Notice, supra note 4, at 96093 (discussing that NES is a broker-dealer owned and operated by Nasdaq, Inc. and affiliated with ISE and the Affiliated Exchanges).

¹² See ISE Notice, supra note 4, at 96093, 96094-96096. See also Phlx Rules 985(c)(2), 1080(m)(ii), (iii), and (v).

¹³ See Nasdaq Rule 2160(c) and Nasdaq Options Rules, Chapter VI, Section 11(d)-(g); and BX Rule 2140(c) and BX Options Rules, Chapter VI, Section 11(d)-(g).

¹⁴ See ISE Notice, supra note 4, at 96093.

¹⁵ Id.

III. Discussion and Commission Findings

After careful review, the Commission finds, as discussed in more detail below, that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁶ In particular, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(1) of the Act,¹⁷ which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purpose of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of the Exchange. Further, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(5) of the Act,¹⁸ 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 foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities; 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. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

¹⁶ 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).

¹⁷ 15 U.S.C. 78f(b)(1).

¹⁸ 15 U.S.C. 78f(b)(5).

A. Restriction on Affiliation

As noted above, ISE proposed that NES be permitted to become a Member of the Exchange to perform certain routing and other functions, as described in more detail below.¹⁹ Absent Commission approval, ISE Rule 312 would prohibit NES from becoming a Member of ISE because of its affiliation with the Exchange and its affiliation with affiliates of the Exchange. Specifically, pursuant to ISE Rule 312, without prior Commission approval, a Member of the Exchange “shall not be or 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.”²⁰

In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest and the potential for unfair competitive advantage.²¹ Although the Commission continues to be concerned about potential unfair competition and conflicts of interest between an exchange’s self-regulatory obligations

¹⁹ See ISE Notice, supra note 4, at 96093. See also infra, Sections III.B-D.

²⁰ See ISE Rule 312. See also ISE Notice, supra note 4, at 96093.

²¹ See, e.g., Securities Exchange Act Release Nos. 54170 (July 18, 2006), 71 FR 42149 (July 25, 2006) (SR-NASDAQ-2006-006) (order approving Nasdaq’s proposal to adopt Nasdaq Rule 2140, restricting affiliations between Nasdaq and its members); 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (order approving the combination of the New York Stock Exchange, Inc. and Archipelago Holdings, Inc.); 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008) (SR-Amex-2008-62 and SR-NYSE-2008-60) (order approving the combination of NYSE Euronext and the American Stock Exchange LLC); 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) (SR-ISE-2008-85) (order approving the purchase by ISE Holdings of an ownership interest in Direct Edge Holdings LLC); 59281 (January 22, 2009), 74 FR 5014 (January 28, 2009) (SR-NYSE-2008-120) (order approving a joint venture between NYSE and BIDS Holdings L.P.); 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (File No. 10-182) (order granting the exchange registration of BATS Exchange, Inc.); 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (File Nos. 10-194 and 10-196) (order granting the exchange registration of EDGX Exchange, Inc. and EDGA Exchange, Inc.); and 62716 (August 13, 2010), 75 FR 51295 (August 19, 2010) (File No. 10-198) (order granting the exchange registration of BATS-Y Exchange, Inc.).

and its commercial interest when the exchange is affiliated with one of its members, the Commission believes that it is consistent with the Act, as discussed in more detail below, to permit NES, an affiliate of the Exchange, to be a Member of the Exchange to perform each of the proposed functions, subject to the proposed limitations and conditions. The Commission also believes that the proposed limitations and conditions will mitigate its concerns about potential conflicts of interest and unfair competitive advantage,²² and that the Exchange's proposed rules are designed to ensure that NES cannot use any information advantage it may have because of its affiliation with ISE.²³

B. Outbound Routing

ISE has proposed to establish NES as the Exchange's exclusive order router.²⁴ Currently, ISE utilizes Linkage Handlers²⁵ unaffiliated with the Exchange to route outbound orders.²⁶ ISE

²² See infra note 59 and accompanying text and Section III.D.

²³ See infra note 60 and accompanying text. The Commission also notes that the functions to be performed by NES for ISE, as well as the related limitations and conditions, are consistent with those previously approved by the Commission for other exchanges. See, e.g., Securities Exchange Act Release Nos. 67256 (June 26, 2012), 77 FR 39277 (July 2, 2012) (SR-BX-2012-030) (order approving rules relating to the establishment of the BX options market, including the use of an affiliated member for outbound and inbound routing of options orders) at 39280-82; and 67280 (June 27, 2012), 77 FR 39552 (July 3, 2012) (SR-BX-2012-034) (order approving a proposed rule change with respect to the authority of the BX or NES to cancel orders when a technical or systems issue occurs and the operation of an error account); and BX Equity Routing Approval, supra note 8.

²⁴ See proposed ISE Rule 1903(a).

²⁵ 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 ISE Rule 1903, by routing ISO(s) to other exchange(s) as an 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 ISE Rule 1901, Supplementary Material .03. ISE Rules 100(a)(28) and (39) define "Non-Customer Order" and "Public Customer Order," respectively.

²⁶ See ISE Rule 1903(a).

has proposed to amend ISE Rule 1903 to provide that ISE will no longer use Linkage Handlers and instead, NES will route orders to other options exchanges, either directly, or indirectly through unaffiliated third-party routing brokers, on behalf of ISE.²⁷ ISE explained that the Exchange will have the option to direct NES to route orders to certain exchanges through a third-party routing broker, in which case NES will submit the orders to the third-party routing broker and the third-party routing broker will route the orders in the third-party routing broker's name.²⁸ ISE noted that its proposed use of NES to handle outbound routing for the Exchange is similar to the arrangement utilized by Phlx.²⁹

Pursuant to the proposal, NES will serve as the routing facility of the Exchange ("Routing Facility"). The sole use of the Routing Facility by the system will be to 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 will be subject to regulation as a facility of the Exchange,

²⁷ See proposed ISE Rule 1903(a). ISE has proposed to retain the first portion of ISE Rule 1903, which provides that the Exchange may automatically route ISOs to other exchanges under certain circumstances, including pursuant to Supplementary Material .02 to Rule 1901, which discusses the handling of orders when the automatic execution of an incoming order would result in an impermissible trade through. See proposed ISE Rule 1903. ISE noted that this provision provides context to the proposed rule and is consistent with the practice on Phlx, even though it is not contained in Phlx's comparable rule. See ISE Notice, supra note 4, at 96094. ISE has proposed to remove from this provision a reference to Supplementary Material .03 to Rule 1901, which defines Linkage Handlers. See proposed ISE Rule 1903.

²⁸ See ISE Notice, supra note 4, at 96094.

²⁹ See id. (citing Phlx Rule 1080(m)). The Commission notes that ISE's proposal is also similar to Nasdaq's and BX's rules. See Nasdaq Options Rules, Chapter VI, Section 11(d)-(f); BX Options Rules, Chapter VI, Section 11(d)-(f).

including the requirement to file proposed rule changes under Section 19 of the Act, as amended.³⁰

NES will be a member of an SRO unaffiliated with ISE that is its designated examining authority.³¹ Also, the Exchange and NES will not be permitted to use a routing broker for which the Exchange or any affiliate of the Exchange is the designated examining authority.³² The use of NES to route orders to other market centers will be optional.³³ Parties that do not desire to use NES will need to designate orders as Do-No-Route-Orders pursuant to ISE Rule 715(m).³⁴

The Exchange will 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.³⁵ The books, records, premises, officers, directors, agents, and employees of the Routing Facility, as a facility of the Exchange, will 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. Also,

³⁰ See proposed ISE Rule 1903(a).

³¹ See id.

³² See proposed ISE Rule 1903(c)(2). ISE noted that this provision is intended to prevent any conflicts of interest that might arise if an entity with regulatory oversight of ISE was privy to trades conducted on ISE. See ISE Notice, supra note 4, at 96095.

³³ See proposed ISE Rule 1903(b).

³⁴ See id. See also ISE Notice, supra note 4, at 96095.

³⁵ See proposed ISE Rule 1903(c). If the routing broker or any of its affiliates engages in any other business activities other than providing routing services to the Exchange, this provision will apply to the flow of confidential and proprietary information 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. See id.

the books and records of the Routing Facility, as a facility of the Exchange, will be subject at all times to inspection and copying by the Exchange and the Commission.³⁶

The Exchange will determine the logic that provides when, how, and where orders are routed to other exchanges. Except as provided, the routing broker(s) will not be able to change the terms of an order or the routing instructions, nor will the routing broker have any discretion about where to route an order.³⁷ ISE explained that it may choose to use a different routing broker by destination exchange, depending upon the costs and technological efficiencies involved.³⁸ ISE stated that, at a minimum, it anticipates using a third-party routing broker to access certain markets where the costs of maintaining a membership for NES or the costs of connectivity and execution do not make sense based on the number or types of orders that the Exchange typically routes to a particular market. ISE added that it will also consider the ease of connectivity and execution and general reliability when selecting a third-party routing broker.³⁹ Entering Members whose orders are routed to away markets will 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.⁴⁰

In addition to the Exchange rules regarding routing away to trading centers, NES will, pursuant to Rule 15c3-5 under the Act, implement certain tests designed to mitigate risks

³⁶ See proposed ISE Rule 1903(c)(1).

³⁷ See proposed ISE Rule 1903(e).

³⁸ For such indirect routing, ISE stated that it would route orders through NES to another routing broker where the Exchange determines that it is appropriate. See ISE Notice, supra note 4, at 96095.

³⁹ See ISE Notice, supra note 4, at 96095.

⁴⁰ See proposed ISE Rule 1903(f). ISE noted that this provision is substantively the same as its current Rule 1903(f), but it is amending the provision to conform the text to Phlx Rule 1080(m)(ii).

associated with providing the Exchange's Members with access to such 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 had been routed.⁴¹

ISE also has proposed to make conforming changes to remove the term Linkage Handler from its rules and replace it with references to NES or third-party unaffiliated routing broker-dealers used by NES, as appropriate.⁴² Further, ISE has proposed to remove ISE Rule 705(d)(4), which provides an exception to the limits on compensation in ISE Rule 705(d) for Members to the extent such Members are acting as Linkage Handlers.⁴³ ISE explained that, unlike NES, Linkage Handlers are not affiliated with ISE and the Exchange does not believe that such an exception to compensation limits is necessary for NES.⁴⁴

As a facility of ISE (as defined in Section 3(a)(2)⁴⁵ of the Act), NES will be subject to Exchange oversight, as well as Commission oversight, and the Exchange will be responsible for ensuring that NES's outbound routing function is operated consistent with Section 6 of the Act

⁴¹ See proposed ISE Rule 1903(d).

⁴² See proposed ISE Rule 1901, Supplementary Material .02(d), .04(a), and .05(a); proposed ISE Rule 1903, Supplementary Material .01, .02, and .03. ISE has proposed to delete its definition of Linkage Handler at Rule 1901, Supplementary Material .03, and reserve this provision. See proposed ISE Rule 1901, Supplementary Material .03. With respect to the references to Linkage Handler in ISE Rules 1904 and 1905, as discussed further below, ISE has proposed to replace ISE Rule 1904 in its entirety and reserve ISE Rule 1905. See proposed ISE Rules 1904 and 1905.

⁴³ See proposed ISE Rule 705(d).

⁴⁴ See ISE Notice, supra note 4, at 96095.

⁴⁵ 15 U.S.C. 78c(a)(2).

and the Exchange's rules.⁴⁶ A participant in ISE's system will be free to route its orders to other market centers through alternative means. The Commission notes that ISE's proposed rules for the operation of NES as an affiliated outbound router on behalf of the Exchange are consistent with the rules and conditions approved by the Commission for other exchanges.⁴⁷ In light of the protections discussed above, including the regulation of NES as a facility of the Exchange with respect to the routing of orders, the Commission believes that ISE's proposed rules and use of NES to route orders to away markets are consistent with the Act.

C. Inbound Routing

As discussed above, NES is currently a member of each Nasdaq Exchange. NES also operates as a facility of each of Nasdaq, Phlx, and BX that provides outbound options routing to other market centers, subject to certain conditions.⁴⁸ ISE Gemini and ISE Mercury have also proposed that NES operate as a facility of each that provides outbound options routing to other

⁴⁶ Further, the Commission notes that the Exchange will be responsible for filing with the Commission proposed rule changes and fees relating to NES's outbound routing function and NES's outbound routing function will be subject to exchange non-discrimination requirements.

⁴⁷ See, e.g., Securities Exchange Act Release No. 62716, supra note 21 at 51303-04. The proposed rules are also consistent with the rules of the Nasdaq Exchanges. See, e.g., Phlx Rule 1080(m)(ii) and (iii); Nasdaq Options Rules, Chapter VI, Section 11(d)-(f); BX Options Rules, Chapter VI, Section 11(d)-(f). See also Securities Exchange Act Release No. 59995 (May 28, 2009), 74 FR 26750 (June 3, 2009) (SR-Phlx-2009-32) (order approving enhancements to Phlx's trading system, including use of outbound routing facility) at 26756-57.

⁴⁸ See supra note 47 (citing Phlx Rule 1080(m)(ii) and (iii); Nasdaq Options Rules, Chapter VI, Section 11(d)-(f); and BX Options Rules, Chapter VI, Section 11(d)-(f)). The Commission notes that these conditions are consistent with the conditions the Commission is approving today for ISE's operation of NES as a facility of the Exchange for outbound options routing to other market centers. See supra Section III.B.

market centers, subject to similar conditions.⁴⁹ The operation of NES as a facility of each of the Affiliated Exchanges providing outbound routing services will be subject to oversight by ISE Gemini, ISE Mercury, Nasdaq, BX, and Phlx, respectively, as well as Commission oversight. Each of the Affiliated Exchanges will be responsible for ensuring that NES's outbound options routing services are operated consistent with Section 6 of the Act and with the respective Affiliated Exchange's rules. In addition, the Affiliated Exchanges must each file with the Commission rule changes and fees relating to their outbound options routing services provided by NES.

Recognizing that the Commission previously expressed concern that the 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 interest, ISE proposed the following limitations and conditions to permit the Exchange to accept inbound options orders that NES routes in its capacity as a facility of the Affiliated Exchanges:⁵⁰

- First, ISE and the Financial Industry Regulatory Authority ("FINRA") will maintain a Regulatory Services Agreement ("RSA"), as well as an agreement pursuant to Rule 17d-2 under the Act ("17d-2 Agreement").⁵¹ Pursuant to the RSA and the 17d-2 Agreement, FINRA will be allocated regulatory responsibilities to review NES's compliance with

⁴⁹ See Securities Exchange Act Release Nos. 79664 (December 22, 2016), 81 FR 96136 (December 29, 2016) (SR-ISEGemini-2016-16); and 79663 (December 22, 2016), 81 FR 96089 (December 29, 2016) (SR-ISEMercury-2016-22). The Commission is also today approving these proposed rules changes. See Securities Exchange Act Release No. 79995 (February 9, 2017) ("ISE Gemini and ISE Mercury Exchange Routing Order").

⁵⁰ See ISE Notice, supra note 4, at 96093-96094.

⁵¹ 17 CFR 240.17d-2.

certain Exchange rules.⁵² Pursuant to the RSA, however, the Exchange retains ultimate responsibility for enforcing its rules with respect to NES.

- Second, FINRA will monitor NES for compliance with the Exchange’s trading rules, and will collect and maintain certain related information.⁵³
- 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 proposed to amend ISE Rule 312 to add ISE Rule 312(c), which will provide that Nasdaq, Inc., as the holding company owning both the Exchange 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 the Exchange’s systems as a result of its affiliation with the Exchange, until such information is available generally to similarly

⁵² NES is also subject to independent oversight by FINRA, its designated examining authority, for compliance with financial responsibility requirements.

⁵³ Pursuant to the RSA, both FINRA and the Exchange will collect and maintain all alerts, complaints, investigations and enforcement actions in which NES (in its capacity as a facility of each of the Affiliated Exchanges routing orders to the Exchange) is identified as a participant that has potentially violated applicable Commission or Exchange rules. The Exchange and FINRA will 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. See ISE Notice, supra note 4, at 96094 n.13 and accompanying text.

situated Exchange Members, in connection with the provision of inbound routing to the Exchange.⁵⁴

The Commission finds that ISE's proposed rule change to permit the Exchange to accept inbound options orders routed by NES from its Affiliated Exchanges, including the related change to ISE Rule 312, are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act⁵⁵ and Section 6(b)(5) of the Act.⁵⁶

In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest and the potential for unfair competitive advantage.⁵⁷ Although the Commission continues to be concerned about potential unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, for the reasons discussed below, the Commission believes that it is consistent with the Act to permit NES, in its capacity as a facility of each of the Affiliated Exchanges, to route options orders inbound to ISE, subject to the limitations and conditions described above.⁵⁸

⁵⁴ See proposed ISE Rule 312(c).

⁵⁵ 15 U.S.C. 78f(b)(1). See also supra note 17 and accompanying text.

⁵⁶ 15 U.S.C. 78f(b)(5). See also supra note 18 and accompanying text.

⁵⁷ See supra note 21 and accompanying text.

⁵⁸ The Commission notes that these limitations and conditions are consistent with those previously approved by the Commission for other exchanges. See, e.g., Securities Exchange Act Release Nos. 67256, supra note 23, at 39281-82; and 69229 (March 25, 2013), 78 FR 19337 (March 29, 2013) (SR-Phlx-2013-15) (order approving a proposed rule change to make permanent a pilot program to permit PSX to accept inbound orders routed by NES from BX); and BX Equity Routing Approval, supra note 8.

The Commission believes that these limitations and conditions will mitigate its concerns about potential conflicts of interest and unfair competitive advantage. In particular, the Commission believes that a non-affiliated SRO's oversight of NES,⁵⁹ combined with a non-affiliated SRO's monitoring of NES's compliance with the Exchange's rules and quarterly reporting to the Exchange, will help to protect the independence of ISE's regulatory responsibilities with respect to NES. The Commission also believes that the Exchange's proposed ISE Rule 312(c) is designed to ensure that NES cannot use any information advantage it may have because of its affiliation with ISE.⁶⁰

D. Cancellation of Orders and Error Accounts

ISE has proposed to amend its rules concerning the cancellation of orders and error accounts. Currently, the Exchange may cancel orders as it deems 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 services provided under ISE Rule 1903, or another exchange to which an Exchange order has been routed.⁶¹ ISE permits Linkage Handlers to maintain one or more accounts for the purpose of liquidating unmatched trade positions that may occur in connection with their routing of outbound orders.⁶²

As described above, ISE will no longer utilize Linkage Handlers and will instead utilize NES as its Routing Facility to route orders to away markets either directly or through one or

⁵⁹ This oversight will be accomplished through the 17d-2 Agreement between FINRA and the Exchange and the RSA.

⁶⁰ See supra note 54 and accompanying text.

⁶¹ See ISE Rule 1904. See also ISE Notice, supra note 4, at 96096.

⁶² See ISE Rule 1905. See also ISE Notice, supra note 4, at 96096.

more third-party unaffiliated routing broker-dealers on behalf of the Exchange.⁶³ In its proposal, ISE stated that a technical or systems issue may occur at the Exchange, NES, or a routing destination that causes the Exchange or NES to cancel orders, if the Exchange or NES determines that such action is necessary to maintain a fair and orderly market.⁶⁴ ISE also stated that a technical or systems issue that occurs at the Exchange, NES, a routing destination, or a third-party unaffiliated routing broker may result in NES acquiring an error position that it must resolve.⁶⁵ In conjunction with the proposed changes to outbound routing described above, ISE has proposed to revise its rules concerning the cancellation of orders and handling of error positions and adopt proposed ISE Rule 1904.⁶⁶ ISE noted that proposed ISE Rule 1904 is similar to Phlx's rule on this subject.⁶⁷

ISE has proposed to provide the Exchange or NES with general authority to cancel orders to maintain fair and orderly markets when a technical or systems issue occurs at the Exchange,

⁶³ See supra notes 27-28 and accompanying text.

⁶⁴ See ISE Notice, supra note 4, at 96096. For examples of some of the circumstances in which the Exchange or NES may decide to cancel orders, see id., at 96096-97.

⁶⁵ See ISE Notice, supra note 4, at 96097. Specifically, proposed ISE Rule 1904(b) defines "error positions" as "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." For examples of some of the circumstances that may lead to error positions, see ISE Notice, supra note 4, at 96097.

⁶⁶ See proposed ISE Rules 1904 and 1905. ISE has proposed to (i) combine its rules concerning cancellation of orders and error accounts into proposed ISE Rule 1904, which it will retitle; and (ii) remove and reserve ISE Rule 1905. See ISE Notice, supra note 4, at 96095-96.

⁶⁷ See ISE Notice, supra note 4, at 96095-96 (citing Phlx Rule 1080(m)(v)). The Commission notes that ISE's proposed rule is also similar to Nasdaq's and BX's rules. See Nasdaq Options Rules, Chapter VI, Section 11(g); BX Options Rules, Chapter VI, Section 11(g).

NES, or a routing destination.⁶⁸ NES will maintain an error account for the purpose of addressing error positions, according to the specified procedures for resolving such error positions.⁶⁹ Specifically, the Exchange or NES will be able to cancel orders as either deems necessary to maintain fair and orderly markets if a technical or systems issue occurs at the Exchange, NES, or a routing destination.⁷⁰ The Exchange or NES will be required to provide notice of the cancelation to all affected Members as soon as practicable.⁷¹

Pursuant to the proposal, NES will be required to maintain an error account for the purpose of addressing error positions that result from a technical or systems issue at the Exchange, NES, a routing destination, or an unaffiliated third-party routing broker.⁷² For purposes of this rule, an error position will 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.⁷³ NES will not be permitted to (i) accept any positions in its error account from a Member's account or (ii) permit any Member to transfer any positions from the Member's account to NES's error account.⁷⁴ In other words, 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 the Exchange, NES, a routing destination of NES, or an unaffiliated third-party

⁶⁸ See proposed ISE Rule 1904(a).

⁶⁹ See proposed ISE Rule 1904(b).

⁷⁰ See proposed ISE Rule 1904(a).

⁷¹ See id.

⁷² See proposed ISE Rule 1904(b).

⁷³ See proposed ISE Rule 1904(b)(1).

⁷⁴ See proposed ISE Rule 1904(b)(2).

routing broker.⁷⁵ If, however, a technical or systems issue results in the Exchange not 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.⁷⁶

In connection with a particular technical or systems issue, the Exchange or NES will be required to 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, will be made in a nondiscriminatory fashion.⁷⁷ The Exchange or NES will be required to assign all error positions resulting from a particular technical or systems issue to the Members affected by that technical or systems issue if the Exchange or NES:

- (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;

⁷⁵ See ISE Notice, supra note 4, at 96097-98 n.30. This provision would not apply if NES incurred a short position to settle a Member's purchase, as the Member would not have had a position in its account as a result of the purchase at the time of NES's action. Similarly, if a systems issue occurred that caused one Member to receive an execution for which there is not an available counterparty, action by NES would be required for the positions to settle into that Member's account. See id.

If error positions 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. If, however, such 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 positions. See ISE Notice, supra note 4, at 96096 n.23.

⁷⁶ See proposed ISE Rule 1904(b)(3).

⁷⁷ See proposed ISE Rule 1904(c).

- (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 proposed ISE Rule 1904(a).⁷⁸

If the Exchange or NES is unable to assign all error positions resulting from a particular technical or systems issue to all of the affected Members, or if the Exchange or NES determines to cancel all orders affected by the technical or systems issue, then NES will be required to liquidate the error positions as soon as practicable.⁷⁹ NES will be required to provide complete time and price discretion for the trading to liquidate the error positions to a third-party broker-dealer, and would be prohibited from attempting to exercise any influence or control over the timing or methods of such trading.⁸⁰ Further, NES will be required to 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, on one hand, and the Exchange and NES, on the other, associated with the liquidation of the error positions.⁸¹ Also, the Exchange and NES will be required to make and keep records to document all determinations to treat positions as error positions; all determinations to assign error positions to Members or to liquidate error positions; and the liquidation of error positions through the third-party broker-dealer.⁸²

⁷⁸ See proposed ISE Rule 1904(c)(A)(i) - (iii).

⁷⁹ See proposed ISE Rule 1904(c)(B).

⁸⁰ See proposed ISE Rule 1904(c)(B)(i).

⁸¹ See proposed ISE Rule 1904(c)(B)(ii).

⁸² See proposed ISE Rule 1904(d).

The Commission recognizes that technical or systems issues may occur, and believes that proposed ISE Rule 1904, in allowing the Exchange or NES to cancel orders affected by technical or systems issues, should provide a reasonably efficient means for the Exchange to handle such orders, and appears reasonably designed to permit the Exchange to maintain fair and orderly markets.⁸³ The Commission also believes that allowing the Exchange to resolve error positions through the use of an error account maintained by NES pursuant to the procedures set forth in the rule, and as described above, is consistent with the Act. The Commission notes that the rule establishes criteria for determining which positions are error positions,⁸⁴ and that the Exchange or NES, in connection with a particular technical or systems issue, will be required to either assign or liquidate all resulting error positions.⁸⁵ Also, the Exchange or NES will assign error positions that result from a particular technical or systems issue to Members only if all such error positions can be assigned to all of the Members affected by that technical or systems issue.⁸⁶ If the Exchange or NES cannot assign all error positions to all Members, NES will liquidate all of those error positions.⁸⁷ In this regard, the Commission believes that the new rule appears reasonably designed to further just and equitable principles of trade and the protection of investors and the public interest, and to help prevent unfair discrimination, in that it should help

⁸³ The Commission notes that ISE stated that the proposed amendments to ISE Rule 1904 are designed to maintain fair and orderly markets, ensure full trade certainty for market participants, and avoid disrupting the clearance and settlement process. See ISE Notice, supra note 4, at 96099. The Commission also notes that ISE stated that a decision to cancel orders due to a technical or systems issue is not equivalent to the Exchange declaring self-help against a routing destination pursuant to ISE Rule 1901(b)(1)(i). See id. at 96097 n.29.

⁸⁴ See proposed ISE Rule 1904(b).

⁸⁵ See proposed ISE Rule 1904(c).

⁸⁶ See proposed ISE Rule 1904(c)(A).

⁸⁷ See proposed ISE Rule 1904(c)(B).

assure the handling of error positions will be based on clear and objective criteria, and that the resolution of those positions will occur promptly through a transparent process.

In addition, the Commission notes that it has previously expressed concern about the potential for unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members.⁸⁸ The Commission has also previously expressed its concern about the potential for misuse of confidential and proprietary information.⁸⁹ The Commission believes that the requirement that NES provide complete time and price discretion for the liquidation of error positions to a third-party broker-dealer, including that NES not attempt to exercise any influence or control over the timing or methods of such trading, combined with the requirement that the Exchange establish and enforce policies and procedures that are reasonably designed to restrict the flow of confidential and proprietary information to the third-party broker-dealer liquidating such positions, should help mitigate the Commission's concerns. In particular, the Commission believes that these requirements should help assure that none of the Exchange, NES, or the third-party broker-dealer is able to misuse confidential or proprietary information obtained in connection with the liquidation of error positions for its own benefit. The Commission also notes that the Exchange and NES would be required to make and keep records to document all determinations concerning error positions and resulting assignments or liquidations.⁹⁰ In addition, the Commission notes that the proposed procedures for cancelling orders and the

⁸⁸ See supra notes 21 and 57 and accompanying text.

⁸⁹ See, e.g., Securities Exchange Act Release No. 67280, supra note 23, at 39554.

⁹⁰ See proposed ISE Rule 1904(d).

handling of error positions are consistent with procedures the Commission has approved for other exchanges.⁹¹

IV. Implementation of Proposed Rule Change

ISE stated that it intends to begin implementation of the proposed rule change in the second quarter of 2017, in tandem with a technology migration to Nasdaq INET architecture, and that the migration will be on a symbol-by-symbol basis. ISE has represented that it will issue an alert to Members to announce the relevant migration date for specific symbols.⁹² ISE explained that the rules in ISE Chapter 19, including ISE Rules 1901, 1903, 1904, and 1905, are incorporated by reference into the rulebooks of ISE Gemini and ISE Mercury.⁹³ ISE Gemini and ISE Mercury submitted proposed rule changes that, among other things, would permit ISE Gemini and ISE Mercury to each use NES to route options orders outbound to away markets, route options orders inbound from the Affiliated Exchanges, and utilize the same procedures for cancellation of orders and handling of error accounts described herein.⁹⁴ ISE stated that it intends to begin implementation of the proposed rule changes for ISE Gemini and ISE Mercury in the first quarter and third quarter of 2017, respectively, on a symbol-by-symbol basis. ISE

⁹¹ See, e.g., Securities Exchange Act Release Nos. 66963 (May 10, 2012), 77 FR 28919 (May 16, 2012) (SR-NYSEArca-2012-22); 67010 (May 17, 2012), 77 FR 30564 (May 23, 2012) (SR-EDGX-2012-08); 67011 (May 17, 2012), 77 FR 30562 (May 23, 2012) (SR-EDGA-2012-09); and 67280, supra note 23. The Commission also notes that ISE's proposed rule is consistent with the corresponding rules of the Nasdaq Exchanges. See Phlx Rule 1080(m)(v); Nasdaq Options Rules, Chapter VI, Section 11(g); BX Options Rules, Chapter VI, Section 11(g).

⁹² See ISE Notice, supra note 4, at 96098.

⁹³ See id.

⁹⁴ See Securities Exchange Act Release Nos. 79664, supra note 49; and 79663, supra note 49. The Commission is also today approving these proposed rule changes. See ISE Gemini and ISE Mercury Exchange Routing Order, supra note 49.

further represented that it will add notations in each rulebook to cross-reference the amended rule text and clarify the respective implementation dates.⁹⁵

III. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁹⁶ that the proposed rule change (SR-ISE-2016-27), 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.⁹⁷

Eduardo A. Aleman
Assistant Secretary

⁹⁵ See ISE Notice, supra note 4, at 96098.

⁹⁶ 15 U.S.C. 78s(b)(2).

⁹⁷ 17 CFR 200.30-3(a)(12).

