

OPTIONS EXCHANGE			
Regulatory Information Circular			
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Subject: Distributive Linkage

This circular supersedes the original RIC 2009-219 which was issued on August 20, 2009. The “self help” bullet on page 2 is the only revision.

The ISE, along with the other six option exchanges, submitted to the SEC the Options Order Protection and Locked/Crossed Market Plan (“The Plan”), commonly called “Distributive Linkage.” Distributive Linkage will replace the current options linkage rules with a Reg NMS-based price protection system. This RIC will highlight some of the major changes associated with Distributive Linkage, answer some Frequently Asked Questions, and provide examples.

It is extremely important to note that these guidelines are specifically designed to assist members with regard to ISE Rules and the Distributive Linkage Plan. Members must always be cognizant of their order handling and best execution obligations.

Prohibition of Trade-Throughs

Distributive Linkage introduces the concepts of Protected Bids, Protected Offers, and Intermarket Sweep Orders (“ISOs”). A Protected Bid is the best OPRA reported bid on each exchange; a Protected Offer is the best OPRA reported offer on each exchange. The ISE will prevent marketable orders from trading through a Protected Quotation. Marketable Customer orders (including Professional Customer orders) will be handled by the Primary Market Maker (“PMM”) while Non-Customer orders will be rejected. A member cannot trade through an exchange’s Protected Bid or Protected Offer except in certain circumstances. The most common circumstances are described below; please see the full text of the rule for all available exemptions.

Common Exemptions to trade-through Liability

- Intermarket Sweep Orders – An order marked as an ISO will be executed up to its limit price *regardless of any better prices at away markets*. By entering an ISO, a member is representing that it simultaneously routed ISO orders for the full size of all better-priced Protected Quotations.
- “Flickering Quotes” – If an exchange’s quote changed within one second prior to the Trade Through and the previous quote would not have resulted in a Trade Through, the member is exempt from Trade Through Liability.
- Stopped orders and Price Improvement – Orders that are “stopped” **on the ISE** at a price that would not constitute a trade through and then later executed at a price that trades through an

away market are exempt from trade-through liability. For example, an order is entered into the ISE's Price Improvement Mechanism ("PIM") at a time when the ISE is the best offer. If another exchange posts a superior offer while the order is in the PIM process, the order can trade through the other exchange's superior offer.

- **Customer Stopped Orders** – Orders that are "stopped" **by the firm prior to entry on the ISE.** This exception permits a Participant to trade through a Protected Quotation if the resulting trade was a "stopped order." The exception requires that the "stopped order" be for the account of a Customer (non Broker/Dealer), and that the Customer agreed to the specified price on an order-by-order basis. This exception corresponds to the customer stopped order exception under Regulation NMS¹.
- Complex Orders as defined by each exchange's rules are exempt from Trade-Through liability.
- If an exchange's quotes are identified as Non-Firm, they may be traded through.
- Crossed Markets – If a Protected Bid is higher than a Protected Offer, trade-through protection does not apply.
- Trading Rotations – There is no trade-through protection for trades that are executed as part of the opening rotation.
- "Self-Help" - If an away exchange repeatedly fails to respond to incoming orders within one second, the ISE can declare self-help against that away exchange and ignore that away exchange's Protected Quotations. If a member believes that Self-Help should be declared against an away exchange, they should contact the ISE Help Desk.

Record Keeping Requirements

ISE's Market Surveillance Department ("MSD") will monitor members to assure that they do not engage in a pattern or practice of trading through Protected Quotations by entering orders marked ISO on the ISE without properly sweeping other markets with Protected Quotations. If MSD believes that a member may be improperly trading through away markets, MSD will request that the member provide evidence that the ISOs are being sent properly and that the member has effective policies and procedures in place to avoid trade-throughs. The ISE will follow the standard set forth by the SEC in the responses to FAQ Concerning Rules 610 and Rule 611 to Regulation NMS².

Locked and Crossed Markets

Members shall reasonably avoid displaying, and shall not engage in a pattern or practice of displaying, any quotations or orders that lock or cross a Protected Quotation. Currently the ISE system does not allow orders entered by EAMs to lock or cross Protected Quotes³. However, the ISE system will not prevent market maker's quotes from locking or crossing Protected Quotations. Therefore, market makers

¹ The ISE plans on implementing a stopped order identifier in the first quarter 2010 allowing members to mark orders stopped.

² For example, a member could randomly select three trading days per month for review (known only to its compliance personnel) and maintain all relevant "snapshots" of the Firm-Specific Quotation Data from those days that are necessary to demonstrate the reasonableness of its policies and procedures to the ISE. The following link shows responses to FAQs regarding Rules 610 and 611 of Regulation NMS.
<http://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm>

³ The ISE will introduce Day ISOs in the first quarter of 2010. The Day ISO order type will be accepted by the ISE System whether or not the order locks or crosses Protected Quotations. The responsibility of avoiding a pattern or practice of locking or crossing Protected Quotations caused by the entry of Day ISOs is on the Member.

must avoid locking or crossing Protected Quotations or must access the full size of all better-priced Protected Quotations using ISOs before locking or crossing a market.

Common Exceptions to Locked and Crossed Markets

- The locking or crossing quotation was displayed at a time when the Exchange was experiencing a failure, material delay, or malfunction of its systems or equipment;
- The locking or crossing quotation was displayed at a time when there was a crossed market.
- The Member simultaneously routed an ISO to execute against the full displayed size of any locked or crossed Protected Bid or Offer.

Example of Locked and Crossed Market – Market Makers

Example 1 – Exception to Locked and Crossed Markets

A market maker wants to post 0.90 bid.

ISE: 0.80 x 0.95 (50 x 50)

Ex1: 0.80 x 0.85 (100 x 10)

Ex2: 0.80 x 0.90 (100 x 20)

Ex3: 0.80 x 1.00 (100 x 50)

Market Maker sends an ISO to Ex1 to buy 10 @ 0.85

Market Maker sends an ISO to Ex2 to buy 20 @ 0.90

Market Maker posts a 0.90 bid.

Frequently Asked Questions and Examples – PMMs

1. What should a PMM do when there is a customer order that is not automatically executed because there is a better displayed bid or offer on another exchange?

A PMM must immediately handle customer orders that are locked because of a better displayed bid or offer on an away exchange⁴. A PMM can either trade report the customer order at a price that matches the best price displayed (NBBO) or send ISOs to all the exchanges with better (or equal) prices and simultaneously release the balance of the order on the ISE.

2. Can a PMM trade report a customer order without sending ISOs?

Yes, as long as the execution price is not inferior to the NBBO.

Example 1 - Trade Report the Customer Order

An order to buy 50 contracts @ market is entered and locks "away better" to the PMM:

ISE: ASK 20 @ 1.10 Top of Book ("TOB")

Ex1: ASK 10 @ 1.00 (TOB)

Ex2: ASK 20 @ 1.05 (TOB)

If no ISO order is sent, the PMM can trade report the entire 50 contracts at 1.00. The PMM cannot trade report 10 contracts at 1.00, 20 contracts at 1.05 (matching the Protected Offers), and release the balance as this would trade through the Protected Offers.

Example 2 – Exception to Trade-Through (ISO)

An order to buy 100 contracts @ market is entered and locks "away better" to the PMM:

ISE: ASK 20 @ 6.00

(ASK 20 @ 6.10)

Ex1: ASK 40 @ 5.80 (TOB)

Ex2: ASK 30 @ 6.00 (TOB)

Ex3: ASK 10 @ 6.20 (TOB)

PMM sends an ISO to Ex1 to buy 40 @ 5.80

PMM sends an ISO to Ex2 to buy 30 @ 6.00

PMM releases 30 contracts with the limit price set to 6.20 (since Ex3 has a 6.20 Protected Offer)

40 @ 5.80 executes on Ex1

30 @ 6.00 executes on Ex2

20 @ 6.00 executes on ISE

10 @ 6.10 executes on ISE

⁴ This Regulatory Information Circular ("RIC") supersedes all previous RICs w/r/t the amount of time a PMM has to handle locked orders.

Example 3 – Exception to Trade-Through (ISO)

An order to buy 60 contracts @ 6.00 is entered and locks "away better" to the PMM:

ISE: ASK 20 @ 6.00

(ASK 20 @ 6.10)

Ex1: ASK 40 @ 5.80 (TOB)

Ex2: ASK 30 @ 6.00 (TOB)

Ex3: ASK 10 @ 6.20 (TOB)

PMM sends an ISO to Ex1 to buy 40 @ 5.80

PMM releases 20 contracts with the limit price set to 6.00 (since Ex2 has a 6.00 Protected Offer)

40 @ 5.80 executes on Ex1

20 @ 6.00 executes on ISE

Example 4 – Exception to Trade-Through and Locked and Crossed Market (ISO)

An order to buy 100 contracts @ 6.00 is entered and locks "away better" to the PMM:

ISE: ASK 20 @ 6.00

(ASK 20 @ 6.10)

Ex1: ASK 40 @ 5.80 (TOB)

Ex2: ASK 30 @ 6.00 (TOB)

Ex3: ASK 10 @ 6.20 (TOB)

PMM sends an ISO to Ex1 to buy 40 @ 5.80

PMM releases 60 contracts with the limit price set to 6.00.

40 @ 5.80 executes at Ex1.

20 contracts trade @ 6.00 on the ISE and the balance gets relocked to the PMM.

ISE Ask moved to 20 @ 6.10.

PMM sends an ISO to Ex2 to buy 30 @ 6.00

PMM releases 10 contracts with a limit price of 6.00. The order is placed on the ISE book, as it is not marketable.

30 @ 6.00 executes at Ex2

Frequently Asked Questions and Examples – EAMs

1. Can you provide some examples of the proper use of the ISO exception with regard to trade-throughs?

The following are some ISO exception examples:

Example 1 – One Protected Quotation

A customer routes an order to an EAM to buy 200 contracts @ 1.15:

ISE: ASK 300 @ 1.00

Ex1: ASK 10 @ .99 (TOB)

Ex2: ASK 100 @ 1.00 (TOB)

Ex3: ASK 20 @ 1.01 (TOB)

EAM sends an ISO to Ex1 to buy 10 @ .99

EAM simultaneously sends an ISO to ISE to buy 190 @ 1.00

10 @ .99 executes on Ex1

190 @ 1.00 executes on ISE

Example 2 – Two Protected Quotations

A customer routes an order to an EAM to buy 200 contracts @ market:

ISE: ASK 50 @ 1.00

(ASK 20 @ 1.01)

(ASK 100 @ 1.02)

Ex1: ASK 20 @ 1.00 (TOB)

Ex2: ASK 30 @ 1.01 (TOB)

Ex3: ASK 100 @ 1.05 (TOB)

The following orders can be sent out simultaneously:

EAM sends an ISO to Ex1 to buy 20 @ 1.00

EAM sends an ISO to Ex2 to buy 30 @ 1.01

EAM sends an ISO to ISE to buy 150 @ 1.02

20 @ 1.00 executes on Ex1

30 @ 1.01 executes on Ex2

50 @ 1.00 executes on ISE

20 @ 1.01 executes on ISE

80 @ 1.02 executes on ISE

Example 3 – ISO Rejected by an Away Exchange

A customer routes an order to an EAM to buy 200 contracts @ 1.15:

ISE: ASK 300 @ 1.00

Ex1: ASK 10 @ .99 (TOB)

Ex2: ASK 100 @ 1.00 (TOB)

Ex3: ASK 20 @ 1.01 (TOB)

EAM sends an ISO to Ex1 to buy 10 @ .99

EAM simultaneously sends an ISO to ISE to buy 190 @ 1.00

190 @ 1.00 executes on ISE

Ex1 rejects the 10 @ .99

EAM sends an ISO to ISE to buy 10 @ 1.00

10 @ 1.00 executes on ISE

In this example, even though the order to buy 10 @ .99 was not executed, this would not be considered a trade-through since the EAM attempted to access the full size of the better priced Protected Offer.

2. Are Reserve, All-or-None, or Hidden Orders part of a “Protected Quotation?”

No, only the displayed portion of an order needs to be protected. However, non-displayed interest on an exchange can execute against an ISO, so an exchange’s displayed price may not change after the execution of an ISO. This may create the appearance of a trade-through when simultaneous ISOs are sent to multiple markets.

3. As an EAM, do I have to use ISOs?

No. If an EAM (priority customer and professional customer) does not want to “sweep” the Protected Quotations, the EAM can send a regular order to the ISE and the Exchange will process the order in compliance with the linkage requirements. The Exchange’s PMM will have the responsibility of handling locked customer orders, when they cannot be fully executed on the ISE without trading through a protected quotation, in accordance with the ISE’s Order Handling Rules.

4. Can a block, facilitation, or solicitation order be marked ISO?

Yes. An EAM can enter these types of orders marked ISO which can trade on the ISE with no consideration of other exchange’s Protected Quotations. However, these orders must be executed contemporaneously with the routing of ISOs for the full size of all better priced Protected Quotations.

Example 4 – Facilitation ISO

An EAM wants to facilitate a customer buy order for 200 contracts @ 1.00:

ISE: 0.80 x 1.00 (50 x 50) No Customer order on the book

Ex1: 0.80 x 0.98 (100 x 10)

Ex2: 0.80 x 0.99 (100 x 20)

Ex3: 0.80 x 1.01 (100 x 50)

EAM sends an ISO to Ex1 to buy 10 @ 0.98
EAM sends an ISO to Ex2 to buy 20 @ 0.99

10 @ .98 executes on Ex1
20 @ .99 executes on Ex2

EAM enters a facilitation order – ISO on the ISE to buy 170 @ 1.00
170 @ 1.00 is facilitated on ISE

Example 5 – Solicitation ISO

An EAM wants to enter a solicitation order to buy 500 contracts @ 1.00:

ISE: 0.80 x 1.00 (50 x 50) No Customer order on the Book

Ex1: 0.80 x 0.98 (100 x 10)

Ex2: 0.80 x 0.99 (100 x 10)

Ex3: 0.80 x 1.01 (100 x 50)

The EAM is required to access the full size of all better priced Protected Offers before entering the solicitation order. *Note: a solicitation order cannot be less than 500 contracts.*

EAM sends an ISO to Ex1 to buy 10 @ 0.98

EAM sends an ISO to Ex2 to buy 10 @ 0.99

10 @ .98 executes on Ex1

10 @ .99 executes on Ex2

EAM enters a solicitation order – ISO (all-or-none) on the ISE to buy 500 contracts @ 1.00.
500 @ 1.00 executes on ISE.

If the customer consents to not receiving the benefit of any better prices obtained by ISOs, the EAM does not need to pass the execution of 10 contracts at 0.98 and 10 contracts at 0.99 to the customer. If the EAM does not receive the customer's consent, the EAM would need to give the customer 10 contracts at 0.98 and 10 contracts at 0.99.

5. Can Non-Customer orders be marked ISO?

Yes. The ISO designation should reflect the client category that is sweeping the top of the book. If an EAM enters an ISO on the ISE marked Broker/Dealer and is simultaneously entering ISOs on other exchanges, all the ISOs should be marked Broker/Dealer (or a category similar to what's provided by other exchanges) when accessing away exchanges.