



INTERNATIONAL SECURITIES EXCHANGE®

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June 15, 2007

Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-0609

Re: File No. SR-NASDAQ-2007-04

Dear Ms. Morris:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above-referenced proposal ("Proposal") of the NASDAQ Stock Market LLC ("Nasdaq") to offer a market in listed, standardized options contracts. We limit our comments to two issues: the proposed trading in penny increments through "Price Improving Orders"; and disclosing the identity of firms entering orders through "Attributable Orders."

#### Price Improving Orders

We echo many of the comments we made with respect to the proposed penny auction by the Chicago Board Options Exchange, Incorporated ("CBOE").<sup>1</sup> As we discussed in the CBOE Letter, all options exchanges currently disseminate options quotations in five and 10 cent increments, with the exception of options included in a limited "penny pilot." As with the CBOE, Nasdaq proposes to permit members to enter trading interest in non-penny-pilot options in penny increments, with the exchange "rounding" that trading interest to display quotations in permitted minimum price variations. The major difference between the CBOE and Nasdaq proposals is that the CBOE can append a "flag" to a quotation in five and 10 cent increments to indicate that there is penny trading interest included in that quotation at a superior price, while Nasdaq is not currently proposing such a "flag."

Despite the lack of a "flag," Nasdaq's proposed "Price Improving Orders" suffers from many of the same problems as the CBOE's proposed penny auctions. As with the CBOE proposal, Nasdaq's proposed "Price Improving Orders" will violate the Firm Quote Rule.<sup>2</sup> That rule requires an exchange to collect bids, offers and quotation sizes, from its members, and then make available to vendors the exchange's best bid and offer ("BBO"). In direct contravention of the wording of Rule 602 and the intent behind that rule, Nasdaq will not disseminate its BBO to anyone – not to its members, not to

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<sup>1</sup> Letter dated June 1, 2007, from Michael Simon, Secretary, ISE, to Nancy Morris, Secretary, Commission, regarding file number SR-CBOE-2007-39 ("CBOE Letter"). We hereby incorporate by reference that letter into this comment letter.

<sup>2</sup> Regulation NMS Rule 602 under the Securities Exchange Act of 1934, as amended ("Exchange Act").

quotation vendors, and not to customers. No one will know the actual prices communicated to the exchange, which are the prices at which transactions can take place. This is a direct violation of the Firm Quote Rule, and, when coupled with the CBOE's proposal, foreshadows moves by the other options exchanges to adopt similar orders creating a trading environment in which there will be no way for customers to make intelligent pricing decisions or for broker-dealers to fulfill their best execution obligations – the stated purposes of the Firm Quote Rule.

### Attributable Orders

Nasdaq's "Attributable Order" proposal would allow Nasdaq members to enter orders specifying that their Market Participant ID or "MPID" be displayed to all Nasdaq members, along with the price and size of the order. We fully appreciate that broker-dealers see significant value in displaying such order-origination information. Indeed, our members inform us that identifying the firm entering an order allows them to make judgments on whether trading against such order flow would be profitable. For example, many firms would prefer to trade against orders that a retail firm may enter, but would shy away from trading against more "professionally-oriented" orders, where the person entering the order may have some form of information advantage.

We have had a number of conversations with the Commission staff over the last few years in which we have raised the possibility of the ISE providing its members with similar information. The Commission staff consistently informed us that it would not approve any proposed ISE rule change that allowed us to disseminate the identify of an order-entry firm. The staff recognized that on floor-based exchanges the physical interaction of members often can result in the two parties to a trade knowing each other's identity. However, the staff believed that it would be inappropriate to extend this form of trading to a fully-electronic market in which pre-trade anonymity can be assured. The staff specified that they envisioned this type of information being used to discriminate against particular members, and that they could not justify such order identification under the Exchange Act.<sup>3</sup>

Similarly, the staff expressed concerns that identifying a firm could encourage internalization. In this regard, all exchanges have rules requiring that members establish an informational barrier between the firm's market making activities and certain other firm functions, such as customer order-entry.<sup>4</sup> Among other things, these barriers limit the ability of firms to trade purposely against their own customer order flow. Identifying the entering firm's MPID with its order obviously defeats this critical purpose of the

<sup>3</sup> For example, it is beneficial for a firm to identify itself when facilitating customer order flow since an exchange and its members may want to allow particular members to trade against more than the minimum guaranteed amount of the order. This could encourage the member to send more order flow generally to that exchange. While the Commission staff understood that this may be happening on floor-based exchanges, the staff did not believe that this was a permissible reason to allow attribution of order flow on a fully-electronic market.

<sup>4</sup> See, e.g. ISE Rule 810 and proposed Nasdaq Options Rule Article VII, Section 10.

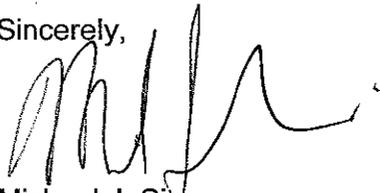
information barrier. Thus, we have never submitted a rule change to permit order identification and we are not aware of the Commission ever approving such a rule.

We believe that "Attributable Orders" actually raise more concerns in Nasdaq's proposed options market than in ours. Nasdaq's is proposing a first-in-first-out ("FIFO") market place, while we offer a "pro rata" market. In the Nasdaq model, it will fill all orders at a particular price in the sequence members entered such orders, regardless of who entered the order. In contrast, we first fill customer orders, after which we fill non-customer orders based primarily on the size of the member's quotation or order, with some preference for our Primary Market Makers. In our market, even if we were to display the identity of the entering firm, there would be no guarantee that a firm could trade against the entire displayed quotation or order. Rather, unless it was a customer order at the inside quote, all non-customers at that quote would share pro rata in the execution. In contrast, Nasdaq's FIFO market, a member seeing its own firm at the top of the book knows that it can execute against – and internalize – 100 percent of the displayed order. Thus, "Attributable Orders" in a FIFO market will foster internalization more so than in a pro rata market.

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Together, the "Price Improving Orders" and "Attributable Orders" run counter to the requirements of the Exchange Act and have the potential to inflict significant harm on investors. We urge the Commission not to approve the Proposal until Nasdaq corrects these two major deficiencies. If you have any questions on our comments, please do not hesitate to call us.

Sincerely,



Michael J. Simon  
Secretary