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June 21, 2010

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

Re: File No. S7-09-10; Regulation NMS Options Amendments

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the Commission's proposed amendments to Regulation NMS regarding access to quotations in the options market, and the fees related to such access.[1] The amendments would prohibit an options exchange from imposing unfairly discriminatory terms limiting access to its quotations. The amendments also would impose a $.30 per contract limit on the access fees that an exchange could charge for trading against its best bid or offer. We fully support these amendments as proposed.

Access to Quotations

Regulation NMS prohibits a national securities exchange or association from imposing unfairly discriminatory terms that prevent or inhibit a person from obtaining efficient access through a member of that exchange to any quotation in an "NMS stock," which currently does not include listed options. The Commission explains that the purpose of this provision in the equity market is "to support indirect access by persons to quotations in NMS stocks through [exchange] members...."[2] The Commission proposes to extend this provision to cover access to quotations in listed options.

In making this proposal, the Commission recognizes that some broker-dealers access an exchange directly through membership, while others "piggy-back" on the direct access of such members. The Commission believes that those accessing an exchange through a member contribute indirectly to the cost of exchange membership through the commissions or other fees they pay to members. As proposed, "any attempt by an options exchange to charge differential fees based solely on the non-member status of a person obtaining indirect access to its quotations would violate [Regulation NMS]."[3] The provision would apply both to disseminated quotations and undisplayed trading interest, such as depth of book and reserve sizes.

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[1] Release No. 61902, April 14, 2010 (75 F.R. 20738, April 20, 2010) (the "Release").
[2] Release at note 45.
[3] Release at text at note 51.

While we agree with the proposal as written, we believe that the provision needs to be applied carefully. In describing the scope of the amendment, the Commission states its preliminarily belief that "an exchange that charges a *non-member broker-dealer* that is registered as an options market maker on another exchange a higher fee than the fee charged to *both member and non-member broker-dealers* that also are not market makers on that exchange for obtaining access to its quotations would violate Rule 610(a), as proposed to be amended."[4] As described, an exchange with such a fee structure would be discriminating against a person solely because that person was not a member of the exchange, a position with which we fully agree.

On the other hand, it would not appear that this heightened anti-discrimination provision would apply to fees that are based on factors other than whether a person is a member of an exchange. For example, ISE has a fee category entitled "Non-ISE Market Maker," defined as "a market maker ... registered in the same options class on another options exchange." However, whether a person falls within this fee category does not depend on whether the person is a member of the ISE. That is, any person that sends an order to the ISE as a Non-ISE Market Maker, whether or not that person is an ISE member (and many "away" market makers also are ISE market makers), is subject to this fee. Such a fee is reasonable and appears not be subject to this rule amendment.

Market makers form the heart of quotation-driven exchanges such as the ISE, and are subject to significant obligations to provide liquidity to customers and other market participants.[5] Market makers on other exchanges have obligations to provide liquidity on those exchanges and access competing markets to limit or lay off risk. It is reasonable for exchanges to have the flexibility to charge such market makers a premium for such access, as long as the differentiation is not based on whether or not the market maker happens also to be a member of the "home" exchange. Since ISE has not structured its Non-ISE Market Maker fee in that discriminatory manner, it is not – and should not be – subject to this proposed rule amendment.

Access Fees

The Commission proposes a $.30 per contract limit on the cumulative fees that an exchange could impose to access its displayed bid or offer. The $.30 would be inclusive of any and all fees, including transaction fees, license fees, regulatory fees and certain payment for order flow fees. The Commission explains that this proposal has two purposes: (1) to support price protection in the national market system of options; and (2) to ensure than an exchange's displayed quotation is fair and useful, and reliably represents the all-in prices that actually are available to investors.

We support this proposal and we believe that both stated purposes of this rule change are equally important. The options industry increasingly is moving to quote and to trade in penny increments, with options trading in pennies now representing 77 percent of industry volume. As with equities, that now trade fully in pennies, the various fees that an exchange charges become increasingly important in making routing decisions. For example, some exchanges may not charge at all for certain orders, while

[4] Release at note 51 (emphasis added).
[5] *See* ISE Rules 803 and 804.

other markets can charge $.45 or more for the same orders. With exchanges not permitted to trade through other markets, there needs to be some degree of comparability with quotes at the same stated prices.

Even apart from trade-through concerns, investors and other market participants pay or receive all-in prices, inclusive of any exchange fees. Net prices that vary significantly from the quoted prices effectively are false advertising. It is entirely appropriate for the integrity of the national market system for the Commission to set limits on the degree to which the actual price at which an exchange advertises a security differs from the truly inclusive all-in price.

While any cap is by nature arbitrary, the $.30 limit equates to the cap in the equities markets and appears to be a reasonable starting point. The Commission can always adjust this cap if necessary as it analyzes the effects of the rule on the market. We similarly believe that to be effective any fee cap must be inclusive of all the fees an exchange charges, regardless of how it denominates a fee. Whether an exchange calls a fee a transaction charge, a comparison fee, a license fee, a regulatory fee, or anything else, it is a cost of accessing a quotation, regardless of how the exchange allocates the revenue from the fee. Applying the cap to less than all such charges simply would lead to exchanges changing the name of various fees. The Commission appropriately has included in the cap all fees – and only those fees – that an exchange charges for access to its displayed bid or offer. Below we address specific issues related to the fee cap.

Application of the Fee Cap to All Options Contracts

The proposed fee cap would apply to the trading of all options contracts a national securities exchange trades, including exclusively-listed products. The Commission specifically requests comment on whether this is appropriate or whether the cap should only apply to multiply-listed options. Alternatively, the Commission asks whether the cap should apply differently to singly- and multiply-traded instruments. We believe that a single cap should apply equally to all exchange-traded options.

The Commission provides two stand-alone rationales for the proposed fee cap: to support price protection in a national market system; and to help ensure that an exchange's quotation is fair and useful. While the Chicago Board Options Exchange ("CBOE"), which has actively-traded exclusively-listed products, may argue that the first rationale does not apply to such options, in many respects it does apply. Moreover, the second clearly applies, and even standing alone, requiring that an exchange's quotation be fair and useful is more than enough of a reason to apply the cap to these products.

An exclusively-listed option, by definition, trades on only one exchange. And while traditional national market system price protection concerns may not be applicable for such options, similar pricing issues would arise if the cap excluded these options. Specifically, the most actively-traded exclusive products are very similar to active multiply-traded options. For example, the CBOE's exclusively-traded Standard and Poor's 500 index option ("SPX") is very similar to the options on the Standard and Poor's SDPR Trust ("SPY"), with at least one commentator saying "they are virtually the same options."[6] One is an option on the underlying index, while the other is an option on an exchange-traded fund based on the same index. As investors trade between these instruments and potentially arbitrage their positions there could be significant hidden differences in the costs of these transactions without the comparability of fee structures that a uniform cap would provide.

With respect to fair and useful quotations, when there is no ability to buy or sell an options contract in another market, it is even more compelling that an exchange's quotation fairly disclose the advertised price. Not requiring such disclosure compounds the problems of permitting the trading of options on an exclusive basis, the most significant of which is monopoly pricing.[7] Indeed, the CBOE's fees demonstrate how exchanges can abuse fees for exclusively-traded products, where it charges up to $.50 a contract for certain exclusive index products, more than double the $.20 a contract it charges for competitive products.[8]

Applying the fee cap to monopoly products is closely tied to the question of whether licensing fees should be subject to the limit. As discussed below, we believe that the fee cap must include license fees. The argument against including license fees in the cap is the same as the argument against imposing the cap on monopoly products: that an exchange or other person that develops a unique product should reap a fair return for that development effort.[9] However, again as discussed below, there is more than enough room in a $.30 access fee to permit an exchange to fund its operation and to compensate an index designer for developing a new product.

If an exchange requires greater funding for the development or licensing of new products than the cap allows, the Release makes clear that the exchange may charge any fee it chooses – other than a transaction fee – to fund those products. For example, an exchange can levy a membership fee on market makers who will have exclusive rights to trade these products, or it can assess its members generally. The proposed cap provides sufficiently flexibility for exchanges to develop reasonable non-transaction-related fees for whatever purposes they deem appropriate, including recovering development costs – without sanctioning the dissemination of inaccurate quotations.

[6] "It's SPY vs. SPX in CBOE Battle With Generics," Dow Jones Newswire, April 1, 2010, quoting George Ruhana, Chief Executive Officer of OptionsHouse LLC.

[7] We believe that there are significant policy issues with permitting exchanges to trade index options pursuant to exclusive licenses. *See* petition dated November 1, 2002 from David Krell, President and CEO, ISE, to Jonathan G. Katz, Secretary, Commission, entitled "Request for Rulemaking to Amend Rule 19c-5 Regarding Certain Options Exchange Licensing Arrangements."

[8] In addition to obscuring the true price of trading, monopoly pricing also leads to cross-subsidization, which the Commission has not permitted in other contexts, particularly in prohibiting entities that own and operate two exchanges from subsidizing the pricing on one exchange with fees generated on another exchange. Exchanges that trade both singly- and multiply-listed products in many ways effectively are running two exchanges, subsiding the competitive exchange with the fees from the monopoly exchange.

[9] In this vein, one commentator on the Release also compellingly argues that the Commission's proposed rules govern the public market, and the benefits to the public investor must be paramount to any private agreements between an exchange and a licensor. Comment of Richard Allen, at http://www.sec.gov/comments/s7-09-10/s70910-13.pdf.

Licensing Fees

License fees are no different than other fees an exchange charges to access its displayed bid and offer and must be included for the cap to be effective. While these fees tend to be high, none currently approach the proposed $.30 cap. Further, the stated size of these fees often is misleading since index licensors generally charge one fee for the trading of a contract on a licensed product, while exchanges have the ability to charge two fees on a transaction – one on the buyer and one on the seller. Thus an exchange can split the cost of a license fee between the two parties.

As with monopoly fees charged for exclusive products, to the extent there are development costs that justify fees higher than the proposed cap, an exchange can impose non-transaction fees on its members to support these products. Excluding license fees from the cap also would seriously undermine the effectiveness of the proposal. Regardless of the name used, any fee that permits total access fees to exceed $.30 a contract is directly contrary to the stated purposes of the cap, enhancing intermarket competition and ensuring the accuracy of the stated quotation. In addition, exempting license fees likely would establish a large loophole in the cap. Exchanges trading exclusive products could simply change the structure of their current fees to break out an explicit – and exempt – license fee. To be effective, the cap must be all-inclusive and must include license fees.

Options Regulatory Fee

We agree that the Commission options regulatory fee or "ORF" should be subject to the proposed cap. This fee is no different than any other access fee. However, we request that the Commission clarify exactly how the cap will apply to the ORF. Specifically, multiple exchanges charge an ORF on all trades effected by a member, regardless of the exchange of execution. Although the Release is not explicit on the point, we assume that the cap would cover only the fee imposed by the exchange on which the trade is executed. Fees charged by competing exchanges are out of the control of the executing exchange, and an exchange should not be limited in what it can charge because a competitor has imposed its own fee on the same transaction.

As currently drafted, the proposed rule provides that "a trading center shall not impose, nor permit to be imposed" fees higher than the cap.[10] Since the executing exchange is not imposing a competing exchange's ORF, nor in any way permitting the imposition of that fee, we believe that the proposed rule text is consistent with our understanding. We request that the Commission confirm this reading of the rule.

Payment for Order Flow Fees

The proposed cap generally would not count payment for order flow ("PFOF") fees towards the proposed cap. The only time the cap would include PFOF fees would be if an exchange member trades against a displayed order or quote on the exchange and is charged the PFOF fee on the execution. The Commission requests comment on whether this proposed treatment of PFOF fees is appropriate and also generally

[10] Proposed Rule 610(c).

requests comment on possible caps on PFOF fees. We believe that the treatment of PFOF fees is appropriate as proposed.

The proposed cap is intended to address costs of accessing a displayed bid and offer that are not included in the displayed price. As proposed, the cap properly covers those fees. Exchanges such as the ISE that impose PFOF fees charge those fees to market makers, providing a fund for market makers to use in attracting order flow. With the one exception the Commission notes, these are not fees charged for accessing a quotation. Rather, they are fees a market maker pays when trading against a customer order. Thus, most likely the market maker pays this fee when a customer order trades against its displayed quotation. In that sense it is actually the inverse of an access fee, more of a fee levied on a market maker to provide liquidity on an exchange.

ISE does impose the PFOF fee when a market maker trades against a displayed bid or offer representing customer trading interest, either by sending an order to trade against that bid or offer or when the market maker's quotation hits such bid or offer. In those cases the PFOF fee does become an access fee for the market maker and should be subject to the cap. If the Commission does adopt the fee cap as proposed, the ISE would need to adjust its PFOF fee schedule to recognize this and to stay within the cap.

We see no regulatory reason to cap PFOF fees any further than currently proposed. The two reasons the Release gives for the proposed fee cap – to support price protection and to ensure that an exchange's quotes are accurate – do not apply to non-access PFOF fees. The Release gives no further reasoning as to why a cap on, or further regulation of, such fees is appropriate. Rather, PFOF fees are more like membership or other exchange fees that are a general cost of doing business on an exchange and do not affect the net price an investor pays or receives when traded against a bid or offer disseminated in the national market system. The Commission has not addressed the level of PFOF fees in the equity market under Regulation NMS and we see no reason to address it in the options market.

Flash Orders

Closely tied to the issue of fee caps is the use of "flash orders" by various options exchanges, including the ISE. At the ISE, we use such orders to permit market participants to match another market's quotation as one way to meet our obligation not to trade-through other markets. While the Commission has proposed to ban flash orders across-the-board,[11] we believe that these orders generally are appropriate, and that they serve an especially important function in the listed options market where there are differing fee and market structures among the exchanges.[12]

For example, while ISE does not generally charge for most customer orders in most options classes, our Primary Market Makers ("PMMs") who route orders to exchanges with maker-taker fee models must pay their taker fees when accessing such exchanges on behalf of customer orders they represent. Thus, flash orders provide an

[11] Release No. 60684, September 18, 2009 (74 F.R. 48633, September 23, 2009).
[12] Letter from Michael J. Simon, Secretary, ISE, to Elizabeth Murphy, Secretary, SEC, dated November 23, 2009.

opportunity to execute these orders on the ISE, thus avoiding the away market taker fees. The Commission recognizes the relationship between flash orders and access fees[13] and requests comment on the issue.[14]

Limiting access fees will partially, but not fully, address the need for flash orders in options. As the Commission notes in the Release, pricing differs in the options market, where maker-taker pricing competes with a model in which there are no fees for customer orders.[15] Even with a $.30 per contract fee cap, there will continue to be a strong economic incentive to execute orders on an exchange that receives a customer order and does not charge an access fee, rather than shipping that order to a maker-taker exchange and paying the access fee. This differs from the equity market, where the use of maker-taker pricing is much more prevalent, with relatively slight variations in those fees between markets.

Market makers price options pursuant to algorithmic models, which include many factors, including access fees. Limiting access fees to $.30 a contract will dampen, but not eliminate the effect of access fees in pricing models. Thus, even with the proposed cap, exchanges that do not charge access fees for customer orders will be at a significant disadvantage in competing for, and retaining, order flow when compared to maker-taker exchanges. For these reasons we do not believe that adopting the proposed fee cap lessens the need to retain flash orders in the options market.

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The Commission's proposals simply extend to the options markets certain rules that currently govern trading in the equity market. These rules have worked well in equities, and we believe that, at least with respect to these proposals, there are sufficient similarities between the markets that warrant the extension of these rules to options. We recommend that the Commission adopt this rules as proposed in the Release. We again thank you for the opportunity to provide our comments. If you have any questions on our comments, please do not hesitate to contact me.

Sincerely,

Michael J. Simon
Secretary

Hon. Mary L. Schapiro, Chairman
Hon. Luis A. Aguilar, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Troy A. Paredes, Commissioner
Hon. Elisse B. Walter, Commissioner
Robert Cook, Director, Division of Trading and Markets
James Brigagliano, Deputy Director, Division of Trading and Markets

[13] Release at notes 72-75 and accompanying text.
[14] *Id* at note 158 and accompanying text.
[15] *Id* at notes 27-33 and accompanying text.