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July 11, 2011

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

Re: File No. SR-C2-2011-08

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to respond to the Commission's request for comments on its Order Instituting Proceedings to Determine Whether to Approve or Disapprove the above-referenced Proposal (the "Proposal").[1] In this Proposal, C2 Options Exchange ("C2") seeks approval to trade options ("C2 options") on the Standard & Poor's 500 Index ("S&P 500") that have very minor differences from the options on the S&P 500 ("SPX options") currently traded on the Chicago Board Options Exchange ("CBOE"). We previously filed two comment letters on the Proposal, and we ask that the Commission include those letters as part of the official record of these disapproval proceedings.[2]

We believe that the Proposal is inconsistent with the Securities Exchange Act of 1934 ("Act") and urge the Commission to disapprove the Proposal. In discussing the potential bases for disapproving the Proposal, the Disapproval Release focuses on the concerns of reintroducing the long-discredited P.M. settlement of index options contracts. Below we discuss why this is an appropriate basis for disapproval. However, as detailed in our prior two letters, and as incorporated by reference herein, we continue to believe that additional grounds for disapproving the Proposal are: the purposeful lack of fungibility between the C2 options and the SPX options; investor confusion between the two options; and the lack of position limits.

With respect to P.M. settlement, in the Disapproval Release the Commission first inquires as to the "operation and structure of the markets today in comparison to the operation and structure at the time of the shift to A.M. settlement of cash-settled index options...." The following two questions seek comment on whether current equity market closing procedures provide a vehicle to manage a potential increase in one-sided volume at the close that likely would result from a move to P.M. settlement.

[1] Release No. 34-64599 (June 3, 2011), 76 F.R 33798 (June 9, 2011) (the "Disapproval Release").
[2] Letters from Michael J. Simon, Secretary, ISE, dated March 29, 2011 and May 11, 2011.

The biggest difference in equity market structure between 1987 (the time of the move to A.M. settlement) and the present is the increase in market fragmentation. In 1987 there were only six registered equity exchanges, few dark pools, and the NYSE executed over 86 percent of the volume in its listed securities. No other market had over three percent market share, and the over-the-counter, or "third," market had only a two percent share.[3] In contrast, there are now 13 registered exchanges competing for order flow in NYSE-listed securities, plus a countless number of off-exchange trading vehicles, including dark pools and electronic communication networks that trade and report over-the-counter. In 2010, the NYSE had a market share of only 24 percent, compared to a 33 percent share for the OTC market.[4]

The same dynamic change in market structure has occurred with Nasdaq securities. In 1987 almost all trading in Nasdaq-registered securities was through Nasdaq, as there was little if any trading of over-the-counter securities on exchanges pursuant to unlisted trading privileges. In contrast, Nasdaq today is a registered exchange, and in 2010 it had only a 29 percent market share in its listed securities. As with NYSE-listed securities, a larger portion of such trading was effected over-the-counter (31 percent).[5]

These stark changes in trading patterns present a clear warning against returning to P.M. settlement. When the Commission effectively outlawed P.M. settlement in 1987, even with almost all volume concentrated on one exchange, the markets could not address closing liquidity and volatility concerns and prevent market disruptions on "triple witch" settlement dates. While the greater competition and fragmentation of the equity markets in the last 24 years have produced significant benefits for investors, it also renders it almost impossible for any single market to concentrate liquidity at the close to produce an effective clearing price at times of market volatility.

We recognize that certain equity exchanges have implemented enhanced closing procedures in an attempt to address volatility at the close on their own exchanges.[6] However successful such procedures may be, any such closing mechanism only can apply to the trading on one exchange, which is a small fraction of the overall market. Moreover, unlike the opening of trading, these mechanisms operate during normal trading hours while active trading continues in the underlying market.[7] With markets far more fragmented now than in 1987, these exchange-specific closing auctions will have little ability to dampen overall market volatility.

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[3] http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=128&category=4.
[4] Two other exchanges (Nasdaq and NYSE Arca) had more than 10 percent market share. Financial Information Forum, Market Share Report (December 2010), http://www.fif.com/docs/2010_12_fif_market_share_report.pdf, at 6. The OTC data combine the NYSE and Nasdaq trade-reporting facilities.
[5] *Id* at 8. NYSE Arca had a 13 percent market share in 2010.
[6] *See, e.g*, NYSE Rule 123C.
[7] It is possible that an exchange can be trading in a "pre-opening" session before the regular 9:30 a.m. (Eastern) opening. However, such pre-opening trading is limited and is not subject to the Regulation NMS protections such as intermarket trade-through protection.

In analyzing the effect of fragmentation of the market on equity market liquidity and volatility, we again draw the Commission's attention to the lessons learned from the May 6, 2010 "flash crash." The market conditions discussed in the following quote from the joint report of the Commission and the CFTC on the flash crash, which we included in our first comment letter, is an ominous warning

> In the present environment, where high frequency and algorithmic trading predominate and where exchange competition has essentially eliminated rule-based market maker obligations, liquidity problems are an inherent difficulty that must be addressed. Indeed, even in the absence of extraordinary market events, limit order books can quickly empty and prices can crash simply due to the speed and numbers of orders flowing into the market and due to the ability to instantly cancel orders. Liquidity in a high-speed world is not a given: market design and market structure must ensure that liquidity provisions arises continuously in a highly fragmented, highly interconnected trading environment.[8]

This quote could well describe events in a market that reintroduces P.M. settlement, as the market searches for liquidity in the highly-fragmented market place, with the trading day effectively ending and no additional liquidity available.

The Disapproval Release next anticipates that, if it approves the Proposal, the futures markets may follow C2 and introduce a P.M.-settled futures contract. The Commission asks for commenters' views on the potential impact on the underlying equity markets if that were to happen. We believe that this is a critical issue, but that the Commission's question is too narrow. The more appropriate inquiry should be on the potential effect if multiple exchanges – both futures and options – reintroduce P.M.-settled derivatives into the market. To the extent that other derivative contracts contain many or most of the same underlying instruments as the S&P 500, the demands on liquidity at the close could well recreate the types of liquidity crises the markets experienced in the previous era of P.M.-settlement and echoed during the flash crash.

In this regard, we believe that Commission approval of the Proposal will lead to the reintroduction of multiple P.M.-settled derivatives. Once the Commission approves a P.M. settled S&P 500 index option, competition will force other index providers and exchanges to seek similar instruments, either in addition to or in lieu of A.M.-settled products. Having approved C2's Proposal, it would seem unfair and discriminatory to deny other exchanges similar "pilots." We also anticipate futures exchanges proposing – and receiving approval for – similar futures contracts so that there would be a full suite of similar products for trading and hedging purposes. While one P.M.-settlement pilot is troubling, having multiple pilots operating simultaneously will seriously undermine the industry-wide move to A.M. settlement. With the proven problems of P.M. settlement, the current dispersion of liquidity in equities, and the very recent experience of the flash crash, we see no basis under the Act for moving in this direction.

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[8] Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010; Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, February 18, 2011.

C2 responds to these concerns by stating that it only is proposing a pilot, and if P.M. settlement causes market disruptions, the pilot simply can expire. We disagree, particularly when the adverse effects of a pilot would be market disruption. Moreover, pilots rarely end, and once a product is trading there is significant momentum to continue such trading. This is especially the case when open interest will extend for three years, and cannot be terminated. There also is a subtle change in the burden of proof, with those arguing for the pilot to end effectively having to show harm in continuing trading. In this regard, no matter how severe the market disruptions may be, proponents of this product likely will argue that P.M. settlement did not cause the disruptions. As the flash crash showed, it is not easy to prove causation of market volatility. This is a "pilot" that should never begin.

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We urge the Commission to disapprove the C2 Proposal to list P.M.-settled S&P 500 options. If you have any questions on our comments, or if we can be of further help to the Commission on this matter, please do not hesitate to contact us.

Sincerely,

Michael J. Simon
Secretary

cc: Robert Cook, Director, Division of Trading and Markets
James Brigagliano, Deputy Director, Division of Trading and Markets
Heather Seidel, Associate Director, Division of Trading and Markets