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June 1, 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-CBOE-2007-39

Dear Ms. Norris:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above referenced proposal ("Proposal") of the Chicago Board Options Exchange, Incorporated ("CBOE").[1] The CBOE states that the Proposal would provide "the expanded ability to effect [options] transactions in penny increments...." In reality, the Proposal would allow the CBOE to effect transactions in an opaque, private market operating in a manner inconsistent with the requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We urge the Commission to institute proceedings to disapprove the Proposal.

The issue of penny pricing is hardly new to the options industry. With the exception of 13 underlying securities included in a "penny pilot," all options exchanges currently disseminate options quotations in five and 10 cent increments.[2] Similarly, with the exception of limited "price improvement auctions,"[3] options executions outside of the penny pilot securities also are in five and 10 cent increments. Under the penny pilot, the options exchange quote and trade options on the 13 underlying securities in pennies, with such quotations and trades being fully visible to all investors.[4] The pilot is an initiative "having the potential to enhance further the already strong competition and innovation that exists in the options markets," but effected in a way that introduces penny pricing in a manner that does "not disrupt the fair and orderly operation" of those markets.[5] Thus, the Commission encouraged the penny pilot as a way to test penny pricing in options in a uniform, controlled and transparent manner.

In contrast to the penny pilot, the CBOE is proposing to quote and trade options in pennies in a manner that is not transparent, that encourages internalization, that is not uniform among the exchanges, and that is wholly-inconsistent with the national market

[1] Exchange Act Release No. 55724, (May 8, 2007), 72 F.R. 27156 (May 14, 2007).
[2] *See, e.g.*, ISE Rule 710 and CBOE Rule 6.42
[3] *See* ISE Rule 723 and Chapter V, Section 18 of the Boston Options Exchange rules.
[4] *See, e.g.*, File No. SR-ISE-2006-62, Exchange Act Release No. 55161, (January 24, 2007), 72 F.R. 4752 (February 1, 2007).
[5] Letter from Christopher Cox, Chairman, Commission, to the six options exchanges, dated June 7, 2006.

system provisions of the Exchange Act. Specifically, CBOE market makers and other market participants would be able to enter quotations and orders in penny increments in options not included in the penny pilot. But since there is no ability to disseminate these quotes and orders in penny increments, the CBOE would "round" the limit price to the nearest standard quoting increment inside the limit price. If there is a penny quote or order inside the displayed market, the CBOE could append a "flag" to its disseminated bid or offer to indicate penny interest inside that quotation. The Proposal also would permit oral penny bids and offers in penny increments in response to orders in its "open outcry" floor-based system. Finally, the CBOE would deem penny orders in its system "exposed" for order interaction purposes under its Rule 6.45A, which establishes exposure requirements before firms can internalize their own customer order flow or trade against solicited orders.

The Proposal is inconsistent with both the letter and spirit of the Exchange Act's national market system provisions. Section 11A(c) of the Exchange Act provides that the Commission must adopt rules to "assure the prompt, accurate, reliable, and fair collection, processing, distribution, and publication of information with respect to quotations for, and transactions in" securities, as well as to provide for the "fairness and usefulness of the form and content of such information." This directive forms the basis of the Commission's Firm Quote Rule, now codified in Regulation NMS as Rule 602. Among other things, 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").[6]

The Commission extended the Firm Quote Rule to apply to listed options in 2000.[7] In so doing, the Commission specifically stated that "in testament to the importance of firm quotes in the securities markets, one of the first national market system initiatives implemented by the Commission in the equity markets was the [Firm Quote Rule]."[8] In the footnote to that statement the Commission continued that "the reliability and availability of quotation information are basic components of a national market system and are needed so that broker-dealers are able to make best execution decisions for their customers' orders, and customers are able to make order entry decisions."[9] In expanding the rule to cover options, the Commission concluded that "options investors deserve the same protections as equity investors...."[10]

The CBOE now proposes to make a mockery of the Firm Quote Rule. Its members will provide bids and offers to the exchange in pennies, indicating the specific prices at which they are willing to trade. However, in direct contravention of the wording of Rule 601 and the intent behind that rule, the CBOE will not disseminate that quotation information to anyone – not to its members, not to quotation vendors, and not to

[6] In relevant portion, Regulation NMS Rule 601(b)(8) defines a "bid" or "offer" to mean the price communicated by a member of an exchange to any broker or dealer, or to any customer at which the member is willing to buy or sell a security.
[7] Exchange Act Release No. 43591, (November 17, 2000), 65 F.R. 75439 (December 1, 2000) ("FQR Release").
[8] Id. at 75442.
[9] Id. at note 34.
[10] Id. at 74558.

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.[11] Moreover, if the Commission were to approve this proposal, competitive forces would require us and the other options exchanges to adopt similar rules. All the public would see are indicative quotations and multiple "flags," with no indication as to which market actually has the best price. Under the CBOE's Proposal there will be no way for customers to make intelligent pricing decisions or broker-dealers to fulfill their best execution obligations – the stated purposes of the Firm Quote Rule.

The Proposal also will foster the ability of CBOE members to internalize their order flow without the possibility of real order interaction. Under existing rules, members must first post a customer order and wait for three seconds before they can trade against the order either as principal or with a solicited non-customer order. The purpose of the three second exposure is to provide other market participants with a chance to trade against the order before the member internalizes the execution. However, when a member enters a customer order in penny increments with only the "flag" identifying the penny pricing, the entering member is the only market participant that will know the true price of the order. Thus, only that member can accurately run its pricing model to determine whether it is economically viable to trade against the order. This is hardly a level playing field, and again shows the critical importance of transparency in the market.

We urge the Commission not to approve the Proposal. The appropriate way to address penny pricing in options is through the current penny pilot, not ad hoc exchange proposals that run counter to the letter and spirit of the law. The industry is currently in the midst of the pilot, and we strongly recommend that the Commission consider any expansion of penny quoting only through a thorough review of the experience under that pilot. If you have any questions on our comments, please do not hesitate to call us.

Sincerely,

Michael J. Simon
Secretary

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[11] Contrast the CBOE's proposed "flag" indicating penny interest at a better price to our "solicitation of interest" ("SOI") in the ISE's MidPoint Match equity trading system. (*See* ISE Rule 2104(c)(2).) When the ISE has an undisclosed order to trade at the mid-point of the national best bid and offer, we only disseminate the symbol in which there is an order. In contrast, the CBOE proposes to disseminate both the symbol and the side of the market (bid or offer) of the order. In our discussions with the Commission staff on the SOI, the staff informed us that providing both the symbol and the side of the market would constitute a "quotation" under the Firm Quote Rule, which would require us to display the actual price of the order. Consistent with that interpretation, the CBOE's display of both symbol and side also constitutes a firm quotation and the need to display the price. As the staff explained to us regarding our MidPoint Match, the inability of reporting systems to provide for such a display does not exempt an exchange from the requirements of the Firm Quote Rule.