CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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

RE: File No. SR-ISE-2007-22

Dear Ms. Morris:

The Chicago Board Options Exchange, Incorporated ("CBOE") is submitting these comments in response to the above-noted rule change by the International Securities Exchange ("ISE"), which would permit orders and responses to be entered, and executions received, via its Block, Facilitation and Solicited Order Mechanisms (collectively the "broadcast mechanisms") in sub-penny increments for options series quoted in the penny pilot program. CBOE believes the Commission should not approve the proposal for the reasons discussed below.

The options exchanges generally quote and trade in \$0.05 increments for series trading below \$3 and in \$0.10 increments for series trading at or above \$3. Current exceptions include series that are quoted and traded in \$0.01 increments through the penny pilot program and certain price improvement auctions which do not involve the dissemination of quotes.[1] For its broadcast mechanisms in particular, ISE currently permits its members to submit orders and responses at, and receive executions in, what ISE refers to as a "split price" but in reality is a single increment. For example, \$0.025 increments are available for option series with a \$0.05 standard increment (e.g., \$1.025, \$1.05, \$1.075, etc.) and \$0.05 increments are available for options series with a \$0.10 standard increment (e.g., \$4.05, \$4.10, \$4.15, etc.).[2]

As ISE indicates, when the penny pilot rules were adopted, ISE amended its rules to state that option series with a standard increment of \$0.01 would not be eligible for its half-increment pricing program and, thus, sub-penny pricing was purposefully prohibited by ISE for the penny pilot series. CBOE believes that ISE was correct and that this prohibition against sub-penny pricing was

[1] These price improvement auctions, such as ISE's PIM or CBOE's AIM, generally permit orders and responses to be entered, and executions to be received, in no smaller than a \$0.01 increment.
[2] It is our understanding that ISE recently amended their broadcast mechanism rules to: (i) limit the use of its \$0.025 and \$0.05 "split price" increments to its Facilitation and Solicited Order Mechanisms; and (ii) permit the use of \$0.01 increments through its Block Mechanism. See ISE Rule 7.16.09. However, these changes were not reflected in the instant rule change proposal. Based on the representations made in its proposal, it appears to us that ISE will either not permit the use of its sub-penny increment for its Block Mechanism or will limit its use to only those series participating in the penny pilot program. If ISE's proposal is meant to cover anything else, we would expect to be provided an opportunity for comment given that it would be a material change from the proposal and have competitive implications that we should have the opportunity to address.

appropriate and necessary in order to comport with the design and intent of evaluating the impact of penny pricing through the penny pilot program. A few months into the penny pilot program, however, ISE is now proposing to take the leap from pennies to sub-pennies by making sub-penny increments available in penny pilot series. Specifically, ISE is proposing to permit $0.005 increments for options series with a $0.01 standard increment (e.g., $2.005, $2.01, $2.015, etc.). CBOE does not believe this proposed change is consistent with the penny pilot program. We believe that the Commission and options industry should, at a minimum, have the opportunity to participate in the current *penny* pilot and evaluate the potential costs and benefits associated with options *penny* pricing in the pilot series before any market moves to introduce options *sub-penny* pricing.[3] It is premature for the Commission to permit sub-penny pricing before fully evaluating the impact of penny pricing in options.

ISE's sole basis for is proposal is its claim that sub-penny pricing is needed to compete with the floor-based exchanges' split price priority.[4] However, ISE's rationale is severely flawed in various respects.

- First, ISE does not need sub-penny pricing to accomplish its goal. Similar to floor-based exchanges, executions of large blocks at two prices that are one-cent apart can occur on ISE and effectively provide for an overall half-penny block print. That ISE only supports an electronic-based trading platform while its competitors have floor-based or hybrid markets is irrelevant. Regardless of whether the execution occurs on a physical trading floor or electronic platform, the fact remains that these are separate executions at standard $0.01 increment prices and not a single execution at a half-penny price. Moreover, the orders and quotes from which these executions originate are entered in standard $0.01 increment prices and not a single entry at a half-penny price.

- Second, the "split price" half-increment that ISE is proposing should not be confused with split price priority. "*Split price priority*" generally provides that, if a member purchases (sells) one or more option contracts at a particular price(s), the member shall have priority at the next lower (higher) price in purchasing (selling) up to an equivalent number of contracts

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[3] The issue of sub-penny pricing for NMS stocks was the subject of considerable comment and analysis before the Commission adopted Rule 612 of Regulation NMS, which prohibits a national securities exchange (among other entities) from displaying, ranking, or accepting a bid or offer, an order, or indication of interest in any NMS stock, that is priced smaller than $0.01 per share, unless the price is less than $1.00 per share or an exception applies. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005). By comparison, the options markets have traditionally required options to be quoted in increments no smaller than $0.05 or $0.10. The options markets have only recently permitted price improvement auctions in increments no smaller than $0.01 and penny quoting in a limited number of series via the penny pilot program. However, unlike stocks, options *sub-penny* pricing previously has not existed. As a result, the benefits or problems that could be created by options sub-penny pricing, including its impact on execution priority and market quality, have not been subject to the same comment and analysis as the equities markets. While we recognize there may be some distinctions between sub-penny auctions and sub-penny quoting, we do not believe the analysis of whether to permit options sub-penny pricing in any form should be shortchanged, nor should it frontrun the ongoing analysis of the penny pilot program.

[4] ISE's proposal states that, "we are seeing floor-based exchanges print large blocks at two prices, one-cent apart, effectively providing for a half-penny block print. For competitive reasons, and to allow our members the same pricing flexibility that floor-based exchanges appear to be providing to their members, we propose to extend Split Prices to penny options." See Securities Exchange Act Release No. 55734 (May 10, 2007), 72 FR 27604, 27605 (May 16, 2007).

of the same series, but only if the bid (offer) is promptly made and the purchase (sale) effected represents the opposite side of a transaction with the same order or offer (bid) as the earlier purchase(s) (sale(s)).[5] A member that attempts to assert split price priority has *no* guarantee – the member is at risk that there will not be any balance of the incoming order to trade at the next price level. We believe split price priority is a good thing – it encourages aggressive quoting, which in turn leads to better executions. However, ISE's sub-penny increment proposal is *not* a replication of the split price priority rules and is therefore a misnomer. Rather, ISE is proposing to adopt a new trading increment. ISE's proposal would allow its members to enter orders and responses at a single sub-penny price without taking on the added risk associated with a split price priority scenario. As a result, instead of simply attempting to level the playing field with its competitors, ISE's proposal would go well beyond what is permitted on other options markets. If ISE is really seeking "the same pricing flexibility" that it believes exists on the floor-based exchanges,[6] ISE should allow its broadcast mechanisms to print executions at multiple price levels in the recognized $0.01 increments and, when sufficient size does not exist at the best price, afford split price priority at the next level(s).

- Third, ISE's rules currently provide for split price priority. Specifically, ISE Rule 713(f), Priority on Split Price Transactions, provides that "[i]f a Member purchases (sells) one (1) or more option contracts on a particular series at a particular price, it shall at the next lower (higher) price at which a Non-Customer is bidding (offering), have priority over such Non-Customers in purchasing (selling) up to the equivalent number of options if the purchase (sale) so effected represents the opposite side of a transaction with the same offer (bid) as the earlier purchase (sale)." Given that ISE has already replicated the split price priority concept into its platform and is able to provide the same pricing flexibility to its members that is available on floor-based exchange, we fail to see how ISE is at any competitive disadvantage, much less any compelling reason that would warrant giving ISE a competitive advantage over other markets by permitting them to introduce a sub-penny pricing increment.

For the foregoing reasons, we request that the Commission not approve ISE's proposal to introduce sub-penny pricing through its broadcast mechanisms. If you have questions about our comments or would like to discuss these issues in further detail, please do not hesitate to contact me at 312-786-7462.

Respectfully submitted,

Joanne Moffic-Silver

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[5] See, e.g., CBOE Rule 6.47, Priority on Split-Price Transactions Occurring in Open Outcry.
[6] See note 4, supra.