

August 10, 2012

VIA ELECTRONIC MAIL

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
comments@sec.gov

Re: File No. SR-ISE-2012-22

Dear Ms. Murphy:

Dechert LLP (“**Dechert**”), on behalf of the Index Industry Association (“**IIA**”), welcomes the opportunity to comment on the proposed rule change (the “**ISE Proposal**”) submitted by the International Securities Exchange, LLC (“**ISE**”) to list and trade options on the ISE Max SPY Index (“**Max SPY Index**”) and such options, the “**Max SPY Options**”).¹ The IIA is a new organization, founded in 2012, which was created to advocate for best practices in the index industry. Founded by S&P Dow Jones Indices LLC,² MSCI, Inc., and FTSE Group, and including a growing number of additional members, including Barclays and the NASDAQ OMX Group, Inc., the IIA was created to promote transparency, sound operational practices, intellectual property rights, and effective index investment practices.

This comment letter objects broadly to the ISE Proposal on the grounds that (i) approval of the ISE Proposal prior to the resolution of all claims before the Illinois courts would be premature and (ii) the ISE Proposal does not meet the applicable standard set forth in Section 6(b)(5) of the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”), which requires that the rules of an exchange be designed, among other things, “to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest.”

¹ See Securities Exchange Act Release No. 66614 (March 16, 2012); Securities Act Release No. 67225 (June 20, 2012).

² S&P Dow Jones Indices LLC and Standard & Poor’s Financial Services LLC are subsidiaries of The McGraw-Hill Companies, Inc. (“**McGraw-Hill**”).

The IIA submits this comment letter because it believes that the ISE Proposal involves the misappropriation of the intellectual property rights of one of its members, but also because it is concerned that the Commission's approval of the ISE Proposal could adversely affect the intellectual property rights of all index providers.

Approving the ISE Proposal Prior to the Resolution of Pending Litigation Would Not Protect Investors and the Public Interest

As you are aware, the ISE has been prohibited from trading options on the S&P 500 Composite Stock Price Index (“**S&P 500**”), on the grounds that doing so would be a misappropriation of intellectual property rights held by McGraw-Hill and licensed exclusively to the Chicago Board of Options Exchange (the “**CBOE**”). As an end-run around this prohibition, the ISE now proposes to trade options on an index whose sole component is the SPDR® S&P 500® ETF Trust (“**SPY ETF**”), an exchange-traded fund (“**ETF**”) that tracks the S&P 500.³ This action is a thinly veiled attempt by the ISE to do indirectly what the Illinois state courts have ruled it cannot do directly.⁴ The ISE all but admitted this when it claimed that the Max SPY Options “constitute a real and meaningful threat to CBOE’s monopoly”⁵ on the intellectual property rights it has licensed from McGraw-Hill. While this statement was presumably meant to invoke the Commission’s obligation to ensure that exchange rules “remove impediments to and perfect the mechanism of a free and open market,”⁶ the Commission should not facilitate the misappropriation of intellectual property rights in the name of free and open competition. To do so would neither prevent fraudulent and manipulative acts and practices nor promote just and equitable principles of trade.

We agree that the Commission should not attempt to rule on issues of Illinois state law. However, final resolution of the pending state litigation will determine the legality or illegality of the Max SPY Options under Illinois law. We believe that the Commission should consider this final resolution in determining whether the ISE Proposal meets the standard set forth in Section 6(b)(5). We understand that the ISE has represented that it would not begin trading the Max SPY

³ As a result, a “Motion to Enforce Permanent Injunction” filed against ISE to enjoin trading of the Max SPY Options (the “**Motion**”) is pending in Illinois state court.

⁴ This assertion is further strengthened by the fact that, as will be discussed in greater detail below, the settlement price for an option on the Max SPY Index is based not on the market value of the component ETF, but on the values of the underlying holdings of the ETF, *i.e.*, the components of the S&P 500.

⁵ See letter to Elizabeth M. Murphy, Secretary, Commission, from Michael J. Simon, Secretary and General Counsel, ISE, dated May 4, 2012 (“**ISE Response Letter I**”) at 2.

⁶ Exchange Act Section 6(a)(5).

Options unless and until the Motion has been resolved in the ISE's favor.⁷ However, even if the Motion is denied, any such decision may be appealed, and the ISE's representation would not preclude it from listing the Max SPY Options pending the resolution of any such appeal. Under this scenario, if the ISE begins trading the Max SPY Options and the pending litigation is subsequently resolved against the ISE, investors could find themselves with open positions that cannot lawfully be closed.

The ISE represents that if such a situation arose, it would seek to have the Illinois court permit it to continue to offer a market for closing-only transactions for so long as it takes all open interests to be wound down in an orderly manner. The ISE further states that it "is inconceivable that the Court would refuse to permit such a closing-only market."⁸ The ISE is not in a position to foresee the actions of an independent judicial body, and the Commission should not be asked to rely on speculation regarding such actions to avoid a market disruption caused by unlawful trading. Even if such a closing-only market were permitted, such a liquidation process could potentially have an adverse effect on other S&P 500-linked products, not just the Max SPY Options.

In addition, an approval of the ISE Proposal would likely encourage additional rule proposals similar to the ISE Proposal involving other index products. Such a result would implicate the intellectual property rights of other index providers, and could create a situation where trading is permitted in a variety of instruments of questionable legality. If the Illinois court ultimately found trading in the Max SPY Options unlawful (and, by extension, trading in options similar to the Max SPY Options), such a scenario would create significant market disruptions over and above those caused by halting trades in the Max SPY Options.

Given the uncertainty surrounding the legality of the Max SPY Options, any approval of the ISE Proposal prior to a final resolution of all claims would be premature. Moreover, we respectfully submit that, in light of the Commission's limited resources, a more efficient approach would be to wait until all open questions of state law have been fully resolved. If after such time it has been determined that trading the Max SPY Options would not violate Illinois state law, the Commission could then turn to an evaluation of whether the ISE Proposal meets the standard set forth in Section 6(b)(5) of the Exchange Act.

⁷ See ISE Response Letter I, *supra* note 5, at 4; letter to Elizabeth M. Murphy, Secretary, Commission, from Michael J. Simon, Secretary and General Counsel, ISE, dated June 15, 2012 ("**ISE Response Letter II**") at 4.

⁸ ISE Response Letter II, *supra* note 7, at 4.

ISE's Proposed Calculation Methodology is Unusual and Potentially Misleading to Investors

The formula used for the settlement value of a Max SPY Option is the sum of prices times numbers of shares of the underlying portfolio holdings of the SPY ETF (i.e., the S&P 500 constituents), plus a cash component less certain specified fees. This is essentially the calculation of the value of a portfolio of approximately 500 constituents. Setting aside the cash and fee components, if one were to think of the Max SPY Index in terms of this formula, then the natural conclusion would be that the Max SPY Index has 500 constituents, not one constituent, and an investor could interpret the Max SPY Index as essentially an ISE version of the S&P 500 Index. The cash component is meant to represent the accrued dividends that are owed to shareholders since the time of the last distribution by the SPY ETF.

In standard index methodology, index values are calculated either as "total return indexes" or as "price return indexes." In total return indexes, dividends are assumed to be reinvested immediately into the index constituents themselves (not accrued as cash), and the index value reflects that assumption. The index value using the Max SPY Index settlement formula does not reflect this assumption, because dividends are accrued as cash and then assumed to be paid out periodically. In price return indexes, dividends are assumed to be paid out of the index portfolio immediately (on the ex-dividend dates), and the index value reflects that assumption. The index value using the Max SPY Index settlement formula does not reflect this assumption, because dividends are accrued as cash and are assumed to be held before being paid out. Therefore, if one were to think of the value of the Max SPY Index as being calculated using the settlement formula, the Max SPY Index is neither an industry-standard total return index nor an industry-standard price return index.

Furthermore, standard industry practice would be to calculate an index value based on the market values of the constituent(s) of the index. In the case of the Max SPY Index, this would be the market value of its sole constituent, the SPY ETF.⁹ The Max SPY Index purports to do exactly that. However, the settlement value of a Max SPY Option is not based on the traded price of the SPY ETF shares. Instead, the settlement value is based on an additional formula which takes into account the market values of the underlying portfolio holdings of the component security (i.e., the constituents of the S&P 500) in order to calculate the net asset value ("NAV") of the SPY ETF, and is not based on the traded price, which may differ from NAV. This is a non-standard way of

⁹ By "market value" we are referring to the price at which the SPY ETF trades, not its net asset value.

constructing and valuing an index and results in the Max SPY Index value being defined in different ways at different times in the trading and settlement process.¹⁰

The ISE has asserted that it “believe[s] that investors will know and understand what it is they are buying – options on the ISE Max SPY™ Index.”¹¹ While investors may understand that they are buying options, we question whether the average investor will know and understand the ISE Max SPY Index. If an ISE Max Option were to settle in shares of its single underlying component, then interpreting the Max SPY Index as a single-component index would be a reasonable interpretation. However, ISE Max Options settle in cash based on a formula that calculates the constituent ETF’s NAV based on ISE’s independent calculation of the values of its underlying holdings. This could lead investors to view a Max SPY Option as essentially an option on the S&P 500 (as the value of the option is calculated by reference to the components of the S&P 500 rather than by reference to the trading value of the constituent security) rather than an option on a single-component index or, at the very least, a device to facilitate options on the S&P 500. In light of the calculation methodology, we believe that the marketing and operation of ISE Max Options are likely to lead to investor confusion.

Conclusion

This comment letter respectfully submits that (i) approval of the ISE Proposal prior to the resolution of all claims before the Illinois courts is premature, and (ii) the ISE Proposal does not meet the standard set forth in Section 6(b)(5) of the Exchange Act. The ISE Proposal, far from preventing fraudulent and manipulative acts and practices, would affirmatively facilitate such practices by allowing the ISE to provide investors with a product that for all intents and purposes functions as an option on the S&P 500. Approving the ISE Proposal would also be inconsistent with the protection of investors and the public interest. Allowing the ISE to list and trade the ISE Max Options could potentially result in investors holding open positions in an unlawfully traded instrument, and the ISE’s proposed calculation methodology is outside standard market practice and potentially confusing to investors. Finally, an approval of the ISE Proposal would likely encourage similar proposals with respect to other index products, which could adversely affect the intellectual property rights of other index providers.

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¹⁰ See ISE Response Letter I, *supra* note 5, at 3 (“The rule filing makes clear that the ISE Max SPY™ Index is calculated based on the traded prices of [the SPY ETF] shares, and that settlement of the options are settled on the basis of a calculation of the [NAV] of the SPY ETF trust’s assets.”)

¹¹ ISE Response Letter II, *supra* note 7, at 2.

Thank you for considering our views on this proposal. If you have any questions or if we can provide any additional information that may assist the Commission and its Staff, please contact John O'Hanlon at 617.728.7111 or john.ohanlon@dechert.com or Michelle Peters at 617.654.8617 or michelle.peters@dechert.com.

Respectfully submitted,

/s/ John V. O'Hanlon

John V. O'Hanlon