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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:

Chicago Board Options Exchange, Incorporated ("CBOE") hereby comments on the proposed rule change of International Securities Exchange, LLC ("ISE") rule filing number SR-ISE-2012-22[1] (the "ISE Proposal") and replies to ISE's letter dated May 4, 2012 (the "ISE Response") that responded to CBOE's original comments on the ISE Proposal (the "CBOE Letter").[2]

Overview

ISE has failed to address satisfactorily the issues raised in the CBOE Letter. The most fundamental regulatory problem is that the ISE Proposal misleads investors about the nature of the Proposed Options, and it therefore would be inconsistent with the Securities Exchange Act of 1934 ("Exchange Act") to approve the proposal. First, ISE claims that the Proposed Options would be options on the so-called ISE Max SPY Index, but the Proposed Options in no way would be options on that index, but rather would be options on the S&P 500 index. Second, the ISE Proposal fundamentally misleads investors about how ISE would calculate the settlement value of the Proposed Options. ISE asserts that the settlement value of the Proposed Options would be calculated based on its calculation of the net asset value ("NAV") of the underlying exchange-traded fund ("ETF") trust. However, the ISE Proposal identifies no inputs into its settlement value calculation other than the weighted values of the component stocks in the S&P 500 index. Third, if the Proposed Options somehow could be considered options on the ISE Max SPY Index, it would be misleading to call them "index options," much less broad-based index options, because there would be only one underlying security.

[1] See Securities Exchange Act Release No. 66614 (March 16, 2012), 77 FR 16883 (March 22, 2012) (noticing SR-ISE-2012-22).

[2] Letter from Edward T. Tilly, President and Chief Operating Officer, CBOE, dated April 13, 2012. CBOE uses the same defined terms here that were used in the CBOE Letter.

It is Misleading for ISE to Characterize the Proposed Options as Options on the ISE Max SPY Index

It is a bedrock principle that a proposed rule – including a rule governing a new product – should not be approved if it is not adequately and accurately described in the rule filing.[3] Even more fundamentally, it is inconsistent with the Exchange Act to approve a rule change that misleads investors. As demonstrated in the CBOE Letter, the ISE Proposal is misleading in at least three critical respects.

First, CBOE demonstrated in the CBOE Letter that the ISE Proposal misleads investors by falsely characterizing the Proposed Options as options on the ISE Max SPY Index. ISE's characterization is simply not true. ISE has admitted that the Proposed Options would *not* settle based on the value of its so-called ISE Max SPY Index. In particular, ISE concedes that, although the ISE Max SPY Index "is calculated based on the traded prices of SPDR S&P 500 ETF Trust ('SPY ETF') shares," ISE "is clearly not taking the closing price of the SPY ETF and multiplying that by ten" in calculating the settlement value of the Proposed Options. ISE Response, p. 4. Moreover, ISE fails to set forth any way in which the settlement value for the Proposed Options would have *any* relation to the ISE Max SPY Index. ISE thereby admits that the Proposed Options in no respect would be options on the ISE Max SPY Index, notwithstanding what ISE misleadingly labels them.

ISE observes that the "concept of utilizing a reference price to settle an index option product that differs from the value of the proposed benchmark is not novel," and ISE references the Special Opening Quotation ("SOQ") by which the settlement value of CBOE's a.m.-settled SPX options is determined. ISE Response, pp. 4-5. However, ISE proposes something radically different than the SOQ that CBOE uses as the benchmark for settling SPX options. That SOQ represents a modified calculation of the same interest that underlies the SPX options during their life – namely, the S&P 500 index. In contrast, ISE would use an entirely *different* underlying benchmark to calculate the settlement value of its Proposed Options. The announced benchmark during the life of the Proposed Options would be the ISE Max SPY Index, but the benchmark value of the Proposed Options at *settlement* would be a recalculated S&P 500 index. In particular, ISE would use both the closing prices of the exact stocks that S&P has selected for the S&P 500 index and S&P's proprietary weightings of those stock prices. *See* ISE Proposal, p. 13 (the settlement value would use the "securities that comprise the S&P 500®"); *see also id.*, pp. 3-4 (component stocks would be identical to the weighting of those same stocks in the S&P 500 index); *see also id.*, p. 6 (that ISE would use those proprietary weightings and adjustments in

[3] *See e.g.,* Order Instituting Proceedings to Determine Whether to Disapprove Proposed Rule Changes, as Modified by Amendments No. 1, Adopting NYSE Rule 107C to Establish a Retail Liquidity Program for NYSE-Listed Securities on a Pilot Basis Until 12 months From Implementation Date, Which Shall Occur No Later Than 90 Days After Approval, If Granted and Adopting NYSE Amex Rule 107C to Establish a Retail Liquidity Program for NYSE Amex Equities Traded Securities on a Pilot Basis Until 12 months From Implementation Date, Which Shall Occur No Later Than 90 Days After Approval, If Granted (instituting disapproval proceedings because of a failure to "describe with precision" the attributes of the mechanism that was the subject of the rule filing), *available at* http://www.sec.gov/rules/sro/nyse/2012/34-66346.pdf.

calculating the "total value" of the S&P 500 component securities and in calculating the settlement value of its Proposed Options). In other words, ISE would use one underlying benchmark during the life of the option (the ISE Max SPY Index) and an entirely different underlying benchmark at settlement (the S&P 500 index).

An obvious question is: having created a so-called "index" based on 10 times the published value of the SPY ETF, why would ISE not base the settlement of its Proposed Options on that same value? ISE explains that it would be easier to manipulate "the closing price of one ETF" than the "closing prices of 500 individual stocks." ISE Response, p. 5. That explanation rings hollow, because the SPY ETF is one of the most actively traded securities in the investing world. The true reason is that ISE wants to replicate European-style, p.m. settled S&P 500 index options through subterfuge. It does so by divorcing its Proposed Options from all connection to the ISE Max SPY Index value at the most important time – *i.e.*, settlement – and by instead calculating the settlement value on the "closing prices of [the] 500 individual stocks" in the S&P 500 index.

In describing the Proposed Options as options on the ISE Max SPY Index, ISE would fundamentally mislead investors about the true nature of this product, rendering that proposal inconsistent with the requirements of Section 6(b)(5) of the Exchange Act. ISE should not be allowed to bait and switch investors, by misleading them about what the Proposed Options would represent.

The ISE Proposal Misleads Investors About How the Settlement Value Would Be Calculated

The ISE Proposal also misleads investors about how ISE would calculate the settlement value of the Proposed Options. ISE claims that the ISE Proposal "makes clear . . . that settlement of the [Proposed Options] are settled on the basis of a calculation of the net asset value . . . of the SPY ETF trust's assets." ISE Response, p. 3. In no respect can ISE legitimately claim that the ISE Proposal "makes clear" anything of the sort. Instead, the only "assets" of the Trust that the ISE Proposal actually identifies as being included in that calculation are the share prices of the 500 stocks in the S&P 500 index, as weighted according to S&P's proprietary methodology.

ISE tries to create the impression that it would consider other factors, but a close reading of the ISE Proposal and the ISE Response reveals that ISE never actually states that it would consider any factors other than the weighted closing prices of the S&P 500 component securities. In particular, ISE states that the NAV calculation of an ETF "generally" is determined by "adding the trust's net cash (accrued dividends minus accrued fees and expenses)" to the value of the portfolio securities. *See* ISE Response, p. 6. ISE thereby *implies* that it would do so as well when computing the settlement value of its Proposed Options. However, ISE is careful never to actually state – either in the ISE Proposal or the ISE Response – that it *would* use dividends and Trust expenses when calculating the settlement value of the Proposed Options.

In fact, it appears that ISE would not be *able* to include those traditional NAV factors in its calculation. ISE states that it would need to calculate and send to The Options Clearing Corporation ("OCC") the settlement value of the Proposed Options during the evening of

settlement, and that the official published SPY ETF value "might not be available in time." ISE Response, pp. 5-6. ISE does not state affirmatively, either in the ISE Proposal or in the ISE Response, that information on the dividends and expenses of the SPY ETF would be available "in time" on the evening of settlement. Because the Trust disseminates information about the SPY ETF's net cash at the same time as the information about the value of its stock holdings – information that ISE acknowledges is not "in time" for its purposes – it is highly doubtful that available information about the net cash in the SPY ETF would be sufficiently timely for ISE to include it in ISE's calculation of the settlement value of the Proposed Options.

The ISE Proposal must be judged by what ISE actually states in its rule filing. If ISE intended to include some factor for the net cash of the SPY ETF, it should have said so in the ISE Proposal and should have explained how it could obtain that information "in time" for OCC's settlement deadline.[4] To date, ISE has implied that it would include such inputs, without ever actually committing to do so. ISE's claim that the settlement value of the Proposed Options would be based on the NAV of the SPY ETF is therefore misleading, at best.

Other aspects of ISE settlement value methodology are misleading as well. ISE acknowledges that its calculation "may be different from the NAV published by the trustee of the Trust" (*see* ISE Proposal, p. 6, n. 5), yet ISE fails to explain those differences. For instance, the ISE Proposal failed to explain the significance of ISE's announced intention to use data from the "primary market" for the closing prices of the component stocks of the S&P 500 index, given that the SPY ETF prospectus requires the same source to be used. *See* ISE Response, p. 6. The ISE Response provides no further explanation about how ISE's approach on this point "may be different" from the trustee's approach and why such difference is consistent with the Exchange Act. Without such an explanation, the ISE Proposal is misleading in its description of how the settlement value of the Proposed Options would be calculated, and is therefore inconsistent with the requirements of Section 6(b)(5) of the Exchange Act.

<u>The ISE Proposal Is Misleading By Characterizing the Proposed Options as Index Options</u>

The ISE Proposal also misleads investors by characterizing the Proposed Options as a type of "index option," and indeed as a form of broad-based index options, when the ISE Max SPY Index actually consists of only a single component security. If investors were to rely on ISE's fiction that these are options on the ISE Max SPY Index, then they should be informed that there is only one component security underlying that index – *i.e.*, the SPY ETF. For the reasons stated in the CBOE Letter, it is misleading to characterize the Proposed Options as options on an "index," much less on a broad-based index. *See* CBOE Letter, p. 5.

In response, ISE relies on CBOE Rule 24.2(d), because it defines a Micro Narrow-Based security index as consisting of "nine or fewer component securities." ISE Response, p. 7. ISE apparently contends that, because one component security is arithmetically "fewer" than nine

[4] Even if dividends and Trust expenses were considered, the essential character of the Proposed Options as being options on the S&P 500 index would be unchanged.

securities, Rule 24.2(d) must contemplate a security index consisting of only a single component stock. ISE is simply wrong, because a Micro Narrow-Based security index must include at least two securities. In particular, Rule 24.2(d) incorporates the definition of a narrow-based security index from the Commodity Futures Modernization Act of 2000 ("CFMA")[5] into CBOE's listing standards for options on a Micro Narrow-Based security index.[6] Those listing standards were derived from the Commission's Staff Legal Bulletin No. 15[7] (the "Division Bulletin"). In the Division Bulletin, the Commission repeatedly stated that Narrow-Based Indexes (known as Micro Narrow-Based security indexes in CBOE Rule 24.2(d)) are composed of at least "two or more securities." *See* Division Bulletin, §§III.A, IV.A and IV.B. Because CBOE's Micro Narrow-Based security index options were based on these same principles, the Micro Narrow-Based security indexes contemplated by CBOE Rule 24.2(d) similarly may consist of no fewer than two securities and no more than nine securities.

In fact, the Exchange Act uses the "9 or fewer" language in a way that demonstrates that a security index cannot consist of a single security. Section 3(a)(55)(A) of the Exchange Act defines the term "security future," in part, as a contract of sale for future delivery of either "a single security" or "a narrow-based security index." Section 3(a)(55)(B) of the Exchange Act in turn defines the term "narrow-based security index" in terms almost identical to the terms of CBOE Rule 24.2(d) – *e.g.*, as, among other things, constituting "an index" that has "9 or fewer securities." Because Section 3(a)(55)(A) recognizes a distinction between a "narrow-based security index" and a "single security," it is clear that Congress did not conceive that a "narrow-based security index" could be based on a single security. Rule 24.2(d) should not be read to have a different meaning than the provision of the Exchange Act on which it is based.

Moreover, ISE's argument about Rule 24.2(d) is circular. Rule 24.2(d) applies only to an underlying benchmark that itself "*is a security index*," and the rule calls for an assessment of various additional criteria, such as the "9 or fewer" test, only in applying those criteria to *a security index*. It is circular to use the "9 or fewer" test to answer the threshold question of whether the vehicle even constitutes a "security index" in the first place. CBOE never has claimed a right under Rule 24.2(d) to trade options on a "security index" comprising a single component security, and security index options have never traded on a single component security. Accordingly, CBOE's Rule 24.2(d) provides no support for ISE's position.

In arguing that security index options may be traded on a security index consisting of a single component security, ISE's only other precedent is CBOE's now-delisted interest rate options contracts, such as the TNX option. The TNX option was based on a reference value calculated as a multiple of the spot yield of the most recently auctioned 10-year Treasury note.

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[5] Section 201 of the CFMA; 15 U.S.C. 78c(a)(55)(B).

[6] CBOE used the term "Micro-Narrow Based" to distinguish this classification of narrow-based indexes from the already existing "narrow-based index" definition under CBOE Rule 24.2(b).

[7] Listing Standards for Trading Security Futures Products (September 5, 2001) ("Division Bulletin"), *available at* http://www.sec.gov/interps/legal/mrslb15.htm.

The term "index" was used in referring to the reference value for the TNX in a manner distinct from the meaning of a "security index." In connection with TNX, the term meant a number or a reference point, in the same sense that the word "index" is used in the term "consumer price index."[8] TNX options were not security index options, but instead were interest rate options based on interest rate values that were "indexed" to make the options contracts a suitable size. TNX options were regulated as interest rate options and were described for all purposes as interest rate options. TNX options have no relevance to the issue for which ISE attempts to invoke them – namely, whether a *security index* may have a single component security.

For these reasons, it would be misleading for ISE to characterize the Proposed Options as index options, much less as broad-based index options. The ISE Proposal therefore is inconsistent with the requirements of Section 6(b)(5) of the Exchange Act and should be disapproved.

Moreover, allowing options to trade on a security index comprised of a single component would implicate potentially far-reaching regulatory considerations under the Exchange Act. If the concept of a "security index option" is that elastic, then options on a single equity stock could just as easily be traded as a security index option, through the fiction of creating a reference point to that single stock's prices. That has never before been contemplated, and should not be permitted – at least without deep regulatory examination of the implications of that development.

<u>The Proposed Options Violate An Existing Injunction and Should Be Disapproved</u>

In its original comments on the ISE Proposal, CBOE demonstrated that the Proposed Options are options on the S&P 500 index and that ISE therefore would violate the Injunction by offering a market for those options.[9] The Illinois Appellate Court affirmed the entry of the Injunction on May 25, 2012. In response to the CBOE Letter, ISE argued that the Injunction only prohibits ISE from multiply listing options under the specific "SPX" designation by which CBOE offers trading in S&P 500 index options. ISE Response, p. 2. ISE's argument mischaracterizes the Injunction, which actually prohibits ISE from providing a market in "S&P 500 index options." *See* Injunction (attached as Ex. 1 to Attachment 1 of the CBOE Letter), p. 16. The Injunction therefore applies to any option on the S&P 500 index, and ISE cannot evade that mandate by the simple expedient of calling its S&P 500 index options by another name.

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[8] In discussing index-linked securities, the Options Disclosure Document ("ODD") underscores the distinct meaning of "index" in the context of a security index. The ODD describes index-linked securities as providing a cash return based on the performance of a "reference asset." The ODD then specifically notes that the term "index" in the context of an "index-linked security" is synonymous with the term "reference asset" and has a "broader meaning" than that set forth in the ODD's description of "security indexes." *See* May 2010 Supplement to the Options Disclosure Document, pp 1-2.

[9] The ISE Proposal itself violates the Injunction because the Injunction prohibits ISE from listing options on the S&P 500 Index and the submission and notification of the ISE Proposal commences the process of listing such options.

Proof that the Proposed Options are S&P 500 index options comes both from ISE's admission and from its own description of how the Proposed Options would settle. ISE acknowledged in its Proposal that the Proposed Options "would provide additional opportunities to trade S&P 500® options with a p.m.-settlement feature in an exchange environment."[10] This was a clear admission that the Proposed Options would constitute "S&P 500® options with a p.m.-settlement." Forced to contend with its admission about the true nature of the Proposed Options, ISE dismissed the statement as "erroneous" and amended the ISE Proposal to scrub out the revealing admission.[11] This amendment is too convenient and comes too late to obscure the truth that the original language revealed – that the Proposed Options are poorly disguised S&P 500 index options.

The true character of ISE's Proposed Options is revealed not only by ISE's admission, but also by ISE's description of how the Proposed Options would settle. As demonstrated above, ISE would determine the settlement value of those options by calculating the closing value of the S&P 500 index at settlement, using both the closing prices of the exact stocks that S&P has selected for the S&P 500 index and S&P's proprietary weightings of those stock prices. In other words, in direct violation of the Injunction, ISE plans to list and trade Proposed Options that would settle against the closing value of the S&P 500 index and that therefore by definition would constitute S&P 500 index options. The Proposed Options should be disapproved because the Commission should not approve a product under the Exchange Act that could not legally be traded.

Furthermore, the existence of the Injunction means that the ISE Proposal is inconsistent with the requirements of Section 6(b)(5) of the Exchange Act, including because the ISE Proposal fails to protect investors and the public interest. Specifically, if the Proposed Options were approved, began trading, generated open interest and were then found to violate the Injunction, significant market disruption would result and investors would be left with no readily available means to trade out of or exercise their positions. By exposing investors to these undisclosed risks, the ISE Proposal fails to protect investors or the public interest, and is therefore inconsistent with the requirements of the Exchange Act.

The Commission's Consideration of the ISE Proposal Should Not Override State Court Proceedings

For the reasons set forth in the CBOE Letter and in this reply, the Commission should disapprove the ISE Proposal. CBOE established in the CBOE Letter that, because of the potential market disruption and harm to investors discussed above, the Commission at least should not act to approve the ISE Proposal until litigation over the Proposed Options has been concluded. *See* CBOE Letter, p. 2. In response, ISE volunteered not to commence trading on the Proposed Options "prior to the Illinois state court ruling" on the motion to enforce the

[10] 77 FR at 16888; also SR-ISE-2012-22, p. 15.

[11] SR-ISE-2012-22, amendment 1.

Injunction. ISE Response, p. 4. This should not satisfy the Commission. The lower court ruling on the motion to enforce may not be the end of the litigation over whether the Proposed Options may be validly traded under state law. The Commission should condition any approval of the ISE Proposal on ISE undertaking not to commence trading until all judicial challenges to the lawfulness of the Proposed Options under state law have been finally resolved.

In the CBOE Letter, CBOE further asked the Commission, if it were to approve the ISE Proposal pursuant to federal law, to expressly acknowledge the Illinois state court's "full and independent authority to resolve the issues that arise under state law." CBOE Letter, p. 2. In support of this approach, CBOE cited to the precedent of the Commission's action on CBOE's rule filing regarding CBOE exercise rights.[12] In response, ISE cited to the SEC's same order and reached the conclusion that the "Commission should approve ISE's rule filing without regard to the Illinois proceedings." ISE Response, p. 3. ISE misses the point of the Commission's exercise right order. In that order, the Commission explicitly stated that the state court remained free to "determine and apply the relevant state law in its normal fashion," notwithstanding the Commission's approval of CBOE's proposed rule change.[13] CBOE asks for a similar statement should the Commission choose to approve the ISE Proposal, and the Commission's approval order on the exercise right filing is precedent for that approach.

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The ISE Response does not answer the concerns that CBOE identified in its original comment letter. CBOE continues strongly to urge the Commission to disapprove the ISE Proposal. At a minimum, the ISE Proposal should be revised to address the issues that CBOE has identified. Furthermore, the Commission should exercise restraint and not take any action to approve ISE's proposed rule change until litigation over the Proposed Options has been concluded, unless ISE formally commits to voluntarily observe such a limitation.

[12] *See* CBOE Letter, p. 2, n. 5, *citing* Securities Exchange Act Release No. 57159 (January 15, 2008), 73 FR 3769 (January 22, 2008).

[13] Securities Exchange Act Release No. 57159 (January 15, 2008), 73 FR 3769 (January 22, 2008), p. 3783.

CBOE appreciates the opportunity to provide these comments. Should you require any further information, please contact the undersigned at (312) 786-7088 or Jenny Klebes, Senior Attorney, at (312) 786-7466.

Sincerely,

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