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June 23, 2009

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

Re: File No. SR-NYSEArca-2009-44

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above-referenced filing in which NYSE Arca, LLC ("NYSE Arca") proposes to extend and expand the Penny Pilot Program (the "Pilot"), currently scheduled to expire on July 3, 2009 (the "NYSE Arca Proposal").[1] While the Pilot is operating under uniform rules adopted by each of the seven options exchanges, the Commission has received three different proposals for the extension of the Pilot, from: NYSE Arca, the Chicago Board Options Exchange ("CBOE") and the ISE.[2]

We believe that adopting a uniform approach is necessary to assure that there is a fair and orderly national market system. Thus, the Commission must analyze these proposals in light of the requirements of the Securities Exchange Act of 1934 ("Exchange Act") and consider the costs and benefits of each proposal. The Commission then must choose the one that maximizes benefits to investors while minimizing negative effects on market quality and the dissemination of pricing information. For the reasons discussed below, we urge the Commission to reject the NYSE Arca and CBOE Proposals and to choose the ISE approach, which we believe will better serve investors and the national market system ("NMS").

Introduction

In January 2007, the options exchanges implemented the Pilot, in which the minimum price variation for quotes in all but one options class in the Pilot is: $0.01 for all quotations in option series that are quoted at less than $3 per contract; and $0.05 for all quotations in options series that are quoted at $3 per

[1] Securities Exchange Act Release No. 59944 (May 20, 2009), 74 FR 25294 (May 27, 2009).
[2] *See* Securities Exchange Act Release No. 60018 (June 1, 2009), 74 FR 27211 (June 8, 2009) ("CBOE Proposal") and File No. ISE-2009-32 ("ISE Proposal").

contract or greater.[3] Under the NYSE Arca Proposal, the current pilot would be extended through December 31, 2010, and would be expanded to include an additional 300 options classes. The NYSE Arca Proposal also designates two additional options classes that would be quoted in $0.01 increments for all series.[4]

The Pilot began with 13 classes, and has been gradually increased to the current level of 58 classes. To date, the Pilot has expanded in a controlled manner, with the Commission staff talking to the options exchanges and determining how to increase the parameters of the Pilot. Upon so doing, the staff has requested the options exchanges to file uniform pilot rules. However, before the Commission staff established parameters for extending the current Pilot, NYSE Arca filed its Proposal. The NYSE Arca Proposal represents the views of the fourth largest market, representing less than 11 percent of industry volume year-to-date.

Following NYSE Arca's unilateral filing, the CBOE and ISE, the two largest exchanges with a combined market share of over 60 percent, each filed similar proposals. Each proposes modifying the pilot so that pilot options with a premium under $1 would be traded in $0.01 increments. Under the CBOE proposal, all pilot options with a premium at or above $1 would trade in $0.05 increments, whereas the ISE believes that there should be an additional breakpoint so that options with a premium at or above $1 but less than $3 would trade in $0.05 increments and those at or above $3 would trade in $0.10 increments. All three of the proposals would expand the pilot to include additional options classes that are phased-in over a period of time, but the proposals differ with respect to the number of additional options classes and the schedule for the phased-in expansion.

Uniform Approach Necessary

The Commission cannot view the proposals as independent exchange decisions, as competition will naturally force all exchanges to adopt the finest increment offered by any one exchange in a particular options series. Because exchanges cannot trade through the prices on other markets, each exchange will need to adopt the smallest approved trading increments.

The Commission must judge each of the proposals pursuant to the standards in the Exchange Act. In so doing, the Commission must consider

[3] The Nasdaq-100 Index Tracking Stock ("QQQQ") is quoted in $0.01 increments for all series.
[4] Under the NYSE Arca Proposal, all series of the SPDR S&P 500 ETF (Ticker: SPY) and the iShares Russell 2000 Index Fund (Ticker: IWM) would be quoted and traded in one cent increments, regardless of premium value.

which approach will result in the best net benefit to investors, taking into consideration not only the potential for investors to receive better prices for their orders, but also the potential that investors will receive worse prices as the result of decreased visible liquidity, weakened trade-through protection, and less timely market information. While we believe our proposed approach will maximize the net benefits to investors and minimize potential negative industry impact, it is necessary and appropriate for the Commission to assure that uniform rules are adopted by the Exchanges so that all options exchanges approach this critical issue in a consistent and coordinated manner.

Impact of Lost Liquidity

The Pilot has provided some benefits to retail investors, who predominately trade lower-priced options in small sizes The same is not true for institutional investors that seek much higher levels of liquidity. The size of displayed quotations in series traded in penny increments has decreased significantly, forcing institutional investors to seek liquidity from other sources,[5] such as off-exchange dark pools, OTC contracts and other asset classes. Furthermore, as institutional investors increasingly look to dark pools for liquidity, market makers are moving to connect to these systems, which further reduces the level of publicly displayed liquidity they provide. We believe that this trend has and will further reduce overall market quality so that any benefits of trading options in penny increments will be lost due to decreased transparency at the exchanges and increased off-exchange trading.[6]

Of equal concern is that the decreased liquidity in pilot options priced over $1 (in which institutional trading is more prevalent than retail) has forced institutions to construct their transactions as over-the-counter ("OTC") options. In the equity market, large trades can be executed and reported to the Alternative Display Facility ("ADF") after market participants use intermarket sweep orders ("ISOs") to satisfy the best displayed prices. In the options market, however, market participants are unable to consummate such large transactions because they have to clear the book on an options exchange. Market participants then

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[5] *See* ISE Penny Pilot Analysis, dated May 23, 2007 (indicating that displayed size in pilot stock had decreased 78%); ISE Penny Pilot Analysis Phase 2, dated November 26, 2007 (indicating that displayed size had further deteriorated); ISE Penny Pilot Analysis 3, dated February 29, 2008 (indicating that displayed size had decreased 81% for the options included in phase 1 of the pilot and 57% for the options added during phase 2 of the pilot); ISE Penny Pilot Analysis 4, dated September 26, 2008 (indicating a continuing decline in displayed size); ISE Penny Pilot Analysis 5, dated May 2009 (indicating that displayed size declined dramatically for the liquid phase 1 symbols and continues to decline). All of these Penny Pilot Reports can be found on the ISE's web site (www.ise.com).

[6] Another negative side-effect of reduced liquidity is the increased pressure and need for broker-dealers to internalize their customer orders.

choose to use OTC options, which are non-transparent and introduce counterparty risk. Our members tell us that the level of OTC options volume is directly correlated to whether the options series is traded in penny increments. Thus, expanding the Pilot to include higher priced options harms liquidity and transparency and is directly contrary to the goals of the NMS that Congress mandated in Section 11A of the Exchange Act.

The concerns outlined above parallel concerns currently being raised in the equities markets regarding fragmentation of liquidity and an explosion in off-exchange dark pools and other non-displayed crossing networks. Many of these dark pools seek to aggregate liquidity to meet institutional demand in the absence of sufficient displayed liquidity. We believe that moving to penny increments in higher-priced options will lead to the same result, but with the added concern of increased OTC activity. A more balanced approach of adopting penny increments for options that are traded by retail investors, while adopting the appropriate tick sizes for the higher-priced options traded by institutional participants will better address the liquidity needs of both types of investors and offer the "best of both worlds" to our Members and more importantly, their customers.

Costs Outweigh Benefits

The Penny Pilot has resulted in an explosion in options quotation traffic.[7] As the number of quotes disseminated to Options Price Reporting Authority ("OPRA") increases, all industry participants must increase their systems capacity to process the additional quotes. The Penny Pilot has clearly shown that only the most liquid options, which are largely those that are priced below $1, benefit from trading in penny increments. The NYSE Arca Proposal to expand the Pilot by 300 options classes with a $3 break-point for trading in penny increments would cause a dramatic increase in the number of quotes sent to OPRA with no real benefit.

ISE has consistently recommended to the Commission a three-tier pricing approach to quoting increments where options under $1 trade in pennies, while options with premiums from $1 to $3 trade in five cent increments and options with premiums above $3 are quoted in $0.10 increments. ISE believes that this is the more appropriate quoting/trading structure because it properly balances the potential for benefits of penny pricing in lower-priced options against the harm to the market of penny pricing in higher-priced options.

[7] *See, e.g.*, ISE Penny Pilot Analysis 5, dated May 2009 (indicating increase in ISE quotation traffic during the initial year of the pilot and during the next six-month period November 2008 through April 2009).

- Options that are priced under $1 tend to move less often than higher priced options. At ISE, approximately 48 percent of all trades occur in options priced under $1 while only 15 percent of all quotes are in options priced under $1.[8] Thus, increasing the number of options in the pilot with a break-point of $1 will have a limited impact on the total quotation traffic that can be easily managed by the industry.

- Options with premiums above $3 do not trade as often, but account for the bulk of the quotation traffic. At ISE, only 18 percent of the trades are in options priced over $3, while 63 percent of all quotes are in options priced over $3.[9] So, while these high-priced options are not retail products, do not trade often, and suffer most when displayed liquidity is reduced, they account for a majority of the quotation traffic. Trading these options in $0.05 increments in an additional 300 options classes would double the quotation traffic for the entire industry while providing negligible benefit to those that normally trade these options. The costs to the exchanges, members and vendors of building the capacity necessary to process this level of quote traffic, and the risk of negatively impacting the quality of publically available data for all options products, is significant. Therefore, ISE believes that the best approach for the next phase of the Pilot is to trade these options in $0.10 increments.

- Options in the $1 to $3 price range should trade in $0.05 increments, due to the negative effects that penny increments have on liquidity and negative side-effects discussed above. Five-cent increments will allow the market to provide institutions with more liquidity, without negatively impacting retail customers.

ISE believes that focusing penny quoting in options where there is the most potential benefit to the retail investor is the responsible and prudent way to expand the Pilot. That is what ISE proposes in its filing: ISE's tiered approach is intended to provide the benefits of penny pricing to the retail investor, while providing liquidity to institutional investors, thus dampening any movement to the OTC market and dark pools.

<u>Conclusion</u>

The ISE believes that the NYSE Arca Proposal is inconsistent with the objectives of Section 6(b)(5) and 11A of the Exchange Act. It will harm investors, reduce liquidity, limit transparency, and impose impediments to a national market

[8] Based on data from May 15, 2009.
[9] *Id.*

system. That proposal will reduce market quality for options priced over $1 and introduce unnecessary industry risk by greatly increasing the quotation traffic. Moreover, the negative effects of the NYSE Arca Proposal are not counter-balanced by demonstrable benefits to investors or the national market system. We thus urge the Commission to institute proceedings to disapprove the NYSE Arca Proposal.

If you have any questions on our comments, please do not hesitate to call us.

Sincerely,

Michael J. Simon
Secretary