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October 30, 2013

Via Electronic Mail

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-NYSEArca-2013-42

Dear Ms. Murphy:

Susquehanna International Group, LLP[1] (SIG) appreciates the opportunity to comment on the above-referenced proposed rule to reduce, and make permanent, the number of listed penny option classes. Although the filing was submitted to the Securities and Exchange Commission (the "SEC" or "Commission") by NYSE Arca, Inc. ("Arca"), its approval would presumably become the standard for all option exchanges. Thus, our comments are focused on how it would, if approved, affect the options industry as a whole.

Currently, the process for adding an options class to the penny pilot program is open-ended. Any option class can be added by any market at the appointed times. Generally, however, a class is added only when customer interest rises to a degree sufficient to incentivize options market makers (MMs) to convert to penny quotes for competitive pricing purposes. Absent this heightened customer interest, MMs and exchanges are not otherwise inclined to convert an option class to pennies.

Consequently, adding option classes to the penny pilot is a naturally occurring and self-governing selection process that keeps the population of penny classes at a reasonable level. It is a process that provides a symbiotic balance of benefits to all concerned – the buy-side, the sell-side and the exchanges. When demand for more liquidity arises in an options class, MMs respond by increasing supply. Because the process is strategically targeted to a small percentage of listed classes, it avoids broader quoting issues for the exchanges.

[1] SIG is comprised of multiple trading and investment entities. Some of these entities operate as options market makers (MMs) and others operate as agency brokers in listed options.

Indeed, just a few (non-adjustment) classes were added to the pilot in each of the last two years. As of today, there are 362 option classes in the penny pilot.

Arca proposes to replace the open-ended process with a maximum fixed level of 150 classes, which would reduce the number of penny options by over 200 classes. In practice, however, the number of "active" classes in the amended penny-pilot would apparently be marginally higher than 150, as the process of deleting classes would involve defined stages that may involve several months of unwinding activity resulting in some crossover between adds and deletes.

As justification for the change, Arca contends the proposal will reduce "unnecessary quote traffic". Arca points out that 90% of option volume occurs in the top-tier 150 classes. Upon review of trading in 203 second-tier penny classes, it notes that the quotes in the strikes under $3 are mostly wider than a nickel (.05) – and usually very much wider. In short, Arca appears to be saying that the impact of the extra quoting requirements is not worth the added value.

Arca makes some good points and should be commended for raising this issue while systems and capacity issues are now a paramount concern. Yet there are facts to the contrary that must be considered. In particular, volume in the second-tier classes may be small relative to the top-tier but the "baseline" average daily volume (ADV) in the current 212 second-tier classes is nonetheless about 500,000 contracts (baseline ADV does not include spreads, auctions and floor crosses). Also, while ARCA is correct about quote spreads in second-tier penny options often being greater than the respective nickel limit, the vast majority of the trading in these classes occurs in the nearer-term around–the-money series, which on average tend to display quotes that are tighter than a nickel. In our own review of baseline trading activity for a recent two-month period, we note that:

- The 212 second-tier options constituted 7% of total baseline volume.
- Approximately 90% of the ~500,000 baseline ADV contracts traded at under $3 per contract.
- For the ~450,000 daily contracts that traded at under $3, about 70% were executed at prices on or inside an NBBO quote that was not in a five-cent increment.
- Had these under $3 trades instead paid the full five-cent spread (if penny quotes weren't available and the respective participants stepped up to trade at the nickel quoted prices), the added difference in dollar terms would have been ~$700,000 per day.

Of course, absent penny increments, we presume many of the investors would not have stepped up to the higher nickel prices. On the other hand, we also believe that many of those investors would not have been investing in those option classes in the first place if not for the fact that they were being offered in penny quotes. So, while we are not saying the $700,000 per day would have been the loss to investors in the absence of penny quotes for second-tier classes, we do believe that some significant amount would have been lost. Moreover, it appears from the evidence that investors appreciate and take advantage of the penny pricing in the second-tier classes to a material extent.

In this regard, any attempt to quantify the overall value of penny quotes in second-tier classes should include an accounting for the fact that penny quotes in second-tier classes can generate better investment choices for customers. It would be naïve to assume that taking away the ability to trade 200 or so option classes in pennies means that the respective penny-trading investors would nonetheless invest their capital in those same wider quoting option classes or simply choose another option class – or for that matter another listed product. The point is that the overall capital-investment pie grows when heightened customer interest prompts penny quotes that in turn create more customer order flow. The fact that these investments often occur at more competitive prices for the customer is an enticement that is beneficial to both the individual investor and to the capital raising process at large. Indeed, the transparency of these tighter quotes to the investment world provides a targeted enticement for adding liquidity to second-tier issues, which adds to the advantages offered by the price improvement mechanisms referenced by Arca as an alternative to penny quoting.

We should not underestimate the extent to which adding a promising option class to the penny pilot may increase the amount of customer order flow in the class. While there may be miscues in choosing classes for the pilot, the miscues are hardly a cause for eliminating 200 classes from the pilot. Nor should we underestimate the extent by which payment-for-order-flow (PFOF) impacts this process. When a series is offered in pennies, the PFOF may be adjusted downward to account for less edge and more risk for the MM. When PFOF is reduced, MMs tend to adjust accordingly with their quotes. The flip side to this coin is that taking an option class off the penny pilot will tend to cause MMs to widen quotes accordingly to adjust for a higher PFOF.

The question at hand is whether the additional quote requirements of the 212 second-tier pilot options merits their removal from the pilot. While some curbing may be appropriate, we believe that reducing the pilot by over one-half will not produce justifiable benefits. Indeed, we estimate the proposal's savings from quoting requirements to be less than 3% of total option quotes[2].

Notwithstanding our concern with reducing the penny-pilot in the manner of the present proposal, quote traffic overall is increasing at an alarming rate. With the growth in the number of exchanges and the fact that many of the

[2] From OPRA quote volume for a recent month we estimated that roughly 8% of quotes come from the 200 least active penny classes. By comparing penny classes to non-penny classes with similar price and volume characteristics we estimated that penny strikes create quote changes 50% times greater than non-penny strikes of similar characteristics. Thus, we conclude that overall quote traffic in options would be reduced by about 2.7% if ARCA's proposal is approved.

current options markets are focused exclusively on maker-taker structures, quote traffic is growing much faster than historical quotes-to-trades ratios. Thus, our market structure quoting problem would not be much abated by the 3% solution proposed by Arca regarding second-tier penny classes. Other solutions should be considered.

Given the above, we believe the proposal should not be approved and that the Commission should instead consider a broader effort by the exchanges to address the excessive quote issue in general. This effort should be undertaken in a manner that does not unduly harm customers by needlessly discouraging competitive quote activity by MMs that is a material benefit to customers.

Thank you again for the opportunity to respond and please do not hesitate to contact us with any questions regarding our comments.

Sincerely,

Gerald D. O'Connell/RJM

Gerald D. O'Connell
Chief Compliance Officer

cc John Ramsey, Acting Director, Division of Trading and Markets
James Burns, Deputy Director, Division of Trading and Markets
Heather Seidel, Associate Director, Division of Trading and Markets