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September 30, 2013

Via Electronic Mail (rule-comments@sec.gov)

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:

   D. E. Shaw & Co., L.P. appreciates the opportunity to comment on the above-referenced filing, a proposed rule change filed by NYSE Arca, Inc. ("Arca") with the Securities and Exchange Commission (the "SEC" or "Commission"). In the proposed rule change, Arca would make permanent its pilot penny trading program in options (the "Program"), but would limit the Program to the 150 most active, multiply listed options classes, eliminating 213 names from the Program ("Arca's proposal").[1] Although we support making the Program permanent, we do not believe Arca should limit the Program; instead, Arca should continue to include all 363 listed options classes currently covered by the existing Program.

   We respectfully submit that Arca has not provided the Commission with a legally sufficient basis to approve Arca's proposal, as discussed below. Arca's proposal to scale back the Program for almost 60% of existing options classes does not satisfy the statutory standards applicable to Arca. As the Commission is aware, Section 19(b) of the Securities Exchange Act of 1934 ("Exchange Act") provides that the Commission can approve an exchange rule only if it finds the rule to be consistent with the provisions of the Exchange Act applicable to the exchange. We believe that Arca has not provided the Commission with sufficient information on which to base its review, nor has it met the standards under Exchange Act Section 6(b)(5) that:

> The rules of the exchange are designed to . . . remove impediments to and
> perfect the mechanism of a free and open market and a national market
> system, and, in general, to protect investors and the public interest . . . .

   Moreover, as the Commission knows, Exchange Act Section 3(f) requires the SEC to consider whether an SRO rule proposal will promote efficiency, competition, and capital

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[1] *See* SEC Release No. 34-70317 (September 4, 2013).

formation, among other things.[2] That section requires the Commission to apply the same exacting statutory standards and obligations when approving an exchange rule as it does when adopting its own rules. [3]

We believe that Arca's proposal would harm investors and create inefficiencies in the market by artificially widening the spreads of the options eliminated from the Program. This change would unfairly benefit large, entrenched market-making firms at the expense of institutional and retail investors. Arca does not address these matters in its filing. In addition, the proposed changes to the processes of adding and removing options on certain issues that are subject to the Program will impose significant operational costs on market participants. As discussed more fully below, Arca's proposed rollback of this Program is inconsistent with the requirements of the Exchange Act, is unjustified, and runs counter to the aims of increasing liquidity, achieving fair pricing in the options market, and reducing operational complexity.

Background. Under the current pilot Program, 363 multiply listed options classes can be traded in penny increments. At the Program's inception, penny increments were introduced to "create tighter markets and thus reduce overall costs of trading in options for investors."[4] Recognizing the benefits of the penny pilot Program to market participants, Arca has steadily expanded the list of issues included in the Program since it began in 2007.

We agree with other market participants[5] that Arca and the other options exchanges should continue to expand penny pricing with the goal of eventually adopting a universal penny pricing structure for all options classes. Penny pricing permits trades to occur at a penny spread, but it does not mandate that they do so. (Indeed, options that are subject to penny pricing can, and do, trade in wider increments.) Rather, penny pricing fosters a competitive pricing environment that enables market participants to trade in pricing increments determined by market forces (whether it be a penny or ten cents, or any other amount), rather than a minimum trading increment higher than a penny. As such, a universal penny pricing structure would

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[2]   Section 3(f) of the Exchange Act, 15 U.S.C. § 78c(f), provides:

> Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

[3]   The Section 3(f) mandate is an exacting one, and the courts require strict compliance with its provisions. *See*, e.g., Business Roundtable v. Secur. & Exch. Comm'n, 647 F.3d 1144, 1148 (D.C. Cir. 2011); American Equity Investment L. Ins. Co. v. Secur. & Exch. Comm'n, 613 F.3d 166 (D.C.Cir.2010); Chamber of Commerce v. Secur. & Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005).

[4]   *See* SEC Release No. 34-54590 (October 12, 2006).

[5]   *See,* e.g., comment letter by BATS Exchange, Inc. (August 28, 2009), available at: http://www.sec.gov/comments/sr-nysearca-2009-44/nysearca200944-10.pdf; comment letter by Global Electronic Trading Company (June 10, 2009), available at: http://www.sec.gov/comments/sr-nysearca-2009-44/nysearca200944-1.pdf.

remove impediments to, and facilitate the mechanism of, a free and open market and a national market system.

Participating exchanges have been required to report periodically on the impact of the Program. Arca and other exchanges have reported that the market-driven spreads in the pilot securities substantially narrowed over time.[6] The Commission itself has noted that allowing market participants to quote in smaller increments has reduced spreads in options classes included in the Program, thereby lowering costs to investors.[7] These findings indicate that previous minimum increments were larger than market forces would otherwise have produced, unfairly subsidizing market makers at the expense of other market participants, such as institutional and retail investors.

Analysis. Arca's proposal, removing almost 60% of existing options classes from the Program, does not satisfy the statutory standards applicable to Arca. The proposal not only fails to promote efficiency, competition, and capital formation, but in fact it may hinder the achievement of these goals.

Arca claims that covering all the current 363 multiply listed classes has resulted in more technology overhead costs. While the Arca filing contains a substantial amount of data concerning quote volumes and other issues, it does not contain any cost data to support the assertions made about the added expense of continuing to support the one-cent minimum price increment to the options issues that have lower contract volume than the top 150 issues. In fact, the data Arca does provide suggests the opposite.[8] Arca points to the high quote-to-contract volume for the approximately two-hundred least active issues, but Arca's own findings that the contracts in the 150 most active issues constitute the vast majority of volume (90.8% of volume

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[6]   *See, e.g., Philadelphia Stock Exchange, Options Penny Pricing Pilot Report (February 29, 2008), available at:* http://www.nasdaqtrader.com/content/marketregulation/phlxreg/022908.pdf *; NASDAQ OMX PHLX, Options Penny Pilot Expansion Report 3 (August 28 2008), available at:* http://www.nasdaqtrader.com/content/marketregulation/phlxreg/082808.pdf *; NASDAQ OMX PHLX, Options Penny Pilot Expansion Report 4 (February 27, 2009), available at:* http://www.nasdaqtrader.com/content/marketregulation/phlxreg/022709.pdf*;* NYSE Arca, The Options Penny Pilot (not dated) Fourth and Sixth Reports on the Penny Pilot Program reporting periods (reporting periods February 1, 2008 – July 31, 2008 and February 1, 2009 – April 30, 2009), available at: https://globalderivatives.nyx.com/sites/globalderivatives.nyx.com/files/penny_pilot_report_phase4_6.pdf; NYSE Amex Penny Pilot Phase VI Report FINAL (August 3, 2010), available at: http://www.nyse.com/pdfs/NYSE%20Amex%20Penny%20Pilot%20Phase%20VI%20Report%20FINAL%208-3-2010.pdf; NYSE Arca Options, Understanding Economic and Capacity Impacts of the Penny Pilot (May 31, 2007), available at: http://www.nyse.com/pdfs/PPSummary.pdf.

[7]   *See* SEC Release No. 34-60711 (September 23, 2009).

[8]   For the Commission to have a legally sufficient basis to accept the NYSE Arca's assertions about cost benefits and cost differentials, it must have at least some relevant and credible cost data. *See*, e.g., NetCoalition v. Secur. & Exch. Comm'n, 715 F.3d 342 (D.C. Cir. 2013) and NetCoalition v. Secur. & Exch. Comm'n, 615 F.3d 525 (D.C. Cir. 2010).

in 2012 and 89.1% in 2011) suggest that the additional systems cost to support quote and order activity for the less active options is minimal.[9]

Arca's findings from previous reports also indicate that the operational cost of maintaining penny increments for the least active issues would be minimal. Arca's ninth report, dated May 23, 2012, states that the number of quotes for the least active securities is small in absolute numbers and as a percentage of overall quotes.[10] This report analyzed three groups of options: the most active, the least active, and a control group. The ten most active securities had between 2,152,612 to 5,390,521 quotes per day, while the ten least active securities had between 36,680 to 120,301 quotes per day. Despite the higher quote/order ratio that Arca cites, the actual volume of associated quotes was a very small portion of total quotes given the much lower volume of trading in these contracts. Therefore, the impact on total costs must also be modest. We also note that none of Arca's previous reports on the Program suggests that an increase in quote-to-contract volume had any adverse impact on its operations.

Furthermore, Arca does not support its assertion that the bottom 213 issues are not sufficiently active to warrant penny increments in the first place. Using the number of contracts traded to determine activity level, as Arca's proposal does, does not paint the full picture. Higher-priced contracts are inherently likely to trade less frequently, and a smaller number of higher-priced contracts is economically equivalent to a greater number of lower-priced contracts. So any statistic measuring activity level alone is insufficient; the analysis should take into account price as well as volume. Under this metric, even if Arca's goal were to limit the Program, we believe that many of the issues that Arca proposes to eliminate should be included. In addition, trading activity can vary over days and weeks, as Arca itself concedes when it notes that the universe of penny options will have to change frequently to take these variations into account. Furthermore, news concerning the underlying equity (or factors that might influence that underlying price) can cause spikes in options activity and quoting and can impact spreads. Static measures of contract volume should not be the only metric that is considered in Arca's analysis.

In addition, as noted above, Arca does not discuss the impact on market participants of its proposed limitation on trading the remaining classes in pennies. Mandating minimum trading increments of five or ten cents could reduce liquidity and activity, raise costs to investors, and impair market efficiency. Nor does the Arca filing address the costs to investors of setting artificially wider spreads. The impact on market participants of limiting the one-cent increment to the top 150 issues would likely be substantial. It would result in higher costs, in terms of both trading fees and operational costs, for those that trade the other contracts. It also would impose considerable costs on market participants, including dealers and investors.

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[9] NYSE Euronext, U.S. Options Report on Penny Trading in Options in 2012 (April 15, 2013), available at https://globalderivatives.nyx.com/sites/globalderivatives.nyx.com/files/nyse_us_options_report_on_penny_trading_in_options_in_2012_0.pdf

[10] NYSE Euronext, Ninth Report on the Penny Pilot Program (May 23, 2012), available at: http://globalderivatives.nyx.com/sites/globalderivatives.nyx.com/files/arca_penny_pilot_report_oct_2011_to_april_2012_period_9.doc

On the operational side, Arca's proposed limitation would result in a floating, frequently changing universe of covered classes. Moreover, market participants would need to regularly monitor for changes and adjust their systems to add and delete classes and series. As envisioned by Arca, existing series of deleted classes would continue to trade in pennies until their expiration, but new series would trade at the higher mandated minimums, in nickel or dime increments. Arca's proposed change to the administration of the program, with the limited removal of certain issues, would potentially require market participants to monitor multiple increment sizes for the same issue. The compliance, systems, and monitoring costs to implement these changes would likely be greater than maintaining the current, more stable Program. Such an outcome would be contrary to Arca's stated goal of reducing investor confusion, but Arca did not address these problems in its proposal.

To the extent that trading in five-cent or ten-cent increments widens spreads on average, as noted above, it would provide additional and unnecessary profit to market makers, at the expense of investors. These consequences run counter to the very statutory standards to which Arca is subject, including the public interest and the protection of investors. Consequently, Arca's failure to consider or analyze these issues deprives the Commission of the information it needs to properly evaluate the Arca filing.

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Arca has not given the Commission the necessary information to evaluate the proposed rule change under the standards that Section 6(b)(5) requires. It has not presented relevant cost-benefit data to support its assertions that continuing to include all 363 options classes in the Program is too costly. Furthermore, as noted above, Arca has not provided information on the operational and trading costs to investors of limiting the one-cent minimum pricing increment to the most active 150 options issues. Arca's proposal also does not address critical issues of fairness, the impact on the establishment of a free and open market and the national market system, and, in general, its duty to protect investors. Accordingly, we must respectfully submit that Arca has not presented a legally sufficient basis for the Commission to approve the proposed rule change.

We believe this proposal should be withdrawn and that the Commission should request that Arca reconsider its proposal, specifically to consider maintaining the current classes. If Arca continues to recommend limiting the Program, the Commission should require Arca to provide a clear cost-benefit analysis that addresses the impact on investors to support any proposed curtailment of the Program. Finally, we recommend that the Commission work with all the options exchanges and a cross-section of market participants to develop a fairer approach, one that will be consistent across all venues where U.S. options are traded, in order to promote the national market system. The national market system mandate from Congress envisions such coordination among market venues.

We very much appreciate the opportunity to share our thoughts with the Commission on this rule filing, and we hope our comments are helpful to the Commission and its staff. We would be pleased to meet with Commission staff to discuss the views expressed in this letter.

Respectfully submitted,

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The D. E. Shaw Group

cc: The Hon. Mary Jo White, Chair
The Hon. Luis A. Aguilar, Commissioner
The Hon. Daniel M. Gallagher, Commissioner
The Hon. Kara M. Stein, Commissioner
The Hon. Michael S. Piwowar, Commissioner
John Ramsay, Esq., Acting Director, Division of Market Regulation
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