

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55161; File No. SR-ISE-2006-62)

January 24, 2007

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Granting Approval to Proposed Rule Change as Modified by Amendment Nos. 1 and 2 Thereto, to Implement a Penny Pilot Program to Quote Certain Options in Pennies

I. Introduction

On October 11, 2006, the International Securities Exchange, LLC (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to permit certain option classes to be quoted in pennies on a pilot basis and to adopt certain quote mitigation strategies. The proposed rule change was published for comment in the Federal Register on October 20, 2006.³ The Commission received three comment letters on the proposed rule change.⁴ On November 6, 2006, the Exchange filed Amendment No. 1 to the proposed rule change.⁵ The Exchange filed Amendment No. 2 to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 54603 (October 16, 2006), 71 FR 62024.

⁴ See letters to Nancy M. Morris, Secretary, Commission, from Christopher Nagy, Chair, Securities Industry and Financial Markets Association (“SIFMA”) Options Committee, dated December 20, 2006 (“SIFMA Letter”); from Patrick Sexton, Associate General Counsel, CBOE, dated November 13, 2006 (“CBOE Letter”); and from Peter J. Bottini, Executive Vice President, optionsXpress, Inc., dated October 31, 2006 (“optionsXpress Letter”).

⁵ Amendment No. 1 made a clarifying change to proposed rule text in ISE Rule 804(h). Amendment No. 1 is technical in nature, and the Commission is not publishing Amendment No. 1 for public comment.

proposal on January 5, 2007.⁶ The Exchange responded to the comment letters on January 11, 2007.⁷ This order approves the proposed rule change as modified by Amendment Nos. 1 and 2.

II. Description of the Proposal

A. Scope of the Penny Pilot Program

ISE proposes to amend its rules to permit certain options classes to be quoted in pennies during a six-month pilot (“Penny Pilot Program”), which would commence on January 26, 2007. Specifically, the Exchange proposes to amend ISE Rule 710 to specify that the Exchange will: (1) participate in the Penny Pilot Program, and (2) state that the parameters of the Penny Pilot Program will be communicated to its members via Regulatory Information Circular.

Currently, all six options exchanges, including ISE, quote options in nickel and dime increments. The minimum price variation for quotations in options series that are quoted at less than \$3 per contract is \$0.05 and the minimum price variation for quotations in options series that are quoted at \$3 per contract or greater is \$0.10. Under the Penny Pilot Program, beginning on January 26, 2007, market participants would be able to begin quoting in penny increments in certain series of option classes.

The Penny Pilot Program would include the following thirteen options: Ishares Russell 2000 (IWM); NASDAQ-100 Index Tracking Stock (QQQQ); SemiConductor Holders Trust (SMH); General Electric Company (GE); Advanced Micro Devices, Inc. (AMD), Microsoft

⁶ Amendment No. 2 revised the Regulatory Information Circular ISE will distribute to its members to reflect the replacement of Glamis Gold, which was delisted, with Agilent Tech, Inc. in the list of options classes permitted to be quoted in pennies. Amendment No. 2 is technical in nature, and the Commission is not publishing Amendment No. 2 for public comment.

⁷ See letter to Nancy M. Morris, Secretary, Commission, from Michael J. Simon, Secretary, ISE, submitted January 11, 2007. On January 23, 2007, ISE supplemented its initial response by providing additional information about its Holdback Timer. See letter to Nancy Morris, Secretary, Commission, from Michael J. Simon, Secretary, ISE, dated January 23, 2007 (collectively “Exchange Response”).

Corporation (MSFT); Intel Corporation (INTC); Caterpillar, Inc. (CAT); Whole Foods Market, Inc. (WFMI); Texas Instruments, Inc. (TXN); Flextronics International Ltd. (FLEX); Sun Microsystems, Inc. (SUNW); and Agilent Technologies, Inc. (A). The Exchange will communicate the list of options to be included in the Penny Pilot Program to its membership via Regulatory Information Circular.

The minimum price variation increment for all classes included in the Penny Pilot Program, except for the QQQQs, would be \$0.01 for all quotations in option series that are quoted at less than \$3 per contract and \$0.05 for all quotations in option series that are quoted at \$3 per contract or greater. The QQQQs would be quoted in \$0.01 increments for all options series.

ISE commits to deliver a report to the Commission during the fourth month of the pilot, which would be composed of data from the first three months of trading. The report would analyze the impact of penny pricing on market quality and options system capacity.

In addition, the Exchange will amend ISE Rule 716, which currently permits trades in the Exchange's Block, Facilitation and Solicitation Mechanisms to be effected at "split prices," which are the mid-points of the current standard trading increments, to clarify that options trading in penny increments will not be eligible for split pricing.

B. Quote Mitigation Strategies

To mitigate quote message traffic, ISE has represented to the Commission that it intends to codify certain quote mitigation strategies, which are currently in place on the Exchange.⁸

⁸ In addition to the quote mitigation strategies discussed herein, the ISE also proposed a fee program that requires market makers to purchase more APIs as the market maker generates more quotes, thus imposing economic incentives on market makers to limit the number of quotations they disseminate. See Securities Exchange Act Release No. 53522 (March 20, 2006), 71 FR 14975 (March 24, 2006) (SR-ISE-2006-09).

- Monitoring. The ISE submits that it actively monitors the quotation activity of its market makers. When the Exchange detects that a market maker is disseminating significantly more quotes than an average market maker, the Exchange contacts that market maker and alerts it to such activity. Such monitoring frequently reveals that the market maker may have internal system issues or has incorrectly-set system parameters that were not immediately apparent. The Exchange believes that, even without uncovering problems, alerting a market maker to possible excessive quoting usually leads the market maker to take steps to reduce the number of its quotes.
- Holdback Timer. The ISE has the systemic ability to limit the dissemination of quotations and other changes to the ISE best bid and offer according to prescribed time criteria (a "Holdback Timer"). For example, if there is a change in the price of a security underlying an option, multiple market makers likely will adjust the price or size of their quotes. Rather than disseminating each individual change, the Holdback Timer permits the Exchange to wait until all market makers have adjusted their quotes and then to disseminate a new quotation. This helps prevent the "flickering" of quotations. The ISE proposes to codify the Holdback Timer. As proposed in ISE Rule 804, the ISE will utilize a Holdback Timer that delays quotation updates for up to, but not longer than, one second.
- Delisting. The ISE has committed to the Commission that it will delist options with average daily volume ("ADV") of less than 20 contracts.⁹ However, it has

⁹ See Securities Exchange Act Release No. 47483 (March 11, 2003), 68 FR 13352 (March 19, 2003) (SR-ISE-2003-04).

been the ISE's policy to be more aggressive in delisting relatively inactive options, thereby eliminating the quotation traffic attendant to such listings. Currently, it is the ISE's policy to delist options with ADV of less than 50, even with the advent of the Exchange's new "Second Market,"¹⁰ which provides liquidity for less-active options.

III. Discussion

After careful review of the proposal, the comment letters and the Exchange's response thereto, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹¹ In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹² which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, 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.

The Commission believes that the implementation of a limited six-month Penny Pilot Program by the ISE and the five other options exchanges will provide valuable information to the exchanges, the Commission and others about the impact of penny quoting in the options market. In particular, the Penny Pilot Program will allow analysis of the impact of penny

¹⁰ See Securities Exchange Act Release No. 54340 (August 21, 2006), 71 FR 51240 (August 29, 2006) (SR-ISE-2006-40).

¹¹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹² 15 U.S.C. 78f(b)(5).

quoting on: (1) spreads; (2) transaction costs; (3) payment for order flow; and (4) quote message traffic.

The Commission believes that the thirteen options classes to be included in the penny pilot program represent a diverse group of options classes with varied trading characteristics. This diversity should facilitate analyses by the Commission, the options exchanges and others. The Commission also believes that the Penny Pilot Program is sufficiently limited that it is unlikely to increase quote message traffic beyond the capacity of market participants' systems and disrupt the timely receipt of quote information.¹³ Nevertheless, because the Commission expects that the Penny Pilot Program will increase quote message traffic, the Commission is also approving the Exchange's proposals to reduce the number of quotations it disseminates.

In this regard, the commenters expressed concern about ISE's proposed quote mitigation strategy. In particular, although optionsXpress generally supported ISE's Holdback Timer, it expressed concern that a longer holdback timer period could negatively impact market quality and undermine transparency in the options market.¹⁴

In addition, SIFMA recommends that all six of the option exchanges adopt a comprehensive and uniform quote mitigation strategy.¹⁵ In particular, SIFMA strongly supports the adoption of the Holdback Timer mitigation proposal as the most efficient means of reducing quotation traffic. SIFMA, however, expressed concern that the lack of uniformity among the

¹³ In addition, the Commission believes that it is appropriate for ISE to amend ISE Rule 716 to clarify that options trading in penny increments is not eligible for split pricing.

¹⁴ See optionsXpress Letter, supra note 4. OptionsXpress also stated its view that current problems with the intermarket linkage will be exacerbated in the option classes participating in the Penny Pilot Program. Id.

¹⁵ See SIFMA Letter, supra note 4.

quote mitigation proposals adopted by the exchanges will impose a burden on member firms and cause confusion for market participants, especially retail investors.

Although SIFMA urges the adoption of a uniform and comprehensive approach to quote mitigation, it does not oppose ISE's quote mitigation proposals. In fact, SIFMA acknowledges that certain of ISE's proposals, such as notifying members whose quote activity suggests systems malfunctions or wrong settings and delisting inactive series can contribute to quote mitigation. SIFMA, however, expressed its belief that these proposals do not go far enough to resolve the industry's concerns regarding systems capacity.

The Commission supports efforts to implement a uniform, industry-wide quote mitigation plan. It does not, however, believe such efforts preclude individual exchanges from initiating their own quote mitigation strategies. The Commission does not believe that ISE's proposed quote mitigation strategies will lead to confusion among market participants.

Finally, CBOE commented that it did not have a fundamental objection to ISE's use of the Holdback Timer, but instead sought additional information concerning how the Holdback Timer functions and how orders sent to ISE by CBOE members or by CBOE through linkage might be impacted by the Holdback Timer.¹⁶ Specifically, CBOE requested additional information about the extent to which the Holdback Timer is utilized throughout the day and whether it is used uniformly in all option classes traded on ISE. In response, ISE indicated that it intends to use the Holdback Timer uniformly in all option classes.¹⁷ In addition, the ISE committed to apply the Holdback Timer mechanism throughout the trading day for a period of

¹⁶ See CBOE Letter, supra note 4.

¹⁷ Telephone conversation between Katherine Simmons, Deputy General Counsel, ISE, and Jennifer L. Colihan, Special Counsel and Cyndi N. Rodriguez, Special Counsel, Division of Market Regulation, Commission, on January 23, 2007. See also Exchange Response, supra note 6.

up to, but no more than, one second.¹⁸ In further response to inquiry from CBOE, the ISE represented that it does not intend to disclose the precise length of the timer to its members, to non-members or to the other exchanges.¹⁹

In addition, CBOE inquired whether the Holdback Timer will apply only to market maker quotations and asked the Exchange to clarify what information will be delayed by the Holdback Timer. ISE clarified that the Holdback Timer will be applied when there is a change in the price and/or size of the security underlying an option. The Exchange will wait (for a period up to one second) until multiple market participants have adjusted their quotes and then will disseminate a new quotation. The Exchange will apply the Holdback Timer to all data that it sends to OPRA.²⁰ Finally, in response to CBOE's inquiry regarding the treatment of incoming marketable orders, ISE indicated that Holdback Timer "does not affect the receipt or processing of quotes, orders or trades within the Exchange's system in any way."²¹ Therefore, incoming marketable orders sent to the Exchange will be executed against the prices and sizes available in ISE's system without regard to the application of the Holdback Timer.²²

¹⁸ Telephone conversation between Katherine Simmons, Deputy General Counsel, ISE and Jennifer L. Colihan, Special Counsel, and Cyndi N. Rodriguez, Division of Market Regulation, Commission, on January 23, 2007.

¹⁹ Id.

²⁰ See Exchange Response, supra note 7.

²¹ Id.

²² Id.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²³ that the proposed rule change (SR-ISE-2006-62), as modified by Amendment Nos. 1 and 2, be, and hereby is, approved on a six-month pilot basis, which will commence on January 26, 2007.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁴

Florence E. Harmon
Deputy Secretary

²³ 15 U.S.C. 78s(b)(2).

²⁴ 17 CFR 200.30-3(a)(12).