

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-60146; File No. SR-ISE-2009-32)

June 19, 2009

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Proposed Rule Change Relating to the Penny Pilot Program

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that, on June 11, 2009, the International Securities Exchange, LLC (“Exchange” or the “ISE”) filed with the Securities and Exchange Commission (the “SEC” or the “Commission”) the proposed rule change as described in Items I, II, and III below, which items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The ISE proposes to amend its rules relating to a pilot program to quote and to trade certain options in pennies. The text of the proposed rule change is as follows, with deletions in [brackets] and additions in italics:

**Rule 710. Minimum Trading Increments**

(a) The Board may establish minimum trading increments for options traded on the Exchange. Such changes by the Board will be designated as a stated policy, practice, or interpretation with respect to the administration of this Rule 710 within the meaning of subparagraph (3)(A) of Section 19(b) of the Exchange Act and will be filed with the SEC as a

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

rule change for effectiveness upon filing. Until such time as the Board makes a change in the increments, the following principles shall apply:

- (1) if the options contract is trading at less than \$3.00 per option, \$.05;  
and
- (2) if the options contract is trading at \$3.00 per option or higher, \$.10.

(b) Minimum trading increments for dealings in options contracts other than those specified in paragraph (a) may be fixed by the Exchange from time to time for options contracts of a particular series.

(c) Notwithstanding the above, the Exchange may trade in the minimum variation of the primary market in the underlying security.

**Supplementary Material to Rule 710**

.01 Notwithstanding any other provision of this Rule 710, the Exchange will operate a pilot program to permit options classes to be quoted and traded in: [increments as low as \$.01.]

- (a) \$.01 increments if the options contract is trading at less than \$1.00 per option;
- (b) \$.05 increments if the options contract is trading between \$1.00 and \$3.00 per option; and
- (c) \$.10 increments if the options contract is trading at higher than \$3.00 per option.

The Exchange will specify which options trade in such pilot, and in what increments, in Regulatory Information Circulars filed with the Commission pursuant to Rule 19b-4 under the Exchange Act and distributed to Members.

.02 No Change.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self regulatory organization has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

On January 24, 2007, the SEC approved ISE's rule filing, SR-ISE-2006-62, which initiated a pilot program to quote and to trade certain options in penny increments (the "Penny Pilot Program").<sup>3</sup> Under the Penny Pilot Program, the minimum price variation for all participating options classes, except for the Nasdaq-100 Index Tracking Stock ("QQQQ"), is \$0.01 for all quotations in options 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 contract or greater. The QQQQs are quoted in \$0.01 increments for all options series. Through subsequent expansions, the Penny Pilot now consists of 63 underlying securities.<sup>4</sup> The Penny Pilot Program is scheduled to expire

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<sup>3</sup> See Securities Exchange Act Release No. 55161 (January 24, 2007), 72 FR 4754 (February 1, 2007) (the "Initial Filing"). The Penny Pilot Program was subsequently extended for an additional two month period, until September 27, 2007. See Securities Exchange Act Release No. 56151 (July 26, 2007), 72 FR 42452 (August 2, 2007).

<sup>4</sup> See Securities Exchange Act Release Nos. 56564 (September 27, 2007), 72 FR 56412 (October 3, 2007) and 57508 (March 17, 2008), 73 FR 15243 (March 21, 2008).

on July 3, 2009. ISE now proposes to extend the Penny Pilot Program through December 31, 2010.

The Exchange also proposes to expand the number of issues included in the Penny Pilot Program to include the top 300 most actively traded multiply listed options classes that are not currently a part of the Penny Pilot Program. ISE is prepared to further expand the Penny Pilot Program to all ISE listed symbols at the end of the proposed extension, subject to the performance of the expanded pilot, as proposed by this rule change.

Under this proposal, these additional classes will be determined based on their national average daily volume over a six month period immediately preceding their inclusion in the Penny Pilot Program.<sup>5</sup> The Exchange notes that it will submit proposed rule changes pursuant to Rule 19b-4 under the Exchange Act announcing the names of the options classes selected to participate in the Penny Pilot Program.<sup>6</sup> The Exchange represents that after the addition of the 300 options classes, as proposed under this rule change, it has the necessary system capacity to support the listing of additional series under the Penny Pilot Program.

The Exchange proposes to extend the existing Penny Pilot Program until October 1, 2009 and then phase-in the additional classes to the Penny Pilot Program over four successive quarters. Specifically, the Exchange proposes to add 35 classes in October 2009 and in January 2010 followed by an additional 115 classes both in April 2010 and in July 2010, each group to be effective for trading on the Monday ten days after Expiration Friday. Thus, the quarterly

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<sup>5</sup> The Exchange will not include options classes in which the issuer of the underlying security is subject to an announced merger or is in the process of being acquired by another company, or if the issuer is in bankruptcy. For purposes of assessing national average daily volume, the Exchange will use data compiled and disseminated by the Options Clearing Corporation.

<sup>6</sup> ISE will also issue a Regulatory Information Circular, which will be published on its website, identifying the options classes added to the Penny Pilot Program.

additions would be effective on October 26, 2009; January 25, 2010; April 26, 2010; and July 26, 2010.<sup>7</sup> The above roll-out schedule contemplates the launch of the new Linkage Plan, which is scheduled to occur on August 31, 2009. ISE believes that the new Linkage Plan should be implemented before the current Penny Pilot Program is expanded because intermarket sweep orders (ISOs) will be available in the new Linkage Plan, which will allow market participants to simultaneously to access better priced quotations across all options exchanges.

During the course of the Penny Pilot Program, ISE has thoroughly analyzed the impact of trading options in penny increments. ISE has also submitted reports to the SEC describing its findings. For the most part, the Penny Pilot Program has continued without any operational issues. The quoted spread tightened in the year following introduction of pennies, but widened for phase 1 and 2 symbols in the past six months. The size available at the BBO, however, has decreased significantly since the start of the Penny Pilot Program, while trading volume has increased.

Despite the increase in the number of quotes that is in large part attributed to the Penny Pilot Program, ISE is supportive of an expanded Penny Pilot Program but one that is measured. Quoting options in penny increments also significantly increases quotation traffic and imposes significant costs on exchanges, market makers and other market participants. Thus, ISE believes that a focused expansion where there would be the most benefit is the responsible and prudent way to proceed. Accordingly, ISE proposes to expand the Penny Pilot Program by adopting three “breakpoints,” as follows:

- \$0.01 increments for options contracts trading at less than \$1.00 per option;

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<sup>7</sup> For purposes of identifying the issues to be added per quarter, the Exchange shall use data from the prior six calendar months immediately preceding the implementation month. For example, the quarterly additions to be added on October 26, 2009 shall be determined using data from the sixth month period ending September 30, 2009.

- \$0.05 increments for options contracts trading between \$1.00 and \$3.00 per option; and
- \$0.10 increments for options contracts trading higher than \$3.00 per option.

ISE believes an expansion with these tiers will allow the industry to manage the large number of quotes generated in high-priced series that have little, if any, trading volume, and which thus far have been excluded from the Penny Pilot Program due to their high quotation rates. If these options were migrated to pennies indiscriminately, the number of quotes sent to OPRA for these series would double. By retaining these tiers, ISE believes that the number of quotes generated by high priced series will be manageable and adequate liquidity will be maintained in higher priced option series. ISE's proposal would also apply to the QQQQs, which are currently quoted in \$0.01 increments for all options series.

The Penny Pilot Program generally has been beneficial to retail investors and ISE believes its proposal would preserve the benefits of penny trading for lower-priced, more retail-oriented contracts. Institutional investors, on the other hand, have been disadvantaged with the lack of liquidity at the inside in the classes that are currently in the pilot and the Exchange believes its proposal will serve to increase the displayed liquidity for options trading above \$1.00.

As proposed in the Initial Filing, ISE represents that options trading in penny increments will not be eligible for split pricing, as permitted under ISE Rule 716. In the Initial Filing, the Exchange also made references to quote mitigation strategies that are currently in place and proposed to apply them to the Penny Pilot Program. The Exchange proposes to continue applying those quote mitigation strategies during the extension of the Penny Pilot Program, as contemplated by this rule filing. Specifically, as proposed in Rule 804, ISE will continue to

utilize a holdback timer that delays quotation updates for up to, but not longer than, one second. The Exchange's monitoring and delisting policies, as proposed in the Initial Filing, shall also continue to apply.

The Exchange agrees to submit semi-annual reports to the Commission analyzing the Penny Pilot Program for the following time periods:

- July 1, 2009 – December 31, 2009
- January 1, 2010 – June 30, 2010
- July 1, 2010 – December 31, 2010

The Exchange anticipates its report will analyze the impact of penny pricing on market quality and options system capacity. The Exchange will submit the report within one month following the end of the period being analyzed.

ISE believes in a measured extension and expansion of the Penny Pilot Program. A properly thought out plan will serve to benefit public customers by providing them with penny quoting and trading in a greater number of actively traded securities. While an expansion of the Penny Pilot Program will lead to greater quotation traffic and confront exchanges with systems capacity issues, the Exchange believes that the benefits of the Penny Pilot Program outweigh these costs.

## 2. Statutory Basis

The basis under the Securities Exchange Act of 1934 (the "Exchange Act") for this proposed rule change is found in Section 6(b)(5), in that the proposed rule change is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system and, in general, to protect investors and the

public interest. In particular, the proposed rule change allows for a measured expansion of the Penny Pilot Program for the benefit of market participants.

B. Self-Regulatory Organization's Statement on Burden on Competition

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. In addition, the Commission seeks comment on the following issues:

1. The Commission requests comment specifically on the extent and cost of the impact, if any, to market participants' technological systems and platforms to accommodate



ISE's proposed change in breakpoints for option classes included in the Penny Pilot.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-ISE-2009-32 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-ISE-2009-32. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing will also be available for inspection and copying at the principal office of the self-regulatory organization. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-ISE-2009-32 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>8</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>8</sup> 17 CFR 200.30-3(a)(12).