

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55162; File No. SR-Amex-2006-106)

January 24, 2007

Self-Regulatory Organizations; American Stock Exchange LLC; Order Granting Approval to Proposed Rule Change as Modified by Amendment No. 1 Thereto, Relating to the Adoption of a Penny Pilot Program

I. Introduction

On November 9, 2006, the American Stock Exchange LLC (“Amex” 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 a quote mitigation strategy. The proposed rule change was published for comment in the Federal Register on November 20, 2006.³ The Commission received four comment letters on the proposed rule change.⁴ On January 18, 2007, the Exchange filed Amendment No. 1 to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 54741 (November 9, 2006), 71 FR 67176.

⁴ See letters to Nancy M. Morris, Secretary, Commission, from Wayne Jervis, Managing Member of the General Partner, Jervis Alternative Asset Management Co. (“JAAMCO”), dated December 1, 2006 (“JAAMCO Letter”); from Christopher Nagy, Chair, Securities Industry and Financial Markets Association (“SIFMA”) Options Committee, dated December 20, 2006 (“SIFMA Letter”); from Peter J. Bottini, Executive Vice-President, optionsXpress, Inc. (“optionsXpress”), dated November 17, 2006 (“optionsXpress Letter”); and from Patrick Sexton, Associate General Counsel, Chicago Board Options Exchange, Inc. (“CBOE”), dated December 12, 2006 (“CBOE Letter”).

proposed rule change.⁵ The Exchange responded to the comment letters on January 19, 2007.⁶

This order approves the proposed rule change as modified by Amendment No. 1.

II. Description of the Proposal

A. Scope of the Penny Pilot Program

Amex proposes to amend its rules to permit certain option classes to be quoted in pennies during a six-month pilot (“Penny Pilot Program”), which would commence on January 26, 2007. Specifically, proposed Commentary .01 to Amex Rule 952 would set forth the parameters of the Penny Pilot Program and note that information concerning the Penny Pilot Program will be communicated to members via Regulatory Circular.

Currently, all six options exchanges, including Amex, 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

⁵ Amendment No. 1 proposed to replace Glamis Gold, which was delisted, with Agilent Tech, Inc. in the list of options classes permitted to be quoted in pennies. Amendment No. 1 is technical in nature, and the Commission is not publishing Amendment No. 1 for public comment.

⁶ See letter to Nancy Morris, Secretary, Commission, from Jeffrey P. Burns, Vice President and General Counsel, Amex, dated January 19, 2007. On January 23, 2007, Amex supplemented its initial response by providing additional information about its Holdback Timer. See letter to Nancy Morris, Secretary, Commission, from Jeffrey P. Burns, Vice President and General Counsel, Amex, 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 Circular.

The minimum price variation 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.

Amex 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.

B. Quote Mitigation Proposal

To mitigate quote message traffic, Amex has represented to the Commission that it has already implemented or intends to implement the following quote mitigation strategies.

- Join Quote. The Amex, through the ANTE system,⁷ provides that registered options traders (“ROTs”) may either stream their own quotes or join the specialist’s disseminated quotation in some or all of his assigned classes or series (“join quote”). In order to participate in “join quote,” a ROT must be physically present in the trading crowd. The purpose of allowing ROTs to piggyback on specialists’ quotes is partly to reduce market data traffic by allowing ROTs to join the specialist’s quote in the less actively traded series (far out months, etc.) while

⁷ See Securities Exchange Act Release No. 49747 (May 20, 2004), 69 FR 30344 (May 27, 2004) (SR-Amex-2003-89).

auto-quoting the more actively traded series.

- Monitoring. The Amex actively monitors the quotation activity of its market participants. When the Exchange detects that a market participant is disseminating significantly more quotes than the average market participant, the Exchange contacts the market participant and alerts them to potentially excessive quotation activity. Often such monitoring reveals that the market participant may have internal system issues or has incorrectly set system parameters. Alerting the market participant usually leads to the market participant to take steps to reduce the number of quotes for dissemination.
- Holdback Timers. The Amex has the systematic ability to limit the dissemination of quotations and other changes to the Amex Best Bid or Offer (“ABBO”) according to prescribed time criteria (“Holdback Timer”). For instance, if there is a change in the price of a security underlying an option, multiple market participants may adjust the price or size of their quotes. Rather than disseminating each individual change, the Holdback Timer permits the Exchange to wait until multiple market participants have adjusted their quotes and then to disseminate a new quotation. This helps to prevent the “flickering” of quotations. The Amex proposes to codify the Holdback Timer in this rule filing. As proposed in Amex Rule 958A—ANTE, the Exchange will utilize a Holdback Timer that delays quotation updates for no longer than one (1) second.
- Delisting. The Amex commits to the Commission that it will delist options with an average daily volume (“ADV”) of less than 25 contracts. However, the Amex represented to the Commission that it has been its policy to be much more

aggressive in delisting relatively inactive options, thereby eliminating the quotation traffic attendant to such listings.

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 No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁸ In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,⁹ 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 Amex 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 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

⁸ 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).

⁹ 15 U.S.C. 78f(b)(5).

and disrupt the timely receipt of quote information. Nevertheless, because the Commission expects that the Penny Pilot Program will increase quote message traffic, the Commission is also approving the Exchange's proposal to reduce the number of quotations it disseminates.

In this regard, the commenters expressed concern about Amex's proposed quote mitigation strategy.¹⁰ In particular, although optionsXpress generally supported Amex's Holdback Timer, it expressed concern that a longer holdback timer period could negatively impact market quality and undermine transparency in the options market.¹¹

In addition, SIFMA recommends that all six of the option exchanges adopt a comprehensive and uniform quote mitigation strategy.¹² 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 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 Amex's quote mitigation proposals. In fact, SIFMA acknowledges that certain of Amex'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.

¹⁰ JAAMCO did not comment directly on Amex's proposal, but rather stated its strong support for quoting in penny increments in the options market, which it believes will improve inequities in the marketplace. See JAAMCO Letter, supra note 4.

¹¹ 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.

¹² See SIFMA Letter, supra note 4.

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 Amex's proposed quote mitigation strategies will lead to confusion among market participants.

Finally, CBOE commented that it did not have a fundamental objection to Amex's use of the Holdback Timer, but sought additional information concerning how the Holdback Timer functions and how orders sent to Amex by CBOE members or by CBOE through linkage might be impacted by the Holdback Timer.¹³ 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 Amex. In response, Amex indicated that it intends to use the Holdback Timer uniformly in all option classes.¹⁴ In addition, the Amex committed to apply the Holdback Timer mechanism throughout the trading day for a period of up to, but no more than, one second.¹⁵ In further response to inquiry from CBOE, the Amex 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.¹⁶

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

¹³ See CBOE Letter, supra note 4.

¹⁴ Telephone conversation between Michael T. Bickford, Senior Vice President, Amex, and Jennifer L. Colihan, Special Counsel, Cyndi N. Rodriguez, Special Counsel, and Johnna B. Dumler, Special Counsel, Division of Market Regulation, Commission, on January 23, 2007. See also Exchange Response, supra note 6.

¹⁵ Telephone conversation between Michael T. Bickford, Senior Vice President, Amex, and Jennifer L. Colihan, Special Counsel, Cyndi N. Rodriguez, Special Counsel, and Johnna B. Dumler, Special Counsel, Division of Market Regulation, Commission, on January 23, 2007.

¹⁶ Id.

Timer. Amex 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.¹⁷ Finally, in response to CBOE's inquiry regarding the treatment of incoming marketable orders, Amex indicated that Holdback Timer only "addresses the dissemination of quote changes on the Exchange not the execution of orders."¹⁸ Therefore, incoming marketable orders sent to the Exchange will automatically trade against Amex's current internal quotation that may be delayed during the one second holdback period.

¹⁷ See Exchange Response, supra note 6.

¹⁸ Telephone conversation between Michael T. Bickford, Senior Vice President, Amex, and Jennifer L. Colihan, Special Counsel, Cyndi N. Rodriguez, Special Counsel, and Johnna B. Dumler, Special Counsel, Division of Market Regulation, Commission, on January 23, 2007.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁹ that the proposed rule change (SR-Amex-2006-106), as modified by Amendment No. 1, 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.²⁰

Florence E. Harmon
Deputy Secretary

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ 17 CFR 200.30-3(a)(12).