

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54590; File No. SR-NYSEArca-2006-73)

October 12, 2006

Self-Regulatory Organizations; NYSE Arca, Inc.; Notice of Filing of Proposed Rule Change to Create a Penny Pilot Program for Options Trading

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 10, 2006, NYSE Arca, Inc. (“NYSE Arca” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the Exchange. 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

NYSE Arca proposes to: (i) clarify the language in NYSE Arca Rule 6.72; (ii) add a reference to a six month penny pilot in options classes in certain issues approved by the Commission (“Pilot Program”); and (iii) provide for an approved quote mitigation exception to NYSE Arca Rule 6.86. The text of the proposed rule is available on NYSE Arca’s Web site at [www.nysearca.com](http://www.nysearca.com), at the Exchange’s Office of the Secretary, and at the Commission’s Public Reference Room.

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

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

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 Exchange 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 Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

NYSE Arca Rule 6.72(a) sets forth the trading increments for option contracts quoted on the Exchange. Currently, the minimum price variation (“MPV”) for option series that are quoted under \$3.00 per contract is \$0.05 and the MPV for option series that are quoted at \$3.00 per contract or greater is \$0.10. The Exchange is proposing to: (i) clarify the language in NYSE Arca Rule 6.72; and (ii) add a reference to a six month penny pilot in options traded on a limited number of classes approved by the Commission.

The Exchange proposes to clarify existing language in NYSE Arca Rule 6.72 to continue a \$0.05 MPV for quoting in all options series trading at less than \$3.00, and \$0.10 MVP for quoting in all options series trading at \$3.00 or more, except those included in the Pilot Program described below.

**Pilot Program**

The Exchange proposes to provide for a penny MPV in options contracts in certain classes approved by the Commission. The Exchange believes that migrating to penny pricing in these classes will create tighter markets and thus reduce the overall cost of trading in options for

investors. Despite the overall benefits provided to investors in migrating to penny pricing, the Exchange believes it is critical to introduce pennies in a measured approach that will not exacerbate the existing quote capacity limitations that currently exist.

The Exchange proposes that options classes in the following issues be approved for inclusion in a Penny Pilot:

QQQQ	Nasdaq-100 Index Tracking Stock
IWM	iShares Russell 2000 Index Fund
SMH	Semiconductor Holdrs Trust
GE	General Electric Company
AMD	Advanced Micro Devices, Inc.
MSFT	Microsoft Corporation
INTC	Intel Corporation
CAT	Caterpillar Inc.
WFMI	Whole Foods Market, Inc.
TXN	Texas Instruments Incorporated
GLG	Glamis Gold Ltd.
FLEX	Flextronics International Ltd.
SUNW	Sun Microsystems, Inc.

Under the proposed Pilot Program, the Exchange will allow trading and quoting in increments of \$0.01 for all options on the QQQQ, and will allow trading and quoting in pennies for series in all other Pilot classes approved by the Commission that are trading below \$3.00. Pilot classes with series trading at or above \$3.00 would have a \$0.05 quoting MPV. The Exchange anticipates the Commission will approve options classes in issues with a contrasting

range of trading activity so that the Exchange and the industry may better understand the effects of the Pilot Program. The Exchange intends to include any option approved as eligible for the Pilot Program for penny trading and quoting. The Exchange believes the Commission should approve a variety of option classes for inclusion in a pilot broad enough to encompass differing quote and trade activity levels.

The Exchange will continue to abide by the existing Options Linkage Plan (“Linkage”) as described in NYSE Arca Rules 6.93 and 6.94 with respect to linkage operation and order protection. If the Exchange receives an order through Linkage in a Pilot Program series from another exchange not quoting and trading in pennies, the Exchange will fill the incoming order at a penny incremented price, as long as the execution price is equal to or better than the reference price of the Linkage order. In the event of a trade through by another Linkage Participant Market of a customer order in a Pilot Program issue that has been denominated and disseminated to the Options Price Reporting Authority (“OPRA”) in a penny increment, the Exchange will assign a reference price on an outbound Satisfaction order in the penny incremented price of the customer order. The Exchange believes that a Linkage Participant market that receives a Satisfaction order in a penny increment should be permitted to fill the Satisfaction order at its reference price; regardless of the actual MPV permitted at the recipient exchange. If a Participating Market is not capable of processing and reporting a transaction in a penny increment, the Exchange believes that it is consistent with the intent of the Linkage plan that the receiving market should fill the Satisfaction order at the next best MPV allowed in that series on the receiving exchange. The Exchange would accept an execution report at that price, and fill the customer order that had been traded through at the price received on the Satisfaction order.

As is widely acknowledged, the options industry is facing significant capacity issues related to excessive quoting rates. Peak quote rates<sup>3</sup> through April 2006 as reported by OPRA, the processor that disseminates quote and trade data for the options industry, have increased to 7 times the 2003 peak quote rates. In the last year, peak rates have more than doubled. In order to limit the capacity impact of migrating to penny trading, the Exchange proposes to limit the pilot to options on QQQQ and other issues approved by the Commission. This will allow the Exchange to carefully study the impact and assess the outcome of penny trading on data traffic. Further, in conjunction with the pilot, the Exchange proposes a strategy to mitigate the volume of data being processed and disseminated by OPRA.

Sixty days prior to the expiration of the Pilot Program, the Exchange agrees to submit a report to the Commission that includes: (i) data and written analysis on the number of quotations generated for options selected for the Pilot Program; (ii) an assessment of the quotation spreads for the options selected for the Pilot Program; (iii) an assessment of the impact of the Pilot Program on the capacity of the NYSE Arca's automated systems; (iv) any capacity problems or other problems that arose related to the operation of the Pilot Program and how the NYSE Arca addressed them; and (v) an assessment of trade through complaints that were sent by the NYSE Arca during the operation of the Pilot Program and how they were addressed. The report will study data produced in the first three months of the Pilot Program.

#### **Quote Mitigation Strategy**

NYSE Arca Rule 6.86 describes the obligations of the Exchange to collect, process and make available to quotation vendors the best bid and best offer for each option series that is a

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<sup>3</sup> Peak quote rates are measured in messages per second over a 1 minute period.

reported security. The Exchange proposes an exception to making quotes available to quotation vendors as part of an approved quote mitigation plan. The quote mitigation strategy proposed by the Exchange is intended to reduce the number of quotations generated by NYSE Arca for all option issues traded at NYSE Arca, not just issues included in the Pilot Program. NYSE Arca plans to reduce the number of quote messages it sends to OPRA by only submitting quote messages for “active” options series. Active options series are defined as the following: (i) the series has traded on any options exchange in the previous 14 calendar days; or, (ii) the series is solely listed on NYSE Arca; or (iii) the series has been trading ten days or less; or, (iv) the Exchange has an order in the series. For any options series that falls into one of the aforementioned categories, NYSE Arca will submit quotes to OPRA as it currently does. For any options series that falls outside of the above categories, NYSE Arca will still accept quotes from OTP Holders in these series; however, such quotes will not be disseminated to OPRA.

In addition, there are certain instances when a series would become active intraday. Such instances include: (i) the series trades at any options exchange; (ii) NYSE Arca receives an order in the series; or (iii) NYSE Arca receives a request for quote from a customer in that series. When one of the above circumstances exists, NYSE Arca would immediately begin disseminating quotes to OPRA in that particular series and would continue doing so until that series fell outside of the active series definition. If the series does not trade, and there are no orders in the series the next day, the series would no longer be considered active. Further, because NYSE Arca will continue to collect quotes from OTP Holders in inactive series, upon receiving an order in an inactive series, the Exchange will either execute that order against any marketable quotes in the trading system, or will link that order to the away market displaying the

NBBO in that series. Accordingly, OTP Holders' orders will not be disadvantaged and will still have an opportunity to execute at the best price in such inactive series.

Based upon studies conducted by the Exchange, it appears less than 25% of the industry's available options series trade each day. In addition, on NYSE Arca on any given day, 75% of the trading volume occurs in options on 200 underlying securities out of a possible 2,000 underlying securities that have listed options contracts listed on NYSE Arca. Accordingly, the Exchange felt it was prudent to analyze the quoting behavior in such inactive series. Based upon the analysis, the Exchange determined that it was possible to reduce quote traffic by 20-30% by limiting quote dissemination to solely active series as described above. As a result, the Exchange believes its proposed data mitigation strategy will have a significant effect on reducing quote traffic and addressing the current capacity problems facing the industry.

## 2. Statutory Basis

The Exchange believes that its proposed rule change is consistent with Section 6(b) of the Act,<sup>4</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>5</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

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

The Exchange does not believe that the proposed rule change will impose any burden on

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<sup>4</sup> 15 U.S.C. 78f(b).

<sup>5</sup> 15 U.S.C. 78f(b)(5).

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

Written comments on the proposed rule change were neither solicited nor received.

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 Exchange 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 approved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the Act. 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-NYSEArca-2006-73 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and

Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NYSEArca-2006-73. 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 Section, Station Place, 100 F Street, NE, Washington, DC 20549-1090. Copies of such filing also will be available for inspection and copying at the principal office of NYSE Arca. 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-NYSEArca-2006-73 and should be submitted on or before [insert date 21 days from date of publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

Nancy M. Morris  
Secretary

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<sup>6</sup> 17 CFR 200.30-3(a)(12).