Janet M. Kissane
Senior Vice President – Legal & Corporate Secretary
Legal & Government Affairs

20 Broad Street
New York, New York 10005
t 212.656.2039 | f 212.656.8101
jkissane@nyx.com

NYSE Euronext

VIA EMAIL AND FEDERAL EXPRESS

August 9, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Release No. 34-62523; File No. SR-ISE-2010-73

Dear Ms. Murphy:

NYSE Euronext, on behalf of its subsidiary options exchanges, NYSE Arca Inc. ("NYSE Arca") and NYSE Amex LLC ("NYSE Amex"), appreciates the opportunity to comment on the above-referenced filing, in which the International Securities Exchange ("ISE") proposes to adopt a modified version of its 2009 proposal to adopt a Qualified Contingent Cross ("QCC") order, as set forth in File No. SR-ISE-2009-35, on which we commented previously.[1] As the Commission is aware, ISE's initial QCC proposal attracted significant opposition, including a formal challenge by the Chicago Board Options Exchange ("CBOE"). In fact, the CBOE challenge resulted in a stay of the Commission staff's approval, by delegated authority, of ISE's initial QCC proposal.

ISE indicates in its current filing that it has requested that the Commission vacate the staff's approval of the previous proposal simultaneously with the approval of the current proposal. In addition, ISE asserts that its modified proposal addresses the two primary objections raised in connection with the initial QCC proposal. Specifically, ISE states that the modified QCC proposal does not permit a QCC to be executed at the same price as a priority customer order on ISE and that the modified proposal increases the required minimum size for a QCC order from 500 to 1000 contracts.

Despite the changes to the original filing, our concerns over ISE's proposed QCC order, which relies on the Qualified Contingent Trade ("QCT") exemption from Rule 611 of Regulation NMS, remain. From a process standpoint, it appears that the Commission is treating the modified proposal simply as an amendment to the initial QCC proposal. We find it extremely surprising that the new filing is being granted a shortened comment period,

---

[1] *See* NYSE letters dated April 7, 2010 and December 3, 2009.

despite the abundance of comment letters the original filing elicited, indicating the enormity of the detrimental market structure change a broad spectrum of participants believe will be effected should this rule be approved. Certainly, we urge the Commission to carefully consider the issues raised by this proposal in deciding whether to approve the proposal. At a minimum, and as described below, we do not believe that ISE has fully responded to a number of comments raised in connection with the initial QCC proposal.

Our concerns with ISE's QCC proposal emanate from the proposal's impact on two important facets of options market structure: (1) the importance of exposure of options orders to the marketplace; and (2) the key role of market makers in maintaining liquidity in the options markets. These crucial aspects of options market structure have only taken on more importance in light of the market events of May 6, 2010. In addition, we do not agree with ISE's contention that its QCC proposal is simply a matter of electronically replicating an existing practice of floor-based exchanges.

Overview:

One of the clear findings from the analysis of the market events of May 6, 2010 is that the options marketplace did not experience nearly the same magnitude of disruption as did the equities markets. Arguably, one of the reasons for this is that the overwhelming majority of listed options volumes are displayed and executed on exchanges that impose quoting obligations for market makers – requiring them to post two-sided markets the majority of the time. Many of our largest market makers accept an obligation to stream two-sided markets in option classes on over 1,000 underlying securities that collectively represent over 200,000 individual option series. The risk that they are taking is substantial, which raises the question – why would market makers take such substantial risk? The answer is that market makers believe that there is a reward for providing liquidity to all market participants in this manner – the reward is the opportunity to trade and potentially earn some portion of the bid/ask spread on publicly displayed orders.

This opportunity to trade has long been a function of an options market structure that has evolved dramatically as a result of competition between exchanges, bolstered by Commission initiatives that led to multiple listing, Intermarket Linkage, and the penny pilot. Indeed, in the past, the Commission generally has limited participation guarantees of a single order to 40% for any one participant or subset of participants.[2] Limitations on participation guarantees, coupled with order exposure requirements, have ensured that market makers who accept the risk associated with quoting obligations are suitably incented to accept those quoting

[2] *See* NYSE Amex Rule 964 NY, CBOE Rule 6.45A , ISE Rule 713, and Nasdaq PHLX Rule 1014(g)

obligations and to provide tight, liquid markets that appropriately reflect the current price of the underlying security and other modeling inputs based on factors including supply and demand, time value, and interest rates in any particular series. Permitting a trade that is privately negotiated between two parties to immediately cross without exposure and with no opportunity for price improvement is the equivalent of a 100% participation guarantee for selected market participants, a result the Commission has previously opposed. If allowed to take effect, this 100% participation guarantee will ultimately eliminate the incentive for market makers to quote competitively, to the detriment of all investors who rely on the transparency and non-discriminatory accessibility of the quoted screen markets to execute trades as part of hedging or risk taking strategies.

Consequently, NYSE Euronext emphasizes that approving ISE's QCC as proposed will lead to higher costs and undermine market stability, affecting all classes of investors and leaving only those participants with access to private negotiations able to trade at the best available prices inside the diluted screen markets. Over the past two decades, multiple listing, Intermarket Linkage, and the penny pilot have served to tighten spreads for retail investors. These gains will be forfeited as the risk/reward of quoting thousands of series with severely diminished opportunity to trade is replaced by the more favorable risk/reward of only providing liquidity to select investors at a time and price of the participants' choosing. Rather than attempting to extrapolate what is proper for the options industry by looking at QCC as it exists in the equities marketplace, NYSE Euronext urges the Commission to consider that the options market is a quote driven, derivatively priced market that is fundamentally different from equities and therefore adopting a "one size fits all" solution is inappropriate.

With that in mind, NYSE Euronext believes that any proposal to permit the crossing of contingent orders in the options market without exposure should be rejected in its entirety. Should the SEC feel compelled to move forward with this filing, we feel that several details of the QCC proposal must be addressed in order to maintain the integrity of the options market structure (a market structure which, given its greater transparency and more cohesive nature, should more appropriately be the example for the equities market rather than the other way around).

<u>QCC Significantly Detracts From Transparency</u>:

Absent full disclosure of all components of an order and any contingencies – including the existence and price of a stock leg – approving a rule that allows an order to trade without exposure will *prevent* –not foster-- price discovery and transparency. ISE has argued that QCC is the equivalent of what happens on floor-based exchanges every day when brokers attempt to cross all or some portion of an order. However, this simply is not the case. The rules of the floor-based options exchanges, including NYSE Amex and NYSE Arca, specifically require participants to disclose cross orders publicly and to disclose any and all contingencies associated with a cross order when the order is exposed prior to trading.[3] ISE's own rules[4] regarding Complex Orders and Stock-Option orders in fact require that,

> A bid or offer made as part of a stock-option order (as defined in (a)(2) above) or a SSF-option order (as defined in (a)(3) above) is made and accepted subject to the following conditions: (1) the order must disclose all legs of the order and must identify the security (which in the case of a single stock future requires sufficient identification to determine the market(s) on which the single stock future trades) and the price at which the non-option leg(s) of the order is to be filled; and (2) concurrent with the execution of the options leg of the order, the initiating member and each member that agrees to be a contra-party on the non-option leg(s) of the order must either elect to have the stock leg(s) of a stock-option order electronically communicated to a designated broker-dealer for execution as provided in .02 below or take steps immediately to transmit the non-option leg(s) to a non-Exchange market(s) for execution. Failure to observe these requirements will be considered conduct inconsistent with just and equitable principles of trade and a violation of Rule 400.

The existence of these requirements severely undermines ISE's argument that QCC is the equivalent of what occurs today on floor-based exchanges. Moreover, ISE already has an analog for floor-based crossing in the form of their facilitation and solicitation mechanisms. The solicitation mechanism on the ISE by design and rule is more difficult to interfere with than solicitation crosses in open outcry.[5] Specifically, we note that in open outcry, the solicited side of the cross can be replaced for any quantity that is better priced – in contrast in the ISE's solicitation mechanism the solicited party to the cross can only be replaced if the full quantity of the order can be better priced. [6]

This is in stark contrast with ISE's QCC proposal, which would allow the option leg of the order to trade immediately with no exposure or opportunity for price improvement *and* with no disclosure to the marketplace about the price and quantity of the stock leg, upon which the options prices are based. Under existing market structure, whether via an electronic crossing mechanism or an open outcry environment, even if the attempt to cross 100% of the order is successful, because all components of the order *must* be exposed, the process still provides the marketplace with meaningful information that fosters the price discovery process. Absent the need to expose *all inter-related components* of the order for potential price improvement, QCC abolishes price discovery and meaningfully corrupts transparency.

---

3 *See* CBOE Rule 6.74(b)(i), Nasdaq PHLX Rule 1064(b)(i), NYSE Amex Rule 934.1NY(1) and NYSE Arca Rule 6.47(b)(2).

4 *See* ISE Supplementary Material .01 to Rule 722.

5 *See* ISE Rule 716(e) Solicited Order Mechanism

6 *See* NYSE Amex Rule 934.3NY, as compared to ISE Rule 716(e).

<u>The 1000 Contract Minimum Does Not Significantly Limit The Scope Of QCC</u>:

While ISE does not state a specific reason for the change, we assume the increase in size from 500 to 1000 contracts is meant to give the impression that the use of QCC will be limited in its scope. In practice, however, nothing could be further from the truth given the fact that a QCT essentially entails simply "a transaction consisting of two or more component orders." Absent the existing restrictions that apply to complex orders under the rules of the ISE and uniformly under the rules of other options exchanges, a significant potential for gaming this rule exists. Those rules require a 1:3 or 3:1 ratio for complex orders of two or more legs, and an 8:1 ratio for stock/option orders to qualify for limited priority over trading interest in the individual option series.[7]

For example, NYSE Amex Rule 900.3NY(e) defines a Complex Order as:

> …any order involving the simultaneous purchase and/or sale of two or more different option series in the same underlying security, for the same account, in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00) and for the purpose of executing a particular investment strategy…

While NYSE Amex Rule 900.3NY(h) defines a Stock/option order as:

> …an order to buy or sell a stated number of units of an underlying stock or a security convertible into the underlying stock ("convertible security") coupled with the purchase or sale of option contract(s) on the opposite side of the market representing either (A) the same number of units of the underlying stock or convertible security, or (B) the number of units of the underlying stock necessary to create a delta neutral position, but in no case in a ratio greater than 8 option contracts per unit of trading of the underlying stock or convertible security established for that series by the Clearing Corporation.

NYSE Euronext does not understand how a QCC Order should not be considered a Complex Order and therefore why it does not need to meet the criteria outlined above.

Additionally because the language regarding orders that qualify for the QCC exemption reads, "a transaction consisting of *two or more* component orders," it will be very easy for those market participants engaged in the private negotiations to append the required number of relatively cheap options to a trade whenever they wish to enjoy a 100% participation guarantee. For example, assume a firm represents a customer interested in selling 100 August

---

[7] *See* NYSE Amex Rule 900.3NY(e), NYSE Arca Rule 6.62(e), Nasdaq PHLX Rule 1080 Commentary .08(a), ISE Rule 722, and CBOE Rule 6.53C(a). BOX Rules Chapter V, Section 27, defines a more restrictive ratio; NASDAQ Options Market and BATS do not presently define, accept or trade Complex Orders. .

45 calls at $5.40. The current NBBO market for the August 45 calls is $5.00 – 5.40; the stock is currently trading $50.00. The fair value of the call with the stock trading at $50.00 is $5.12, which lines up correctly with the current NBBO.[8]

Without bringing all components of the order to auction for price discovery, a solicited party—who may have no quoting obligations whatsoever—is contacted for a private negotiation. The solicited party is willing to facilitate buying the options against selling 2,000 shares of stock at $51.00.[9] Since the customer is eager to sell the calls at $5.40 and can hedge the trade's remaining 7,300 delta at the stock's market price of $50.00, he agrees.

A 100-contract trade is not a QCC-eligible order under the currently-proposed rule. However, the solicited party notes that selling the stock $1.00 higher offers a profit opportunity, and in order to use QCC to guarantee a 100% clean cross, asks "would the other party mind buying 450 August 75 calls for $0.01 and selling 450 August 80 calls at $0.01 each as part of the package?" Since both of these options are worthless and far out of the money, buying and selling for $0.01 on each strike is an essentially riskless way to meet the definition of a QCC eligible order, under the rule as currently proposed. The customer would get a free call spread as part of the trade and thus has little reason to refuse the suggestion.

In an auction, this trade would not go up at these prices because the fair value of the call against stock at $51.00 is $6.06, $0.66 higher than the current NBBO offer and $0.94 higher in fair value, and competition via an auction would very likely result in a better net price for the initiating customer.[10] Using QCC to avoid the auction, however, the trade could take place, and therefore if during negotiations the customer and firm agree to an amount and price of stock without the checks and balances of price discovery, the price and delta relationships between options and stock are vulnerable to abuse. Furthermore, although the option prices are on or within the NBBO, neither the 3:1 nor the 8:1 ratios that have long served the marketplace are being respected—the 3:1/1:3 ratio, which protects participants from exactly the type of abuse highlighted in the example above, and the 8:1 requirement that 8 option contracts be hedged by at least 100 shares of stock (equivalent to a 12.5 minimum delta)

---

8 *See* the Options Industry Council ("OIC") Pricing Calculator ("PC") at http://www.optioneducation.net/calculator/main_advanced.asp. Using the OIC PC, the inputs were as follows: stock price = $50, days to expiration = 12, interest rate = 0.25%, volatility = 40%, no dividends. According to the OIC PC, the call has a 96 delta with the stock at $51.00 and a 93 delta with the stock at $50.00.

9 It is assumed that $50.00 and $51.00 per share are both within the stock's trading range for the day.

10 Changing the stock price to $51.00 and all other inputs remain unchanged.

which ensures that “fully hedged” does not end up meaning hedging 1,000 option contracts that have a 9,300 total delta with 2,000 shares of stock when traded via QCC.

This result is a distinct possibility given that “fully hedged” is not a clearly defined term within the ISE rules, or any other published rule text, commentary, or SEC documents. (There is the generally recognized definition of “fully hedged’ in accordance with accepted risk models, but that language is vague enough to leave ample room for liberal interpretation – there were several large, now defunct, firms whose risk models indicated that they were “fully hedged”.) Absent a mandate to adhere to the existing requirements for ratios governing complex orders, QCC orders can be creatively constructed to meet the loose definitions provided by the ISE filing. Without a requirement to divulge all components of an order via an auction, whether in open outcry or electronically, QCC, as demonstrated above, effectively destroys the price relationship between options and the underlying security. NYSE Euronext believes ISE has not demonstrated a sufficient basis to forsake the existing, sensible guidelines – especially at a time when greater transparency, not less, is more desirable than ever.

ISE’s Failure to Respond to Concerns Raised in Previous Comment Letters:

As we noted above, ISE’s original proposal elicited abundant comment letters from a wide cross section of market participants. The modified proposal purports to “address the most significant issues that some commentators raised regarding the QCC.[11]“ It claims to do so simply by raising the minimum size to 1,000 contracts – a red herring as described above – and by respecting customer priority by not permitting QCCs to cross ahead of customer interest at the same price on the ISE Book. While the issue of customer priority is relevant, it does not address the significant matters of market integrity implicated by the QCC proposal. This larger issue – one where privileged parties can negotiate privately and cross, without any type of exposure, trades of their choosing – creates a tremendous disincentive for market makers to accept quoting obligations, and discourages competition via onscreen liquidity across many classes of investors, because market makers with quoting obligations will have no opportunity to trade with the orders executed as part of a QCC unless they are privy to the private negotiation and retail customers will end up paying a larger bid/ask differential as a result. Nothing in this filing responds to the larger concern that QCCs would cause grievous harm to transparency and discourage competitive quoting. Here are some excerpts from earlier comment letters raising the key issues of transparency, price discovery, and competition, which ISE has declined to respond to and which are not addressed anywhere within the new rule filing:

---

[11] *See* the “Request to vacate” letter dated July 14, 2010 submitted by the ISE.

1. In its comment letter, Liquidpoint noted that "The exposure rules promote the important principles of price discovery, transparency, competition and accountability," while, "QCC allows transactions to be privately negotiated and consummated without prior dissemination of all terms and conditions for competitive responses. This private negotiation and execution precludes transparency for other market participants." [12]

2. "Citadel agrees that QCC orders (4) provide a disincentive for market makers to display liquidity, and (5) diminish transparency"[13]. Again ISE has not responded to issues raised by, "…one of the most active market makers admitted to dealing on both the CBOE and ISE."[14]

3. "NYSE Euronext questions how QCCs can benefit the market as a whole and contribute to the efficient functioning of the securities markets and the price discovery process."[15]

What is notable is that three different types of market participants are all asking the same question – one firm offers execution tools/brokerage, another commits capital and the last operates two options exchanges with competing market models. The fact that such a diverse group of participants all raise the same concerns—concerns that remain unanswered by the ISE or the SEC—is of particular concern and should give the Commission pause.

<u>Conclusion</u>:

Market structure changes are inevitable as exchanges strive to differentiate themselves in an attempt to attract more business. Balancing the need to foster competition while protecting the integrity of the marketplace, and in particular ensuring retail investors are not harmed, is a difficult task. The Commission to date has managed this balancing act very successfully, as evidenced the dramatic growth in the options marketplace – both in trading volume and the number and variety of participants. NYSE Euronext strongly cautions that approving QCC as proposed would constitute a ruinous market structure change that will void the progress in accountability and transparency that has been made since the advent of multiple listing, Intermarket Linkage, and the implementation of the penny pilot. Tight, transparent screen markets benefit all investors, large and small. QCC will only benefit those privileged few who have access to the private negotiations and will lead to less liquid, more widely quoted

12 *See* Liquidpoint letter dated October 7, 2009.

13 *See* Citadel letter dated December 3, 2009.

14 *See* Citadel letter dated December 3, 2009.

15 *See* NYSE Euronext letter dated December 3, 2009

markets. Decreased transparency, wider markets, less liquidity, and less incentive to make robust markets can only add up to higher costs and asymmetrical access to best execution prices. The industry as a whole would be much better served if the Commission dismisses this type of encroachment on an existing market structure that invites a broad and healthy range of participation, and instead continues in the tradition of championing transparency, price discovery, and competition that have given us the robust and active marketplace we enjoy today.

Very truly yours,

Janet M Kissane