International Securities Exchange

October 16, 2013

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: File No. SR-NYSEArca-2013-42

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the proposal ("Proposal") of NYSE Arca, Inc. ("Arca") to make permanent the penny pilot trading program for options (the "Pilot").[1] Although ISE supports making the Pilot a permanent program, we do not support Arca's Proposal. We believe that this Proposal is inconsistent with the Securities Exchange Act of 1934 ("Act") in that it inappropriately restricts the number of options that would be quoted and traded in pennies. We therefore respectfully request that the Commission institute proceedings to determine whether to approve or disapprove the Proposal. In the interim, we recommend that the Commission accept rule filings from the options exchanges extending the current Pilot while also considering alternative proposals to make the Pilot permanent.

The Arca Proposal Inappropriately Limits the Number of Options Trading in Pennies

Arca proposes to reduce the number of options that trade in pennies from over 350 under the Pilot to 150.[2] Under the Pilot, approximately 83 percent of options

[1] Release No. 34-70317, September 4, 2013 (78 *F.R.* 55312 (September 10, 2013)). This is our second letter on the Proposal. In a letter dated October 1, 2013 from Michael Simon, Secretary, ISE to Elizabeth Murphy, Secretary, Commission ("Initial Letter"), we requested that the Commission delay action on the Proposal to give the options exchanges an opportunity to come to agreement on a common approach to quoting and trading in pennies. Because it now appears that agreement on a common approach may not be possible within the time frame in which the Commission must act on the Proposal, we are submitting this letter providing our substantive comments.

[2] Arca generally would retain the provision of the Pilot in which all options with premiums above $3 (with limited exceptions) would trade in $.05 increments. We support the continuation of this distinction, although any proposal we ultimately may make likely will recommend minor changes to this aspect of the Pilot. Similarly, Arca proposes a procedure to determine how to add and delete options from penny trading. Again, while we may propose procedures slightly different from those of Arca, we generally believe that Arca's position on this aspect of the Proposal is reasonable.

trading volume is in penny names. Under Arca's Proposal, only approximately 70 percent of the volume will be in pennies. We believe that this is a significant decrease in penny trading that will deny investors the benefits of better prices that penny trading offers. We do not believe that Arca has provided a sound justification for inflicting such harm on investors.

By way of background, the options exchanges have traded options in pennies under the Pilot since 2007. The Pilot grew over the years until the exchanges settled on the current number of over 300 options in 2009, as first proposed by Arca.[3] Throughout the Pilot all the options exchanges have filed periodic reports analyzing the effects of penny trading. Over these six years, no exchange has filed a proposal to limit the Pilot in any manner. Yet, in filing to make the Pilot permanent, Arca now proposes to decrease by over 200 the number of options trading in pennies.

The only affirmative reason that Arca gives for decreasing the number of penny options is that it will reduce quotation traffic. Arca bases this conclusion on its study of quote-to-trade ratios. Otherwise, the only support Arca provides for its Proposal is that it will do little, if any, harm to investors. ISE believes that the quote-to-trade analysis is an insufficient basis to support decreasing the number of options that trade in pennies by 200 names. We further disagree with Arca that its Proposal will not harm investors.

With respect to the quote-to-trade ratio, we do not dispute Arca's study, which showed higher ratios in less active Pilot options than in the more active Pilot options. That result clearly is to be expected, and has been the case since the beginning of the Pilot. That is also irrelevant. No exchange previously has argued that this alone is reason to reduce the number of penny options and we see no basis for such a conclusion today. Quotations are the means by which options exchanges and their members advertise their willingness to trade, and greater quotation activity indicates greater competition among these market participants. For less active options it is obvious that there will be fewer trades in relation to quotations. But Arca does not explain why this is harmful to investors.

If the costs of collecting and disseminating quotations presented serious problems to the industry, we could understand concerns about quote-to-trade ratios. However, in its proposal Arca does not identify any inappropriate costs associated with quotations. In fact, Arca doesn't discuss the costs of quotations at all. Moreover, in a comment letter on the Proposal, D.E. Shaw convincingly shows that the volume of quotations in the less active penny options is relatively low, and notes that Arca never has suggested that an increase in quote-to-trade ratio has had an adverse impact in its operations.[4]

Over the last 15 years the options exchanges have faced the challenge of increased quotation traffic as competition has increased the number of exchanges from four to 12 exchanges, with a corresponding explosion of trading volume. Increased

---

[3] File No. SR-NYSEArca-09-44, Release No. 34-59944, May 20, 2009 (74 *F.R.* 25294 (May 27, 2009)).

[4] Letter dated September 30, 2013 from John M. Liftin, Managing Director and General Counsel, The D.E. Shaw Group, to Elizabeth M. Murphy, Secretary, Commission.

competition, increased trading and quotation volumes, and overall greater interest in options products are good problems to have. While penny quoting is one driver of increased quotation traffic, it pales in comparison to other factors, such as the tripling of the number of options exchanges, the increase in the number of options series that trade, and the development of new products, such as short-term (or "weekly") options. Like penny trading, all of these initiatives benefit investors. The options exchanges themselves, and collectively through the Options Trade Reporting Authority ("OPRA"), have adopted new technologies to deal with this increase in quotation traffic in a cost-efficient manner. Before this Proposal, no exchange has ever argued to scale back benefits to investors due to quotation volume or quote-to-trade ratios.

Furthermore, and contrary to Arca's claims, investors will suffer harm if the number of options that trade in pennies falls. Arca states that the average spread in the 20 least active penny options is $.60, and then claims that a $.05 minimum price variation for such a product is "not an unreasonable ratio." First, we question why Arca limited this analysis to the 20 least-active options rather than the 200 options they propose to eliminate from penny trading. We further question what analysis Arca used to reach this conclusion since the Filing provides no support for the claim.

Contrary to Arca's assertions, it is obvious that investors will be harmed: An investor seeking to sell or buy an option in such a series at a penny price will need to adjust his or her price to the nearest nickel, either paying more or receiving less than the investor truly seeks. ISE's data, as well as data from other exchanges and Members, in fact shows that market quality in the less active penny options is quite high, not only on average, but specifically when examining displayed quotes in the at-the-money front month series, where the vast majority of trading occurs. This data shows that penny-traded classes outside the top 150 have an average spread of just $.061 in the most actively-traded option series. Increasing the minimum increment in these classes to $.05 only could cause a significant widening of the displayed markets. ISE also examined market quality in non-penny classes and found that those markets are on average much wider than those traded in pennies, a data set Arca's filing also failed to include while proposing to convert over 200 classes to non-penny trading.

In an effort to dismiss this obvious harm, Arca argues that investors still can achieve penny executions in the deleted classes through certain industry price improvement mechanisms. This argument hardly supports Arca's proposal since it acknowledges that, rather than eliminating penny trading in these 200 options, it simply will drive the penny trading from the quoted, transparent market to non-transparent market mechanisms. The price improvement mechanisms that Arca cites are limited to certain categories of investors, in many cases only customers or priority customers. The mechanisms also allow market professionals to pick and choose which options to trade in pennies, rather than provide such prices in an open and competitive market. Finally, certain markets, like the Nasdaq Options Market ("NOM"), continue to permit the entry of "hidden penny orders" in non-penny options, directly moving penny pricing from the open, transparent, market to the opaque markets that hide true prices.

A further consequence of eliminating penny trading in these 200 options will be increased levels of payment-for-order-flow ("PFOF") in these classes. As the Commission is aware, PFOF is a system in which market makers pay order flow providers to gain access to their order flow. PFOF developed in the options market prior to the introduction of the Pilot, in an economic environment in which market makers could rebate a portion of the profitability of trading against a segment of order flow back to the originating brokerage firm. In effect, the market makers split the spread with the firm who sent the customer order to the market maker.

One of the main goals of penny pricing was that, by decreasing the minimum price variation to a penny, the competition for order flow that existed in PFOF arrangements could be transferred directly to investors in large part due to competition for order flow in transparent, quoted markets. That clearly has occurred. For example, PFOF rates at exchanges that operate PFOF programs are $.70 per contract for non-penny options, and only $.25 in penny options.[5] The elimination of penny quoting in these 200 options almost certainly will lead to increased levels of PFOF in these classes.

Supporters of the Proposal argue that they see no harm in this since the benefits of PFOF ultimately flow back to the investor through lower commissions or other benefits. However, while all market participants and firms benefit from penny pricing, professional investors derive no benefits from PFOF and not all firms accept PFOF. It is these other participants in our markets that will interact with the visible, wider markets that result from higher PFOF charged to market makers. Furthermore, we believe that the relative levels of PFOF rates are an indication, and symptom, of the relative quality of the markets on a class-by-class basis, and that this rate differential is a clear indication of the results of widening the minimum tick increment.

<u>The Industry Can and Will Achieve Uniformity Even With Competing Proposals</u>

In publishing the Proposal for comment, the Commission specifically asks for commentators' views on whether minimum quoting increments should be the same across all exchanges trading the same option. We believe that maintaining consistent trading increments is strongly desirable. While it would be preferable for the industry to reach a consensus on trading increments and to file similar rule changes with the Commission on the matter, we do not believe that is the only way to achieve consistency. Absent uniform filings, we believe that natural competitive forces will lead to consistency in the market in a very short period of time. Moreover, we do not believe

---

[5] *See, e.g.,* NASDAQ OMX PHLX LLC Pricing Schedule, Section II, Multiply Listed Options Fees, Payment for Order Flow Fees and Chicago Board Options Exchange, Inc. Fees Schedule at http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf. Exchanges that have "maker/taker" pricing models do not operate PFOF programs. Rather, they rebate fees to order flow providers when resting customer orders are executed. While rebates for non-penny options are $.82 a contract, they vary between $.25 and $.48 for penny options. *See, e.g.,* Nasdaq Options Market Rules, Chapter XV Options Pricing, Section 2, NASDAQ Options Market—Fees and Rebates, and NYSE Arca Options Fees and Charges at https://globalderivatives.nyx.com/sites/globalderivatives.nyx.com/files/nyse_arca_options_fee_schedule_10_07_13.pdf. Again, this shows that payments hidden from the transparent world of OPRA quotations – whether PFOF or fee rebates – flourish in the wider spreads of non-penny options.

that long-term benefits to investors of penny pricing should be sacrificed for the short-term benefits of achieving consistency quickly through sub-optimal common rule filings.

As discussed in our Initial Letter, in order to remain competitive, an options exchange will need to conform to the broadest version of penny increments adopted by its competitors. Failure to do so would limit that exchange's ability to compete for order flow through its disseminated quotations and could require the exchange to "round up" or "round down" execution prices in an uneconomical manner to avoid trading through markets. While we initially were hopeful that the exchanges could agree on a common approach to penny trading, discussions with our fellow options exchanges indicate that we may not be able to reach a consensus.

We believe that the Commission should judge each penny proposal on its own merits and should approve only those proposals that meet the applicable statutory standards. We do not believe that the Arca proposal meets those standards since it does not provide any justification for eliminating 200 options from penny trading. Assuming that the Commission receives multiple, but differing, proposals that meet the statutory standards, we see no long-term harm if the Commission approves such proposals and then lets the competitive forces – not regulatory fiat – determine the ultimate scope of penny trading in options.

* * *

ISE believes that greater analysis is needed before permanently approving options penny trading that is not as broad as the Pilot. Arca has not provided any basis under the Act to support its Proposal to eliminate 200 options from penny trading. We respectfully request the Commission: (i) to begin proceedings to determine whether to approve or disapprove the Arca Proposal; (ii) to permit the options exchanges to continue the Pilot through the submission of effective-on-filing rule changes; and (iii) to approve only those proposals for permanent trading of options in pennies that comply with the requirements of the Act. If the options exchanges are unable to agree on a joint proposal to make the Pilot a permanent fixture of the options market, ISE will be prepared to offer its own proposal on the matter.

We again thank the Commission for the opportunity to comment on the Arca Proposal. If you have any questions on our comments, please do not hesitate to contact us.

Sincerely,

Michael J. Simon
Secretary

cc: John Ramsey, Acting Director, Division of Trading and Markets
James Burns, Deputy Director, Division of Trading and Markets
Heather Seidel, Associate Director, Division of Trading and Markets