SIFMA®
Securities Industry and
Financial Markets Association

March 10, 2008

Ms. Elizabeth King
Associate Director
Division of Trading and Markets
Securities and Exchange Commission
100 F St., NE
Washington, DC 20549

Dear Ms. King,

The Equity Options Trading Committee ("Committee") of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to provide the Securities and Exchange Commission (the "SEC" or "Commission") with our comments with regards to the Long Term Penny Pilot Rollout Plan detailed in the Penny Pilot Phase II Report, submitted by the Chicago Board Options Exchange, Inc. ("CBOE") on March 4, 2008.

Over the past several years, the Committee has expressed concerns regarding the roll-out of the options penny pilot program at various times.[2] In particular, the Committee has commented with regards to liquidity, capacity constraints, quote mitigation, and dollar ($1) strike initiatives. Since early 2007 when the penny pilot program was rolled out, the reports and findings submitted by CBOE and other exchanges appear to mirror the Committee's concerns.

The Committee applauds the CBOE's Penny Pilot Long Term Rollout Plan. The Committee agrees with the CBOE's analysis that retail order flow is far more likely to concentrate activity in low premium options as opposed to those with much larger premiums levels; as a result, the Committee supports the CBOE's proposal, which is the following:

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[1] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C. and London, and its associated firm, the Asian Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] *See, e.g.,* SIA Comment Letter to SEC re: quote mitigation plans (Dec. 20, 2006); SIA Letter to Erik R. Sirri re: Pilot Program for Quoting of Options in Penny Increments (Oct. 19, 2006).

1. The industry should adopt a structure for all option classes – except those of such high underlying levels as to make the effect of penny pricing moot – whereby all option series of less than $1 premium value are quoted in penny increments, with all series at $1 or above quote in nickel increments.

2. The SEC should postpone the next phase of the penny pilot until July 2008, at which time all current penny pilot classes as well as the 28 additional classes would be transitioned to the new pricing structure.

3. An additional 100 classes should be added in September 2008, January 2009, and March 2009, with all remaining classes transitioning to the new pricing structure by July 2009.

The Committee appreciates the opportunity to comment and specifically endorses the recommendations put forth in the CBOE report, in particular the adoption of a tiered quoting structure whereby all option series priced under one dollar ($1) are quoted in penny increments, and all series priced at or above $1 are quoted in nickel increments. The Committee agrees with CBOE that this breakpoint shift to the $1 threshold is substantiated by the analysis and data found across several exchanges' Phase II Penny Pilot Reports. The Committee respectfully requests, that in light of the two (2) breakpoint proposals presented by both the International Securities Exchange and the Philadelphia Stock Exchange, additional analysis should be undertaken to determine if there should be a second breakpoint, and at what level – either $3 or $5.

With regards to the postponement of the Phase III rollout until July 2008, the Committee is pleased to note that all of the exchanges' Penny Pilot Phase II Reports[3] have cited a significant and consistent decrease in spread widths. Although the Committee believes it is important to consider that there has been a dramatic shift in volatility since the pilot has started. Historically, there is a correlation between market uncertainty and higher volatility. The Committee has specific concerns with regards to the impact increased volatility could potentially have on quote velocity. OPRA has recently stated that the highest quote traffic peak had already reached 440,000 messages per second in February 2008, which is more than half the amount of OPRA's current capacity. OPRA has seen a 62% increase in capacity usage over the past six (6) months. The Phase II Penny Pilot Reports from each exchange also noted significant increases in quote traffic. Latency in quote traffic could potentially have detrimental impacts to

[3] Chicago Board Options Exchange, Penny Pilot Report dated March 4, 2008; International Securities Exchange Penny Pilot Analysis Phase 2, dated November 27, 2007; Philadelphia Stock Exchange Options Penny Pricing Pilot Report, dated February 29, 2007; American Stock Exchange Penny Pilot Report, dated November 2, 2007; New York Stock Exchange Arca Options: Understanding Economic and Capacity Impact of the Options Penny Pilot, dated November 14, 2007. Please note the Boston Options Exchange Penny Pilot Report for Phase 2 has note yet been published for review, so the Boston Options Exchange Penny Pilot Report for Phase 1, dated June 18, 2007 comments was taken into account.

customers that trade electronically, as noted by the TABB Group Study, Equity Options Trading 2008, "Rising Out of Obscurity."[4] Customer or retail options flow almost exclusively trades electronically due to the smaller order sizes and the prevalence of online options trading. As a result, the Committee also supports the CBOE's proposal to delay the next phase of the pilot from March 2008 until July 2008, which would be inline with OPRA's plan to significantly increase capacity. In addition, the Committee fully supports the CBOE's plan to have all Phase I, II and III option classes trading in penny pricing under the $1 threshold.

SIFMA also would like to commend the CBOE for taking the lead and developing a systematic rollout going forward for penny names. It is imperative for the industry while planning for the significant impact under the Symbology Initiative, that enough lead time is planned in for any additional system or technological enhancements that may be required. In addition, the Committee respectfully requests that the CBOE and Commission consider the potential impact of symbology changes, and large expiration months might have with respect to rolling out additional penny names in January 2009.

With regards to the rollout of additional option classes, it is important to note that the Exchange Penny Pilot Phase II Reports have detailed a decrease in average daily volume, or liquidity in many of the classes in the pilot program. The Committee has noted that several of the Exchange Reports and the recent TABB Group Study, have identified an increase in the use of Over the Counter (OTC) options. The TABB Study has attributed the primary factor behind the expected future growth of OTC Option usage as the need for liquidity, and the challenges of executing large orders in illiquid contracts. Both the CBOE and ISE reference institutional customers being forced to execute larger orders OTC at an increasing rate, noting that institutional participation has been a significant source of growth for the options industry.

The Committee appreciates the opportunity to work with the Commission and the exchanges to determine the parameters and further clarify the definition for high priced or less liquid underlyings, and any process going forward for the potential removal of underlyings from the penny pilot. The Committee is continuing to monitor Dendreon Corporation ("DNDN") and The AMEX Energy Select Sector Spider ("XLE") since the average spread width has increased versus decreased during the penny pilot, which was also noted in the CBOE Report.

Finally, the Committee would like to once again encourage the Commission to consider granting expanding the $1 strike programs proposed by the exchanges. The Committee believes the penny program combined with the $1 strike initiative will significantly help investors find penny priced precision and deeper liquidity for at the money strikes.

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[4] *See* www.tabbgroup.com.

For the above mentioned reasons, SIFMA respectfully requests the Commission consider modifying the Penny Pilot Phase III rollout in conjunction with the CBOE's Long Term Penny Rollout Plan. Thank you for your consideration of these views. If you have any questions, please do not hesitate to call me at 202-962-7385.

Sincerely,

Melissa MacGregor

Melissa MacGregor
Vice President and Assistant General Counsel

cc: Dr. Erik R. Sirri, Director, Division of Trading and Markets, SEC
Marlon Paz, Counsel, Division of Trading and Markets, SEC