April 3, 2000

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. 4-429; Release No. 34-42456; Options Linkage

Dear Mr. Katz:

The International Securities Exchange LLC ("ISE") is pleased to offer its comments regarding a linkage between the options exchanges. Attached is a copy of the recent letter the ISE submitted to Chairman Levitt regarding our views of the proper structure of an options linkage.[1] We request that the December letter be included in this file and that the Commission consider that letter in its deliberations regarding the linkage. In addition, we also submit for your consideration the attached copy of an exchange of viewpoints that the ISE "overheard" in an *imaginary* internet "Options Market Structure Chat Room."

We remain committed to working with our fellow options exchanges and the Commission in the development of an intermarket options linkage. Even before our official registration as a national securities exchange, we played an active role in the development of a linkage plan. Now that we are registered, we can continue our participation in these discussions in a more formal manner.

We believe that the timely implementation of a linkage is critical to the growth and vitality of the options markets. Indeed, the lack of a linkage adversely affects our markets in two critical ways. First, it is now unnecessarily difficult for market participants to reach other markets to help assure that customer orders receive the best available price. Second, there is no efficient mechanism for members on one exchange to "probe" the prices on another exchange to determine if those prices are firm. This lack of efficiency must be addressed quickly if the options markets are to continue their recent (and phenomenal) growth.

We also believe that enhanced intermarket efficiency is necessary for new, electronic exchanges such as the ISE to fully achieve the benefits that they can offer to the investing public. While we can build the most automated

[1] Letter dated December 10, 1999, from David Krell, President & CEO, ISE, to The Honorable Arthur Levitt, Chairman, Commission (the "December Letter").

systems, the lack of a linkage necessitates manual intervention to reach other markets. This "weak link" can result in investors losing the advantages of the automated order handling and execution services that we will be offering.

As to the specifics of a linkage, we continue to support the "Joint Plan" filed by the American Stock Exchange ("Amex") and the Chicago Board Options Exchange ("CBOE") and endorsed by us.[2] This plan best achieves the Commission's objectives of protecting investors, while maintaining the competitive nature of the markets. In contrast, the two plans filed by the Pacific Exchange ("PCX") and the Philadelphia Stock Exchange ("Phlx") raise extraneous issues, such as "price/time priority," that are more intended to advance the perceived competitive positions of those exchanges than to benefit investors. We urge the Commission to move quickly to approve the Joint Plan and to consider the more general market structure issues in the context of its recent request for comment regarding market fragmentation issues.[3]

We again offer our continued support in the development of a linkage. If you have any questions on our comments, please do not hesitate to call us.

Sincerely,

Michael J. Simon
Senior Vice President and Secretary

Attachments:

A. Options Market Structure Chat Room "Transcript"
B. ISE Letter to Chairman Levitt dated December 10, 1999

[2] At the time of the submission of the Joint Plan, the ISE was not yet registered as a national securities exchange. Now that we are so registered, concurrently with submitting this letter, we are formally signing the Joint Plan and submitting it to the Commission
[3] Release No. 34-42450 (February 23, 2000) ("Fragmentation Release").

Attachment A

Transcript of "Options Market Structure Chat Room"

VOR: I just read the SEC's release on an options linkage. It seems to me that the ISE, Amex and CBOE got it right: link the exchanges' auto-ex systems for smaller orders; provide an efficient means for shipping larger customer orders; let market makers clear out stale quotes in other markets; and provide customers with trade-through protection. Protect the public customer! This sure looks a lot more efficient than the Intermarket Trading System in the equity world. What a shame if the Phlx and PCX hold this up by trying to change the options market structure to suit their competitive game plans. Any thoughts out there?

CK: Yeah, I have a thought. You bought into the status quo to help the big markets maintain their dominance! How can the little guys compete if they don't get a fair shot at order flow? You definitely need price/time priority to reward the smaller exchanges if they improve the market.

VOR: Big markets maintain dominance? Are you joking? The ISE supports the Joint Plan, and last I heard they haven't even started trading. They have no flow, yet they think they can compete just fine without an SEC-imposed price/time regimen. They looked at the competitive landscape and decided to compete not only with better prices (and I'm sure they will have their share of those!), but with lower costs, quotes with size, anonymity, and direct access to the exchange for their electronic access members. In fact, I challenge you to show me any market *more* competitive than the U.S. options markets are right now. The Phlx and PCX proposals are actually *anticompetitive* since they would eliminate all forms of competition except one: the race to quote first. It seems to me that they feel if they can get the SEC to buy into focusing all competition on price/time, they can ignore all the other competitive areas. How will that protect the pubic customer?

BSD: I hate to admit it, but I agree with VOR. While I have my own problems with the Joint Plan, price/time makes no sense, especially for options. What convinced me was the "Rock Bottom Airlines" analogy in ISE's December Letter. Options are derivatively priced and, with price/time, all the exchanges would simply focus on building faster auto-quote systems. They sure will be able to quote fast, but I wouldn't want to trade in that market! I control a lot of order flow, and I want the exchanges to compete for that order flow by offering me better markets with more liquidity, faster executions, better reporting, and cheaper fees. Who knows what else they can devise to get my business. The ISE now shows size; maybe someone actually will offer firm quotes across-the-board. Besides, the SEC's Fragmentation Release requests comment on market structure generally. Let's focus on linkage-specific issues, get the linkage up and running, and let the industry and the SEC consider these other issues in a more global context.

CK: You say you want to control your order flow, BSD, but it sounds to me you just want to auction it off to the highest bidder!

BSD: I won't dignify your comment with a response other than to say that I would gladly support any SEC efforts to abolish payment for order flow. Abolishing that

practice only would benefit investors. However, payment for order flow has nothing to do with a linkage.

CK: I'll meet you in the payment for order flow chat room to continue that debate, but your argument to put aside "big picture" issues is what we always hear from the entrenched interests. All they want to do is maintain the status quo and prevent an outbreak of real competition! As to "Rock Bottom," give me a break. The Phlx's letter last December referred to academic studies showing how "quote matching" harms competition. I'll take the academics over cutesy arguments to support a point of view any day of the week.

BSD: Academics have an uncanny ability to state the obvious. All things being equal, I admit that allowing a competitor to match a price may decrease the incentive to improve prices. But in the "real world" all other things are never equal. First, those studies did not involve "derivative" markets, such as options. But even assuming that a strict price/time system may sometimes narrow options spreads, what would be the cost? Smaller quote sizes? Less efficient executions? More price volatility? Higher trading fees? Why enhance one aspect of competition by forsaking all other forms of competition? Can you name any industry, in any country, where the government has imposed price/time priority? Where it has told people they can't buy goods from one vendor at the same price being offered by other vendors, just because someone set a price first? I sure can't. CK, you are asking the SEC to take an unprecedented step to shape competition and market structure! And to take this action in an industry that is perhaps the most competitive in the U.S. securities markets! Let competition work. Multiple trading and the very existence of the ISE shows that it *is* working; the last thing we need is for heavy-handed government intervention.

CK: But its not just the academics. Some of the nation's largest firms have publicly called for building a strict price/time consolidated limit order book, a "CLOB." Take a look at the February 29, 2000 Senate Banking Committee hearing. Also read the draft "white paper" these firms apparently commissioned, which the *Wall Street Journal* posted on its web site the same day. They express well-reasoned arguments that the current hodge-podge of barely-connected markets not only hurts investors but places us at a disadvantage in the global arena.

VOR: I've read the testimony and the report, and these firms sure do express support for price/time priority. I think they raise some valid concerns, but I don't think that a CLOB is the right way to address those concerns. First, they focus primarily on the equities world, noting that some markets don't provide automatic execution, while also complaining about the limits of the Intermarket Trading System.

BSD: They also don't address the derivative nature of options, and the fact that time priority just means faster auto-quoting. Besides, they acknowledge that you need to carve out blocks and perhaps other orders from a true price/time system. Once every constituency gets to carve out their special situations, a "simple" CLOB will become more complex than the tax code, or even the net capital rule! Why worry about all those problems when we need an options linkage now.

VOR: More important, the Joint Plan resolves the problems with ITS that concerned the firms, particularly the need for timely executions. Just imagine how it would

work: a broker-dealer could send a customer order electronically to the ISE for execution. The primary market maker on the ISE, if he doesn't want to trade at that price, can set his system automatically send a "principal acting as agent" order into the linkage for auto-ex in another market's system. In the blink of an eye you have an entry of an order on the ISE, the routing of that trading interest to another exchange, an execution, and a report back to the entering firm and the customer. You can't get more efficient than that. This is the best mechanism yet proposed to help broker-dealers achieve best execution of their customer orders. Not only that, but it certainly helps all markets, and especially electronic markets like the ISE, by allowing their market makers to access other markets quickly and efficiently. This is what a linkage should be about. Price/time priority is an unrelated market structure issue.

BSD: The structure of the options market also is much different than the equity markets. In the equity world, you have exchanges, the third market, electronic communication networks and alternative trading systems. In options, all trading of standardized products must take place on an exchange. Thus, you don't have the same fragmentation concerns as you have with stocks. Plus, the Joint Plan provides for *automatic* entry for new exchanges, eliminating any barriers to competition. One point possibly influencing these firms is that strict price/time priority eliminates "best execution" concerns: if you only have one central market, these firms never will have a best execution complaint! But the price we pay for that is a lack of competition. I think that Charles Schwab's testimony at the February 29th Senate hearing and Chairman Levitt's March 16th speech at Northwestern Law School clearly articulate that point.

VOR: Also, while you cite the draft report and testimony, CK, you conveniently ignored the one industry response specifically addressing the options linkage issues. In a January 4, 2000 letter to the heads of the options exchanges, the Securities Industry Association's Options Committee *rejected* price/time priority, stating "price/time should not be employed to force the shipment of options orders."

BSD: It also is important to focus on the concerns regarding the global competitiveness of our markets. Here I just don't see the value of a CLOB. Our markets are the envy of the world, with far more trading volume than any other venue. A major reason why we so dominate trading is that our markets are far more competitive than any other country's. And these firms want us to limit that competitiveness? The CLOB seems like a dubious cure for a disease that doesn't exist! Indeed, the cure is more likely to kill the patient than do any good. It strikes me as odd that champions of a free market economy argue in favor a government-mandated central market to compete in the world-wide economy.

CK: I'm not quite ready to admit defeat yet, but let me shift gears for a minute. I am intrigued about BSD's earlier comment that, while he doesn't favor price/time priority, he has other problems with the Joint Plan. Like what?

BSD: My focus is on the actual operation of the linkage. I have some concerns that it doesn't give market makers enough access, and that it unfairly limits principals from trade-through protection. I also question whether a 10-contract auto-ex guarantee is large enough. But my main concern is that it doesn't protect

exposed customer limit orders. Sure, let a market maker "quote match." But I don't buy letting him step ahead of customer orders on other markets.

CK: Good points. VOR, how are you protecting the customer by allowing professionals to step ahead of customer limit orders? Sell me on that one!

VOR: BSD raises some valid points, and I'd like to address them one at a time. Let's start with the smaller issues, and then focus on customer limit order protection:

- As to principal access, the Joint Plan gives professional orders auto-ex for orders up to 10 contracts, subject to an "80/20 test." The Phlx wants unlimited principal access and the PCX suggests principal access only when markets are locked or crossed. The Joint Plan's proposal for limited principal auto-ex is a major step forward. Currently, only the ISE has plans for auto-ex for principal orders. The Phlx's open access proposal seriously undermines the fact that exchanges are competitive membership organizations. The purpose of a linkage is to protect customers (yes, I know I said it again), not equalize the price of seats. You need something like the 80/20 test to make sure that the linkage is not simply a way to allow market makers to trade on other exchanges. If you have a better idea, let me know. The only other suggestion was the PCX's proposal to limit access to locked and crossed markets. That proposal is unique in that it is both too narrow and too broad: It is too narrow because there are many legitimate situations other than locked and crossed markets where market makers should be able to send orders over the linkage. The obvious example is the need to remove stale quotes. It also is too broad because there are no limits on the orders a market maker can send when a market is locked and crossed. It invites potential abuse by encouraging market makers to "lock and ship," providing potentially unfettered principal access. The last thing we should be doing is extending an open invitation to lock and cross markets!

- Limits on principal trade-through protection? I honestly don't understand the argument that market maker quotes deserve trade-through protection. Unfortunately, we live in a world of "trade or fade" rules, where market makers can walk away from their quotes when presented with non-customer orders. Yet some markets argue that these "quotes" should be protected if traded-through? Better yet, they should be protected only if the market maker lodges a complaint! So, lets see: a market maker puts up a quote, but can yank it when a professional sends in an order. Yet someone trades through the quote in another market, and the market maker should have the ability to pick and choose when to have his quote honored? Give me a break! Once we have firm quotes, with size, we can begin to talk about protecting market makers from trade throughs. Not now.

- Finally, there seems to be a misunderstanding of 10 contract auto-ex. The exchanges agree to provide auto-ex for customer linkage orders up to their internal auto-ex guarantee, provided the sending exchange guarantees the same size. The 10-contract number is just a minimum, since this is currently the minimum on all the markets. While the PCX proposed a 20-contract minimum, it did not explain why it did so. This seems like a non-issue, and only reflects the current competitive realities of the market. The key is that

each exchange is willing to provide automatic execution to all linkage orders to the extent it automatically executes orders received within its own market. Again, once we have firm quotes, with size, the artificial 10- or 20-contract guarantees will fall by the wayside.

BSD: OK, so you knocked the softballs out of the park. Now I'd like to hear you explain your way out of limit order protection.

VOR: Do either of you remember LOIS?

CK: I assume you are not referring to my ex-wife. She was one of those die-hard "anti-CLOBers" in the '70's. Can you believe the court bought her argument that our pro- and anti-CLOB positions were "irreconcilable differences"!

VOR: I remember those days of violent demonstrations on both sides of the issue. But I actually was referring to the "limit order information system" discussed in the early days of ITS.

BSD: Yeah, I think it was around October 6, 1980. Exchange Act Release No. 34-17194, if I recall.

CK: That's right, but there was a better description in the SEC's Division of Market Regulation's Market 2000 Report, in Study 1, on pages I-7 and I-8.

VOR: Whatever. The point is that the equity exchanges were building this elaborate mechanism to protect away-from-the-market limit orders without checking to see whether there really was a problem. When they did a "reality check," they found that there were few orders that needed to be protected, and scuttled the whole idea. The outcome was the adoption of the more simple trade-through rule.

CK: VOR, you seem to be arguing against yourself here. The equity exchanges ditched LOIS because they decided there was no problem with *away from the market* limit orders. No one is suggesting that here. The focus is solely on customer limit orders disseminated as part of the best bid or offer. All the markets agree that these orders should be protected if traded through. The only issue is whether they should be protected when "traded at." Shouldn't a market maker have to protect customer limit orders included in another exchange's disseminated bid or offer when the market maker steps up to trade at that price? Even if you can move me off price/time priority, you are not going to convince me that professionals should be able to step ahead of customers!

VOR: You miss the point of the story, CK. The equity exchanges ditched their LOIS faster than your Lois ditched you once they discovered that they were building an elaborate system to address a non-existent problem. No one knows if we have a problem here. How often does a market's disseminated quote represent a customer order? In the case of a trade-through, we all agree that, even if it is very infrequently, a customer order deserves protection if there is an execution at an inferior price. But that is not the case with a trade-at. You would have to build some elaborate systems and adopt some esoteric rules to address these situations. Why take such action unless we have a problem?

BSD: What's so elaborate? Simply apply the trade-through rule to trade-at situations. Isn't that the ISE's so-called "Alternative Proposal"?

VOR: The ISE simply made some suggestions that even they realized required a lot more thought. Trade-throughs are driven by complaints, but would that work for trade-ats? Can you reasonably expect a market to lodge a complaint every time an exchange prints a matching trade? Is it fair to hold a market liable for trade-ats when it has no idea how many customer limit orders are included in a quote? Also, the ISE recognized that trade-at liability should not apply when customers, rather than market makers, match the away-market price. How do you factor in that issue? My preference is first see if you have a problem. If so, then address the issue, perhaps as part of the global review of market structure the SEC has undertaken in the Fragmentation Release. I also think that trade-at protection would work a lot better once you have quotations with size. Then maybe you can indicate in the quote how much of the size represents customer limit orders.

CK: Hmmm. By saying it is your "preference" to wait, are you flexible on the issue?

VOR: I am flexible on every issue. If the SEC decides that this is an area that must be addressed as part of the linkage, fine, but they should send the exchanges back to the table to work out the implementation of trade-at protection. Those are the parties best able to work through the difficult issues here. My fear is that resolving this issue will take time, and the industry can't afford to waste a lot of time before implementing the linkage. If the SEC decides to act here, I would suggest approving the linkage currently reflected in the Joint Plan, while directing the exchanges to establish a trade-at provision within a year or so.

BSD: OK, I can live with that. But one last question. Although all five exchanges agreed on a governance plan for the linkage, the SEC still asked for comment on the issue. Their specific questions involved the scope of the operating committee's authority and the requirement that all plan amendments require unanimous approval of all members. Can't the SEC leave well enough alone? Why are they raising issues that the exchanges themselves resolved?

VOR: Even though the exchanges did agree, the SEC still must determine that this is consistent with the Exchange Act; it can't let the exchanges agree to act anti-competitively. Having said that, the plan's governance requirements *are* fair. The Operating Committee generally does not make policy decisions. Where it does, like defining what "complex trades" should be exempt from trade-through liability, the SEC may want to require the exchanges to file the definitions as plan or rule amendments. As to unanimity, the plan addresses the SEC's concerns in the area: new exchanges automatically can join the linkage, and, unlike the ITS Plan, there are no limits on how to enter linkage orders. Thus, the plan will not interfere with internal exchange operations. The plan is limited to core concepts, and it is reasonable to expect unanimous approval to change any of these concepts. Of course, the ultimate "fail-safe" provision remains: the SEC always can revisit any of the plan provisions, either at an exchange's request, or on its own. The exchanges proposed a reasonable governance structure that seems fairer than ITS, and the SEC should give this a chance to work.

CK: Agreed. In fact, I think I'm with you on this, but I sort of lost track of some of these issues. Can you give me a quick recap?

VOR: I think we have agreed to the following:

- Forget price/time priority. This actually is anti-competitive and elevates one form of competition over all others. It is even more of a problem in the options world, where prices are derived from the prices of underlying stocks: it will lead to building faster auto-quote systems, not real price competition. It also would be an unprecedented and unwarranted government intrusion into a fiercely competitive market that does not warrant such extreme intervention.

- Keep the focus on public customers. This means limit principal access to the defined purpose of validating quotes; do not make the linkage an alternative to membership on the competing exchanges. It also means that the quotes of market makers and other professionals should not be protected against trade-throughs, at least not until all options quotes are firm.

- Focus on the current problems in the options market. With multiple trading and increased competition, options customers are being disadvantaged every day by trade-throughs and inefficient pricing. Build the linkage now. Don't tie the linkage up in knots in an attempt to resolve overall market structure issues. The SEC is reviewing that whole area now in the Fragmentation Release. Fold the issue of limit order protection into that process. A reasonable alternative would be to approve the Joint Plan as is, but order the markets to address limit order protection within a year or so. Alternatively, the SEC always has the ability to revisit these issues after it considers the comments it receives on the Fragmentation Release. It would be unfortunate if the linkage was delayed, or never implemented, because it was used as a vehicle to cure perceived ills more properly addressed in other contexts.

- Seize the benefits of the Joint Plan. This proposal would create the fairest and most efficient linkage in our securities markets. It provides for auto-ex of both customer and principal orders, automatic entry of new exchanges, and fair governance. It establishes a firm foundation for future enhancements that may result from the ongoing market structure discussions.

- Let the exchanges themselves have first shot at resolving open issues, with government intervention only a last resort. This applies both to the limit order protection issue and other issues, such as governance of the linkage. If the exchanges make reasonable proposals, the SEC should at least give the exchanges an opportunity to implement those proposals and see if they work.

BSD: I'm a buyer.

CK: Me, too, I guess. And to think I lost my wife over this! I have to say that these issues are complex, but let's keep the focus on the public customer.

VOR: Thanks. Its hard to argue with the voice of reason.