INTERNATIONAL SECURITIES EXCHANGE.

January 13, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, DC 20549-0609

Via Electronic Mail

Re: File Nos. SR-Phlx-2004-91 and SR0-CBOE-2004-71 (Preferencing)

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") appreciates the opportunity to comment on the Philadelphia Stock Exchange's ("Phlx") proposal to allow order flow providers to designate or "preference" certain market makers to execute against their orders. The ISE recently filed a comment letter on a similar proposal by the Chicago Board Options Exchange ("CBOE"),[1] and we incorporate that letter (the "CBOE Letter") by reference. While we primarily address the Phlx proposal in this letter, the two proposals are related and we submit this letter with reference to both filings.

The Phlx proposal represents a step away from an agency-action market where market participants compete based on the quality of their quotes rather than their relationship with the order flow provider. As we stated in the CBOE Letter, we believe that awarding allocation guarantees to market participants based upon their status generally will have a negative impact on quote competition and thus will result in worse prices for customers. Like the CBOE preferencing proposal, the Phlx proposal lacks the protections the Commission has required in approving other, more limited, exceptions to agency-auction rules. This lack of protection is exacerbated in the Phlx proposal because it (1) is not limited to specialists and (2) provides far greater guarantees to preferenced market makers than even the CBOE proposal. We urge the Commission to reject this type of status-based preferencing in the options markets and to institute proceedings to disapprove both the Phlx and CBOE proposals.

Overview of Phlx Proposal

The Phlx currently allocates automatically-executed orders according to an algorithm that includes an "Enhanced Specialist Participation." The Enhanced Specialist Participation gives the specialist a higher percentage of incoming orders when it is at parity with other professionals at the best price in a manner that generally is consistent with the allocation procedures of the other options exchanges, with some variation for new specialist units, new options and new products. Specifically, the specialist receives 60 percent of an order if there is one other market maker quoting at the same price, 40

[1] Letter from Michael J. Simon to Jonathan G. Katz, dated December 31, 2004 (referencing SR-CBOE-2004-71).

percent if there are two other market makers quoting at the same price, and 30 percent if there are more than two other market makers quoting at the same price. Other participants at the best price receive allocations according to an algorithm that is based upon the number of participants at the best price and the relative size of their bids/offers.

The Phlx now proposes to permit an order flow provider to preference specified categories of members (*i.e.*, a specialist, remote streaming quote trader ("RSQT") or streaming quote trader ("SQT")), who will receive an enhanced allocation if they are quoting at the NBBO as follows:

- If the order is preferenced to the specialist, it is entitled to receive the greater of (1) the proportion of the aggregate size at the NBBO associated with its quote; (2) the Enhanced Specialist Participation; or (3) 40 percent of the order. Accordingly, a preferenced specialist is guaranteed at least 60 percent of the order if there is one other market maker quoting at the same price, and 40 percent if there are multiple market makers quoting at that price. The result is that the 30 percent Enhanced Specialist Participation is increased to 40 percent due solely to the relationship the specialist has with the order flow provider.

- If an order is preferenced to a RSQT or SQT, it is entitled to receive the greater of (1) the proportion of the aggregate size at the NBBO associated with its quote; or (2) 40 percent of the order. There would be no Enhanced Specialist Participation awarded when a RSQT or SQT receives a directed order preference, and all other participants would share in the allocation of the remainder according to the algorithm. This proposal will grant these non-specialist market makers an execution guarantee for the first time although these members are providing neither special liquidity or other service to the market.

Limits on Allocation Guarantees

The proposal would provide greater allocation entitlements to a specialist, RSQT or SQT based solely on its status as the preferred market maker. As we stated in the CBOE Letter, the Commission previously has sought to prevent options exchanges from becoming dealer-based trading systems and has reviewed all proposals by an options exchange to provide execution guarantees with a critical eye. The Commission has approved status-based allocation guarantees in the options market only in two limited circumstances: (1) enhanced participation rights for specialists; and (2) facilitation rules.

With respect to specialist guarantees, the Commission has required that such rules properly reward market making firms for the obligations they provide to the market, and not simply due to a firm's designation as a specialist. We believe the Commission has struck the right balance between the rewards that a specialist receives for its obligations to the marketplace and the concerns that arise if specialists lock-up too much order flow based on their status in the market.[2] While we believe that specialists deserve slight preferences over other professional market participants in any exchange algorithms that allocate incoming order flow, the degree to which an exchange preferences specialists should depend on the specific obligations specialists have on that particular exchange.

[2] Letter to Jonathan G. Katz from Michael J. Simon, dated April 8, 2004.

The Phlx proposal is not limited to specialist, and the Phlx does not attempt to justify this proposal other than as a way to reward market makers that attract order-flow to the Phlx. Thus, the proposal is similar in principal to the facilitation guarantees that have been adopted by the options exchanges. In this respect, the Commission has permitted the options exchanges to provide minimum allocation guarantees to facilitating brokers in two contexts: (1) where additional liquidity may be needed for large-size orders *(i.e.*, order of at least 50 contracts); and (2) where the facilitating member guarantees the order price-improvement over the NBBO. In both circumstances, the Commission has required that the entire order be exposed to the market place to give the order an opportunity for price improvement before the facilitating firm is entitled to any minimum execution guarantee.

There is no distinction between a broker "facilitating" an order and a broker directing an order to a particular market maker for execution, as no broker will preference an order unless there is some economic incentive to do so, *i.e.*, the broker is either affiliated with the market maker or is receiving payment in return for directing the order to the market maker.[3] Yet the Phlx proposal is inconsistent with all of the standards and policies the Commission has applied to facilitation rules. Specifically, the proposal: (1) would not expose the order for price improvement before executing the order against the preferenced market maker; and (2) would not require price improvement over the NBBO for small-size orders. Moreover, as with the CBOE proposal, the Phlx's proposal contains no safeguards against coordinated actions between market makers and order entry firms.[4]

The Phlx does not attempt to justify the proposal based on anything other than rewarding market makers who establish relationships with order-flow providers that result in more orders being directed to the Phlx. The Phlx states that the proposal will encourage "the capture of order flow on the Exchange by rewarding Directed Order recipients with a participation guarantee in trades involving Directed Orders." We fail to see how encouraging "captured order flow" furthers the objectives of Section 6(b)(5) of the Exchange Act. It is not designed to perfect the mechanism of a free and open market and the national market system. To the contrary, it provides a mechanism for "capturing" order flow through non-competitive practices. It also does not protect investors and the public interest since it encourages brokers to make routing decisions based on relationships with particular market makers rather than the market that offers the best execution. It does not promote just and equitable principles of trade. In fact, it rewards market makers based upon relationships rather than market quality.

Conclusion

In the CBOE Letter, we urged the Commission to consider carefully the implications of allowing order-flow providers to determine which market participants, quoting at the same price, may execute against their orders. The CBOE proposal limited

[3] The Commission long has discussed payment for order flow, specialist guarantees and internalization together as related topics. See the Options Concept Release, supra note 1, at Section III.C.

[4] There are no protections against an order flow provider notifying a market maker of an incoming preferenced order, the market maker changing its quotation to match the NBBO for the split second necessary to capture the preferenced order, and then fading its quote. While exchanges generally have "informational barrier" protections against this form of coordinated activity within a market maker's own firm, there is no protection against this form of abuse in preferenced orders.

preferencing to specialists, but we cautioned that the distinction between specialists and other market makers was tenuous. And now the Phlx has filed a preferencing proposal that is not limited to specialists. This is the path all of the options markets will follow if the Commission opens the door to status-based allocations as proposed by the Phlx.

Approval of this non-competitive status-based guarantee would be a significant departure from the Commission's policy on allocation entitlements and facilitation rules. It would have a significant negative impact on price competition, as the other options exchanges will be forced to explore similar arrangements that allow order-flow providers to direct the execution of their orders to market makers with which they have relationships. Moreover, in contrast to the options exchanges' facilitation rules, the proposal allows the facilitation of small-size orders without requiring price improvement over the NBBO, and without even providing an opportunity for other market participants to provide price improvement.

We believe the Commission must reject this and all other proposals to introduce preferencing into the options markets to maintain the fiercely competitive options markets we have today, as allowing this type of non-competitive, relationship-based allocation guarantee will discourage quote competition. Public customers have benefited dramatically from the competitive environment. This benefit will be lost, as these preferencing proposals will have a negative impact on the quality of the markets and the prices available to public customers. Therefore, we urge the Commission to institute proceedings to disapprove both the Phlx and CBOE preferencing proposals.

Sincerely,

Michael J. Simon,
General Counsel and Secretary

cc: Annette Nazareth
Robert Colby
Elizabeth King
John Roeser