

May 28, 2002

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

Re: File No. SR-Amex-2002-33

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") is pleased to offer its comments on the above-referenced rule filing (the "Proposal") of the American Stock Exchange ("Amex"). We believe that the Proposal would harm customers and would impose a significant burden on competition that is not justified under the Securities Exchange Act of 1934 (the "Act"). We further believe that the Amex can achieve the limited regulatory purpose that it seeks through alternate means that do not impose any burden on competition.

The Amex's Proposal

The Amex characterizes its proposal as permitting members, on an interim basis, to use non-Amex facilities both to send and receive orders electronically from other options exchanges. However, the Amex would prohibit any such access to other exchanges once a permanent options linkage ("Linkage") is established.¹ The Amex attempts to justify the post-Linkage prohibition on alternate electronic access to other exchanges by stating that: "for reasons of regulatory oversight, a single mechanism for routing orders between options exchanges is preferable to a number of different proprietary systems."

The Proposal Would Harm Customers and Would Burden Competition

The five options exchanges vigorously compete with each other for order flow. We compete not only for public customer order flow, but also for broker-

¹ The Proposal also would require written Amex approval to establish electronic access pending implementation of the Linkage. We believe that any approval should be conditioned only on compatibility with the Amex's technical infrastructure, not on competitive issues or the exchanges being accessed. We also note that while the other requirements in Amex Rule 220 regarding communications require only "the approval of the [Amex]," this Proposal requires "prior written approval." The Amex does not explain why only this aspect of Rule 220 requires prior approval and that the approval be in writing.

dealer proprietary order flow, including order flow from members on the floors of the other exchanges. As a fully-electronic options exchange, we often post prices that are attractive to members on other exchanges since they can access us electronically and they know the prices and sizes we post are firm.

The Amex's Proposal would prohibit its members from sending orders electronically to the ISE from the Amex floor outside of the Linkage. To reach our market, Amex members would need to send an order off-floor and then have off-floor personnel send that order to us. This limitation has significant customer protection and competitive implications.

As to customer protection, an Amex floor broker working a customer order may see an ISE price that is superior to the Amex price. Today, that broker can use proprietary facilities or even an ISE terminal to send an order to the ISE for immediate and automatic execution. The Amex proposes to deny the broker such access and apparently will require that the broker route the order off-floor for transmission to the ISE. This raises serious risks that the ISE market may not be available when the customer order reaches us. Indeed, the Amex floor broker may determine that imposing this delay makes the possibility of ISE execution too risky and thus may execute the order on the Amex at the inferior price.²

As to competitive implications, the Amex's filing contains the boilerplate statement that "the proposed rule change will impose no burden on competition." That is wrong: In limiting members' ability to send orders electronically to other markets, the Amex is impeding competition. Without this limitation, free market forces and price competition would lead to the sending of order flow to exchanges displaying superior prices.

Not only is this anticompetitive with respect to floor brokers who would be prohibited from accessing better markets, but it also imposes competitive barriers on market makers. As proposed, Amex market makers only could use the Linkage to access competing exchanges electronically, notwithstanding the fact that there may be more efficient methods of access. More important, and as discussed below, the Linkage is purposely designed to provide only limited access to other markets and will not meet all of a market maker's needs.

Recognizing the Proposal's burden on competition, the Amex must explain how this burden is justified based on the supposed regulatory benefits the Amex cites. Because the Amex incorrectly claims the Proposal has no competitive implications, it makes no attempt to justify the Proposal's competitive burdens. Moreover, as we discuss below, the Proposal's minor regulatory benefits do not outweigh the Proposal's competitive harm.

² As discussed below, the Linkage actually will make matters worse for a floor broker. Because only market makers will have access to the Linkage, the broker could not use the Linkage to send the customer order to the ISE. Thus, the broker will be forced either to send the order upstairs for processing (which could result in his missing the market) or to execute the order on the Amex at the inferior price (which could result in trade-through liability).

The Linkage is Not Appropriate as a Sole Means of Intermarket Access

The Linkage will provide only limited access and will not serve the full needs of the Amex's members. First, only market makers can send orders through the Linkage. Thus, brokers will not be able to use the Linkage at all, either to send their customers' orders to other markets or to send any proprietary trading interest they may have. Thus, the Proposal will preclude any form of electronic intermarket access by these members.

The Linkage also will restrict market maker access. With respect to market makers sending "P/A Orders" representing customer orders they hold, Section 8(b)(ii) of the Linkage Plan states the Linkage:

is not designed to be, and should not be used as, an order delivery system whereby all or a substantial portion of Customer orders to buy and sell series of Eligible Option Classes that are sent to a Participant market are not executed within that market, but executed using P/A Orders routed through the Linkage. In the normal course, a great majority of orders received within a Participant market are expected to be executed within that Participant's market without the use of P/A Orders.

With respect to market makers sending Principal Orders (when they do not hold customer orders), there are even more severe restrictions. Section 8(b)(iii) of the Linkage Plan first states that: "The Participants agree that Eligible Market Makers should send Principal Orders through the Linkage on a limited basis and not as a primary aspect of their business." The Plan then imposes a strict "80/20" test that significantly limits the amount of principal order flow a market maker can send through the linkage. If a market maker does not comply with this test, it cannot use the Linkage at all for P Orders for the next calendar quarter.

These provisions show that the Linkage will serve a limited purpose, providing access between exchanges that is restricted to specified members and that can be used only for narrow purposes. The Linkage will not provide the same level of access and services that proprietary systems now provide and will not serve the same market needs. The Amex wrongly implies that the Linkage will render obsolete the need for proprietary electronic access systems.

There is No Regulatory Purpose for this Limitation on Access

The Amex attempts to justify the Proposal with the claim that: "for reasons of regulatory oversight, a single mechanism for routing orders between options exchanges is preferable to a number of different proprietary systems." Even conceding that having one mechanism is "preferable" from a regulatory standpoint (a position we question), there is no indication that having to monitor multiple systems imposes any significant regulatory burdens on the Amex. There certainly is no explanation of what those burdens may be, and how those burdens justify the proposed burden on competition.

In fact, we do not see any significant regulatory burdens in having multiple means of electronic access. The Amex seeks to ban only electronic access systems, not systems where members route orders to other markets through off-floor facilities (which may be electronic). Thus, members will be able to continue to use alternate means to trade on other exchanges. However, those methods now will be less efficient since they cannot use direct electronic facilities. It would seem that requiring the use of less efficient systems would result in more manual handling of orders, a greater instance of errors, more opportunities for members to "miss" the fast-changing options markets, and more manual surveillance requirements. Thus, their proposal appears to raise even more regulatory concerns.

Second, the Amex has alternate – and more competitive – ways to address any legitimate regulatory concerns that it may have. They can require that members maintain records of their trading activity and provide those records to the Amex upon request. Indeed, the Amex will still need to conduct surveillance of multiple order-routing vehicles since the proposal will permit members to send orders to other exchanges via non-electronic facilities. We fail to see any regulatory benefits that would overcome the Proposal's competitive harm.

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For the reasons discussed above, we urge the Commission to institute proceedings to disapprove the Proposal. If you have any questions on our comments, or if we can be of any other assistance to the Commission on this matter, please do not hesitate to call us.

Yours very truly,

Michael J. Simon
Senior Vice President and Secretary

cc: Annette Nazareth
Elizabeth King