

May 7, 2003

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

Re: File No. SR-PHLX-2002-86

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") is pleased to offer its comments with respect to the above-referenced rule filing (the "Proposal") of the Philadelphia Stock Exchange ("Phlx").

The Phlx proposal, among other things, seeks to impose a 30 second exposure requirement before a broker-dealer can internalize its customer orders via Phlx's AUTOM system. In concept, the ISE supports the imposition of such an exposure requirement. However, the ISE does not believe that the Proposal as currently drafted is adequate. This is particularly true when compared to the requirements the ISE has included in its Rule 717(d) and (e) and the supplemental material thereto, which resulted from much discussion between the ISE and the Commission staff.

When the ISE proposed the first all-electronic options marketplace, there was a recognition that an automatic delivery and execution system would provide broker-dealers the potential to execute pre-arranged proprietary or solicited crosses, without giving other market participants an opportunity to participate in the trade, by entering both sides of a trade in close time proximity. Accordingly, ISE adopted Rule 717(d) and (e) to require its members to wait at least 30 seconds after first entering an order the member represents as agent before entering a contra proprietary or solicited order. In addition, we recognized that a strict and narrow application of Rule 717(d) and (e) would allow members to easily avoid the exposure requirements by entering into arrangements with other broker-dealers to achieve the same result. We thus adopted Supplemental Material .01 and .02 to assure that ISE members adhered to both the letter and spirit of the exposure requirements.

The interaction of various manual and automated processes on the Phlx results in more complicated rules than the ISE's single integrated electronic market. We believe there are several areas where the Proposal is inadequate and that the Phlx must address before the Commission can approve the Proposal:

The rule does not appear to cover all appropriate transactions.

The proposed exposure requirement would apply to orders entered by off-floor broker-dealers into the AUTOM system. The Proposal defines the term “off-floor broker-dealer” as either: (1) A broker-dealer that delivers orders from off the floor of the Exchange for the proprietary account(s) of such broker-dealer; or (2) a market maker located on an exchange or trading floor other than the Exchange’s trading floor who elects to deliver orders via AUTOM for the proprietary account(s) of such market maker. These orders are termed “L” orders. It is unclear why market makers from other exchanges are specified, as these orders are proprietary orders of a broker dealer that would seem to be covered in the first clause. This raises the question of whether there are proprietary broker-dealer orders entered into AUTOM that would not be categorized as “L” orders. It is thus unclear whether the Phlx proposal is as broad as we believe is necessary, covering all broker-dealer proprietary orders in the same manner as the ISE’s exposure requirements. The Commission should require the Phlx to clarify the application of the rule.

The exposure requirement does not appear sufficiently broad.

The Proposal states that “the Options Committee has determined to allow a customer limit order to be submitted *in conjunction with* a proprietary contra-side order via AUTOM.” (emphasis added). It thus would appear that the requirement would only apply if two orders are entered simultaneously or as a single transaction. If that is the case, the exposure requirement is too narrow, as it would allow broker-dealers to enter two orders separately, but within a few seconds of each other, to avoid the 30 second exposure requirement altogether. The Proposal also does not require the exposure of the agency order as opposed to the broker-dealer order. This is significant because exposure of the agency order usually provides a clearer signal to the trading crowd that a cross is imminent. Moreover, it would appear possible for a member to enter one order via AUTOM and give the other to a floor-broker, thereby achieving the same result without giving other exchange participants an opportunity to participate in the pre-arranged trade. The lack of supplemental material prohibiting members from entering into arrangements with other broker-dealers, whether the orders are delivered on-floor, off-floor or as a combination of both, undermines the purpose of having an exposure requirement – to allow other market participants to participate in proprietary crosses.

Solicited transactions should be covered.

It does not appear that the definition of an off-floor broker-dealer order would cover the execution of an agency order against an order solicited from another broker-dealer. The same opportunity to achieve an execution of this type of pre-

arranged cross exists as with a proprietary cross. Therefore the ISE has applied the same exposure principles to solicited orders as applied to facilitated orders. For purposes of regulatory consistency, the Commission should require the Phlx to include such solicited transactions in its Proposal as well.

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The Phlx Proposal would lower the standard that has been set by ISE with respect to the manner in which broker-dealers are permitted to execute proprietary and solicited crosses in an automatic execution system. We believe that the ISE's standards in this area, which require 30 seconds between order entry, entry of the agency order first, and exposure of both proprietary and solicited crosses, are superior and properly protect public customers and the integrity of the market. Moreover, if the Commission were to approve the Phlx Proposal, to remain competitive the ISE would be forced to seek lesser standards for its market; a regulatory direction we do not believe is beneficial to investors or to the options market.

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