August 30, 2000

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. SR-Phlx-00-01; Specialist Participation

Dear Mr. Katz:

The International Securities Exchange LLC ("ISE") appreciates the opportunity to comment on the Philadelphia Stock Exchange's ("Phlx") proposal to provide their specialists with "enhanced" participation rights. We concur with the Commission's preliminary concerns, as discussed in the publication release ("Release"), that the proposal is not consistent with the requirements of the Securities Exchange Act of 1934 (the "Exchange Act"). Accordingly, as a necessary procedural precursor to rejecting the filing, we urge the Commission to institute proceedings to determine whether the proposal should be disapproved.

The Phlx is urging the Commission to approve a rule change that puts the competitive interests of its largest specialists ahead of the interests of every other market participant, including public investors. The proposal likely would result in the Phlx becoming a "private exchange" controlled and operated by a few large firms. These firms would operate free from the competitive forces that have made our markets the most efficient in the world, providing unparalleled benefits to public investors. As competitive pressure forces the other exchanges to mimic the Phlx's model, the negative effects of this proposal will spiral.

The only justification the Phlx offers for this proposal is that the exchange has not been successful competing for market share in the top 100 options. At least the Phlx is honest in its motives. It is asking the Commission to forsake the bests interests of investors and the national market system ("NMS") so that it can benefit as an exchange. As the Commission so clearly explains in the Release, its charge under the Exchange Act is to protect the interests of investors and to encourage a competitive overall market structure. Nowhere does the Exchange Act instruct the Commission to put the interests of a particular exchange above the interests of investors and the NMS. There is no legal basis for the Commission to approve the Phlx's proposal.

Overview of Phlx Proposal

All options exchanges have rules governing the rights of their market makers to participate in trades. Currently, the Phlx provides its specialists with the right to trade against 60 percent of an order when one other member is "at parity." The more members at parity, the lower the allocation to the specialist, subject to a 30 percent "floor." This is similar to most other exchanges, although, as discussed below, the Phlx does not provide priority to public customer orders in all circumstances. The Phlx proposes to increase this allocation to a flat 80 percent for those specialists appointed to one of the top 100 options since the beginning of 1997. These options account for over half of all options trading volume.[1] For specialists appointed to a "top 100 option" before 1997, their allocation would be either 60 or 50 percent, depending on the number of members at parity. For a specialist to ensure its ability to retain its appointment, the Phlx must transact at least 10 percent of the aggregate contract volume in that option. Failure to meet that threshold could result in the option being reallocated to another specialist.

The Phlx states that this proposal is "intended to create incentives to retain and attract specialists" and that these incentives "are reasonable in light of the increasing responsibilities of specialists." The Phlx further notes that specialists must "market to upstairs firms in order to attract order flow to the [Phlx], entailing efforts that require expenditures for appropriate staff to plan and implement strategies." As to the effect of the proposal on Phlx market makers other than specialists (who now will compete for 20 percent of an order), the filing states that such market makers may actually benefit. The theory is that increased order flow to the Phlx would increase the "size of the pie" generally, and that this bigger pie would compensate for the fact that these market makers would be competing for a smaller piece of that pie.

Market Structure Concerns with the Phlx Proposal

The Phlx's proposal would significantly impede intramarket competition, which is critical to the price discovery mechanism in the options market. Quotes and orders of market makers, customers and others (such as broker-dealer proprietary orders) compete in an auction environment, forming the essence of the price discovery process. While there also is intermarket price competition, that competition is somewhat less critical to the price discovery process. Although exchanges do compete on price, they also compete on speed of execution, efficiency and other factors. Thus, maintaining intramarket price competition is critical to the efficient operation of our markets.

The Phlx proposal will impede intramarket price competition by making it virtually impossible for smaller market makers that currently compete with a specialist on the Phlx to continue in business. As less order flow is available to the smaller, non-privileged market makers, their economic viability becomes questionable, and they likely will be forced to merge into the larger specialists.

This likely will result in the concentration of market making on the Phlx into a few large specialist units, with few (if any) other market makers in the crowd to provide price competition, added liquidity or price improvement opportunities. There is little reason for a non-specialist market maker to quote competitively when that market maker is competing for, at most, 20 percent of an order.

We are not suggesting that the Commission's regulatory policy should focus on preserving all existing market makers. We recognize that enhanced competition will likely lead to consolidation among market makers. Weaker firms that survived in an era of sole listings and guaranteed order flow may not be able to adapt to the current competitive climate. Such consolidation is healthy and often occurs following major structural changes in an industry. However, the Phlx proposal will choke even strong market making firms by denying them access to the critical mass of order flow that they need to survive.

To justify its proposal, the Exchange Act requires the Phlx to demonstrate some strong regulatory reason to reallocate order flow in the anticompetitive manner proposed. However, the Phlx's filing provides no regulatory justification at all. The "responsibilities" and "obligations" of specialists that the Phlx cites to support its proposal are the same that have applied to specialists since the dawn of the agency-auction market. The Phlx provides no reasoning as to why it now must seriously enhance the benefits that specialists receive at the expense of competition in exchange for meeting these obligations. The experience of the ISE shows a market structure that *increases* the opportunity for intramarket price competition is both beneficial to investors and economically attractive to market making firms.

The ISE has 10 specialist or "Primary Market Maker" ("PMM") positions, as well as 100 "Competitive Market Maker" ("CMM") positions. As the Commission is well aware, many firms are interested in these PMM and CMM positions. Yet, as the Commission notes in the Release, our incentives for PMMs are similar to the incentives currently in the Phlx rules: an allocation of an order to the PMM of between 60 and 30 percent (after all customer trading interest is satisfied), depending on the number of other members with trading interest at the same price. This allocation has proven attractive both to PMMs and CMMs and has led to unprecedented price competition on the ISE. Our experience demonstrates that there is no need to reformulate the benefits of being a specialist to establish a strong, competitive market.

The unstated reason behind the Phlx's proposal is that this structure is necessary for the Phlx to achieve its goal of restructuring itself into a "private exchange," operated by a few large market makers who are guaranteed enough order flow for them to be able to pay order flow providers to send their orders to the Phlx. It appears that this is the competitive path that the Phlx has determined to follow. Indeed, we note that the Phlx also recently adopted a "shortfall fee," imposed on specialists that fail to garner at least 10 percent market share in one of the top 120 options.[2] This will require such specialists to pay the Phlx a fee for each contract below the 10 percent threshold that they *do not* execute. The clear intent of this fee is to impose a tax on smaller specialist units, forcing them to combine with larger units that are better able to pay for order flow.

The Phlx's strategy of becoming a "private exchange" certainly will benefit the large remaining specialist units, as well as the Phlx itself. It certainly will not benefit investors or the market as a whole. Indeed, approval of this proposal likely will lead to a cascading effect that will harm the markets as a whole, and not just the Phlx: The same market makers that are active on the Phlx are active on other exchanges. These entities and their brethren will be seeking similar benefits on all exchanges. It is likely that both the ISE and the other markets will need to respond to the Phlx proposal to attract and retain these market makers. The effect on the price discovery mechanism, and on the options markets, could be catastrophic.

Further Limitations on Order Interaction on the Phlx

The Phlx's market structure already contains significant limitations on intramarket competition that this proposal will exacerbate. Currently, market makers have priority over broker-dealer proprietary orders. In addition, because public customers do not have absolute priority on the Phlx, specialists on that exchange can trade ahead of customer limit orders in many circumstances, limiting the competition that these orders can provide. Under this proposal, specialists now will have additional priority over other market makers, even further limiting competition on that exchange.

With respect to customer orders, on the ISE, customer limit orders at the same price as market maker quotes are always executed in their entirely before any market maker, including the PMM, is permitted to trade for its own account.[3] However, under the Phlx's rules, public customers and crowd participants jointly trade against certain orders, even if the customer's trading interest is not entirely filled. To the extent that professionals trade at the same price as a resting customer order that is not filled, the crowd is trading ahead of that customer order.[4] This limits the incentives for customers to place limit orders on the Phlx, and thus limits competition in that market. As to broker-dealer orders, there currently is no price competition at all from broker-dealer proprietary orders on the Phlx.[5]

With no price competition from broker-dealer proprietary orders, and with limited price competition from customer orders, the Phlx now proposes to scale back the competition provided by other market makers. This would give the specialist nearly unfettered ability to set prices and trade with incoming orders. The Phlx provides no justification that would support a finding that it is in the interest of fair and orderly markets and investor protection to allow an exchange to provide these advantages to its specialists.

Responses to Specific Commission Questions

In the Release, the Commission asks for comment on six specific questions. While we have addressed many of these issues in our general discussion, we summarize our views on these six issues below.

1. Will the proposal discourage price competition and price improvement? Yes it will. We carefully considered the allocation of orders to our market makers and proposed our 60-40-30 split to provide incentives for all market participants to compete for order flow. In our judgment, a strict 80 percent allocation to specialists will destroy incentives for market makers to provide price improvement, since they will not be rewarded with any significant order flow. Specialists simply would match a market maker's price to retain its 80 percent of an order, resulting in market makers becoming increasingly passive market participants. It also will lead to a contraction in the number of market makers, undermining price competition and even further limiting the opportunity for competing market makers to provide price improvement.

2. If the Commission was to approve this proposal and the other exchanges were to adopt similar programs, what would be the effect on price competition and the width of bid-ask spreads? Approval of this filing likely would create competitive pressure forcing other exchanges to adopt similar rules, extending the harm to price competition and price improvement to other markets. As the disease spreads, individual markets would become less competitive and their quotes would widen. As a smaller number of large firms increasingly dominate the markets, there would be a loss of price competition, leading to inferior prices across all markets. With fewer market makers there would be less capital committed to the market, leading to wider spreader and less liquidity, as well as greater concentration of risk in just a few firms.

3. Would the enhanced specialist entitlements be unfairly discriminatory and induce the exit of market makers? Yes to both legs of the question. An exchange's rules cannot permit "unfair discrimination between customers, issuers, brokers and dealers."[6] This proposal certainly discriminates between dealers by allocating 80 percent of an order to a specialist and 20 percent to all the other market makers. The issue is whether this discrimination is "fair." As the Commission noted in the Release, it previously has concluded that "discrimination" providing specialists with up to 60 percent of an order with one other market maker at parity is fair (with more than one market maker at parity, the allocation is only 40 or 30 percent). Indeed, we agree that such an allocation reasonably reflects the costs and benefits of being a specialist. However, the Phlx proposes a radical departure from this standard with absolutely no justification as to why an across-the-board 80 percent allocation is "fair" discrimination. The burden of proof is on the Phlx to justify this significant a deviation from industry norm, and the Phlx's filing is woefully inadequate in providing that proof. Finally, in our judgment, a 20 percent allocation to all market makers other than the specialist does not provide sufficient order flow to

sustain a business and will accelerate the current trend of market makers merging or exiting the business.

4. How have existing specialist entitlements on the options exchanges affected competition and market quality? There currently is unparalleled competition both on individual options exchanges and between exchanges. This indicates that the existing entitlements work. However, it does not follow that the Commission should prohibit any changes to market maker entitlements. Rather, it means that the Commission must carefully scrutinize proposed changes to ensure that they would encourage competition. For example, we proposed rules regarding market maker entitlements somewhat different from the rules on the other exchanges: we reward our market makers for the obligations and responsibilities they have to the market based on the price and size of their quotations. This is a pro-competitive change to the existing market structure that encourages vigorous intramarket competition. Nonetheless, we have had no problem finding candidates for our PMM and CMM memberships. The Phlx provides no evidence at all that its 80 percent allocation proposal will attract more or better specialists to its exchange. There already is a concentration on the Phlx of three large specialist units. This proposal will merely hasten this evolution to foster payment for order flow and preferencing, as discussed in the response to the next question.

5. What is the likelihood of the Phlx proposal leading to preferencing as a norm, and in turn creating a risk to market quality? This proposal obviously is intended to foster preferencing and payment for order flow. Large market maker units are seeking to trade on as many exchanges as possible so that they have venues to which to direct the order flow for which they paid. They similarly are seeking to eliminate competitors so that they have an unimpeded ability to trade against these orders. This will make it more efficient for them to pay for order flow and send that order flow to the exchange on which they are a specialist, PMM, designated primary market maker or lead market maker. This impedes competition, not enhances it.

6. What impact would this proposal have on other Commission proposals regarding disclosure of trade executions and order routing practices? We presume that the Commission asks this question to help determine whether the disclosure required by the proposed rules would help ameliorate any adverse effects of the proposal. While we believe it is premature to make any final judgement on this issue, we doubt that any form of disclosure would provide sufficient safeguards to address the competitive infirmities of this proposal. We also note that approval of this filing likely will lead to rapid changes in market structure. Thus, even if the Commission ultimately adopts the disclosure rules, and those rules have a significant effect, there already may be irreparable harm to the markets. Moreover, as the quality of market deteriorates, these rules simply would require that market centers and broker-dealers disclose to investors that they received what then passes for "best execution" in a less competitive, less deep, and less liquid market.

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We urge the Commission to reject the proposal. We recognize that the Exchange Act first requires the Commission to institute "disapproval proceedings" before it can outright disapprove the filing. Thus, we urge the Commission to take swift action to institute disapproval proceedings. This will send investors and the other market participants a clear message that there is no room for this type of anticompetitive and discriminatory proposal in today's options markets.

We again thank the Commission for the opportunity to comment on the filing. If you have any questions on our comments, or if we can be of further help, please do not hesitate to contact us.

Yours very truly,

Michael J. Simon
Senior Vice President and Secretary

cc: Annette Nazareth, Esq.
Robert Colby, Esq.
Elizabeth King, Esq.
Deborah Lassman Flynn, Esq.