September 18, 2000

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

**Re: Firm Quote and Trade-Through Disclosure Rules for Options;
File No. S7-17-00, Release No. 34-43085 ("Release")**

Dear Mr. Katz:

The International Securities Exchange LLC ("ISE") is pleased to comment on the Commission's proposals to enhance the market structure for the trading of listed options. We support the Commission's initiatives and urge the Commission to adopt and implement these rules as quickly as possible, subject to the amendments we discuss below.

We focus our comments primarily on the Firm Quote Rule.[1] We view the proposed Trade-Through Disclosure Rule[2] as a vehicle to compel options exchanges to join an intermarket linkage plan. The reporting requirements of that rule are so onerous that broker-dealers most certainly will shun trading on any exchange not participating in a "qualified" linkage. Thus, we expect that all options exchanges will join a linkage plan, and no broker-dealer will ever make the disclosures required under this rule. Since we agree that all exchanges should be linked, we support the adoption of the disclosure rule as proposed.

With respect to the proposed amendments to the Firm Quote Rule, we strongly support the extension of this rule to the options market. The advent of multiple trading has spawned increased competition in the options market, providing investors with narrower, more liquid and deeper markets. However, the lack of certain basic protections long accepted in the stock world has hampered the growth of the options markets. The development of the intermarket linkage will be one positive step for our markets. The display of the size associated with a quotation (which currently is available only on the ISE, and only on our proprietary trading screens) is another positive step. The application of the firm quote rule is equally important, and will help ensure that the prices displayed to the market are "real" and available.

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[1] Rule 11Ac1-1 under the Securities Exchange Act of 1934, as amended ("Exchange Act").
[2] Proposed Rule 11Ac1-7 under the Exchange Act.

As a general matter, we believe that the application of the rule to the options exchanges should mirror the application of the rule to the stock markets. However, due to capacity and competitive issues, it may be necessary to make at least temporary accommodations in the rule to recognize unique aspects of the options market. Our proposed modifications to the Commission's proposal center on three issues: (i) the dissemination of the size of quotations; (ii) whether to require one firm size for all quotations or whether to allow a differentiation in sizes; and (iii) the proposed thirty-second "response time." We also have some technical comments on the proposals.

I. Dissemination of Size

We support extending the Firm Quote Rule to the options market. However, in so doing, the Commission must take care to tailor the application of the rule to recognize certain idiosyncrasies of this market. Failure to make these necessary accommodations could well impede many of the competitive initiatives in the market, rather than benefit the market. Of most concern to us is tailoring the firm size requirement to recognize the capacity restraints currently facing the Options Price Reporting Authority ("OPRA").

As the Commission is well aware, OPRA has limited "bandwidth," resulting in a mandatory allocation of available capacity among the five exchanges.[3] Because OPRA currently does not carry any size information, all exchanges currently use their allocated bandwidth solely to disseminate price quotations and last sales. However, as proposed, the Firm Quote Rule could result in each exchange using its portion of the OPRA bandwidth differently. Ironically, this could benefit exchanges that show relatively limited size information, while having a significant adverse effect on exchanges, such as the ISE, that collect and disseminate the "real" size of their trading interest.

This unintended discrimination would result from the alternative ways in which exchanges could disseminate quotation size. The rule would require an exchange that collects the size of trading interest from its members to abide by the "traditional" structure of the Firm Quote Rule by disseminating "real size" on a continuous basis. Such an exchange must disseminate a new quotation each time the size of a quote changes. However, an exchange that does not collect size could "pre-set" a static size for each series, thus resulting in fewer quotes. Such an exchange need not even disseminate size with its quotes, as long as it lists its guaranteed sizes in some other medium.

The effect of this proposal will be to seriously hamper exchanges that collect and disseminate "real size," and thus try to provide investors with the most complete and accurate quotation information. Such exchanges will need to "burn up" their limited allocation by disseminating significantly more quotes in a series compared to exchanges that do not disseminate size at all, or simply

[3] *See* Exchange Act Release No. 42755 (May 4, 2000).

disseminate a pre-set uniform size. Indeed, we estimate that there could be more quote changes reflecting only adjustments to size than there are quote changes reflecting a new price. This will permit exchanges not showing "real size" to quote – and trade – significantly more options products with the same allocation of OPRA bandwidth as exchanges providing investors with more accurate and useful information.

We believe that a first step to address this inequality, and to provide investors with more useful and accurate information, is to require all exchanges to disseminate size with their quotations. While exchanges should be permitted to set size by rule, and not by actually collecting quotes, the pre-set size should be disseminated with a quote. Given the multitude of option products trading, and with there likely being different "pre-set" sizes for different classes, or even series, it is unrealistic to expect investors and other market participants to consult tables or web sites to discover the size of the quote.

To address the issue of unequal use of OPRA bandwidth, we believe the Commission should announce that it will flexibly apply its exemptive authority under the Firm Quote Rule[4] to level the playing field between exchanges showing "real size" and exchanges using a pre-set size. Unfortunately, we do not believe that it is possible to codify in the rule each and every possible way to address this problem. Indeed, attempting to do so will be unnecessarily limiting and is likely to inhibit innovation by exchanges. Moreover, an exchange's decision on how to address this problem may well have competitive implications. Thus, we recommend that each exchange privately discuss this issue with the Commission and its staff, and that the Commission announce its intention to use its exemptive authority to apply the Firm Quote Rule in a flexible manner. This will help ensure that firm quotes in the options market result in the equal treatment of all exchanges in a manner that enhances, not impedes, competition.

II. One Firm Size Versus Multiple Firm Sizes

As applied to the equities market, the Firm Quote Rule mandates that a quote be firm up to the disseminated size for any person that attempts to access that quote. However, recognizing the unique aspects of the options market, the Commission proposes for comment two alternatives applications of the rule: "one size fits all" (the same as in the equity market); or separate sizes for broker-dealers and for "customers" that are not broker-dealers. Our preference would be to adopt a "one size fits all" approach, but we currently do not believe it is feasible to achieve this goal.

As the Commission is aware, the options exchanges now are "firm" only for their disseminated size (on the ISE) or their guaranteed size (on the other exchanges) with respect to customer orders. This reflects the fact that options market comprises two tiers, with non-customers generally trading in larger size

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[4] Paragraph (e) of Rule 11Ac1-1.

than customers. Thus, if market makers must establish a single quotation size for all, they likely will decrease the disseminated size of their quotes and their execution guarantees, limiting the liquidity available to customers.

While there also are multiple tiers of trading in the stocks underlying listed options, this is less of an issue in that market, where trading interest of different prices and sizes interact as part of the price discovery process. In contrast to the stock market, the options markets are derivative in nature, with prices derived from the stock prices, and with liquidity at a given price dispersed over multiple series of options. If non-customers "take" the liquidity at a given price in a "one size fits all" environment, the likely result would be wider, less deep options quotes, without any benefits to the price discovery process. In contrast, permitting separate sizes will allow market makers to provide customers with greater liquidity, while limiting their exposure to non-customers.

While we propose allowing dual sizes for customers and non-customers, we do not believe it is appropriate to require exchanges to disseminate two sizes with their quotations, as the rule proposal appears to contemplate. For the reasons discussed above, requiring the dissemination of two different sizes will even further tax the strained OPRA resources. Thus, we propose that the Commission require all exchanges to disseminate a firm customer size with their quotations (whether reflecting "real" size or a size established by rule) and mandate that the exchange must be firm for at least the minimum trading unit (currently one contract) for non-customers. We believe it is likely that the exchanges will seek to attract non-customer order flow by providing greater-than-minimum size either for all or some broker-dealers. Such competition is healthy, and may pave the way for eliminating this distinction in the future.

Finally, we agree with the Commission that, coupled with dual sizes levels, there must be some continuation of the "trade or fade" policy, as proposed in the "thirty second response" provision.[5] While we have a number of suggestions regarding this proposal (discussed below), we believe the concept is sound: if the disseminated size is sufficient to execute an entire order, a market should be required to execute that order in its entirety or it must execute the order up to its firm size for that type of order and move its quote to an inferior price.

III. Thirty-Second "Response Time"

The proposed amendments to the Firm Quote Rule would require a market maker, within 30 seconds of receipt of an order, either: to execute that order in its entirety; or to trade against that order up to its firm quote and then to "fade" its quotation to an inferior price. We agree with this general concept. However, we believe that allowing a market maker 30 seconds to address an order is generally much too long, and certainly is too long for the listed options markets, where prices change very rapidly.

[5] Proposed paragraph (d)(3) of the Firm Quote Rule.

The Commission states that this 30-second time period "is based on the trade-through provisions of the Amex/CBOE/ISE [linkage] plan ["Linkage Plan"], under which broker-dealers are exempted from trade-through liability when a receiving market fails to respond to an incoming linkage order within 30 seconds."[6] In fact, the Linkage Plan calls for immediate turn-around of some linkage orders, and no more than a 15-second turn-around for other orders. At no time does the linkage plan allow a 30-second turn-around time. The relevant provisions are as follows:

- Orders available for automatic execution[7]: There must be an *immediate* execution in the exchange's auto-ex system; there is no stated provision allowing *any* turn-around time.

- Orders not available for automatic execution[8]: The plan requires the receiving market to turn an order around within 15 seconds of receipt of the order. This is for orders that are larger than the pre-determined auto-ex size, and thus require some manual intervention on the floor-based exchanges.

- Failure to receive a response[9]: A member of an exchange that sent a P/A or principal order not eligible for automatic execution can reject a response it receives more than 30 seconds after sending the order. This provides some "cushion" around the 15-second turn-around time for transit and receipt of messages. As the Commission also notes, a market can ignore an away-market quote for trade-through purposes once this 30-second window expires.

These plan provisions represent the unanimous view of the five options exchanges (including the two exchanges that did not initially sign the plan for other reasons) that, at most, 15 seconds is enough time for market makers to turn around an order. In contrast, the Commission proposes to adopt an across-the-board 30-second turnaround time. This would apply even if the order was not larger than the quotation being accessed, a situation where the linkage plan requires *immediate* turnaround. We believe that there is no basis for providing a 30-second turnaround time, and that this could lead to abuses by market makers, who may hold orders until the last allowable second to attempt to gain an advantage in the market.

As in the linkage plan, we propose that the Commission require immediate turnaround of all orders that are no larger than the disseminated quotation. An exchange and its market makers should be able either to give an immediate fill of

[6] Release 34-43085 at note 92 and accompanying text, citing Section 8(c)(iii)(B) of the linkage plan.
[7] Section 8(a)(ii)(A) for specified principal-acting-as-agent ("P/A") orders and Section 8(a)(ii)(C) for principal orders of 10 contracts or less.
[8] Section 8(a)(ii)(B) for larger-sized P/A orders and Section 8(a)(ii)(C) for larger-sized principal orders.
[9] Section 8(a)(iii) of the Plan.

these orders, report that one of the existing Firm Quote Rule exceptions apply (such as "traded ahead" or "in the process of changing a quote"), or fade its quote for non-customer orders. For orders greater than the size of the stated quotation, the Rule should parallel the linkage plan and provide a 15-second turnaround time. Recognizing that it takes time to receive and react to a message, the Trade-Through Disclosure Rule also should adopt the approach of the plan by exempting from the disclosure requirements any trade-through where the party initiating the trade-through had attempted to access the other market's quote, and that market had not responded within 30 seconds.

IV. Technical Comments

We have a number of technical comments on the two proposed rules:

- *Definition of "complex trade"*: The Trade-Through Disclosure Rule defines a "complex trade" as a trade in an options series "executed in conjunction with a related transaction occurring at or near the same time" as part of the same investment strategy.[10] Complex trades would be exempt from disclosure under the rule. This definition would appear to include option trades executed in conjunction with stock trades, such as "buy-writes," in which an investor buys stock and writes a call on that stock. We believe that this definition is overly-broad and that there is no reason to exempt "buy-writes" from the rule. In these types of trades, we do not believe it is appropriate to permit trade-throughs, either in the stock or option leg of the transaction.

  We earlier noted that it is likely that the requirements of the Trade-Through Disclosure Rule will induce all exchanges to join a linkage plan. Thus, there never may be actual disclosure of trade-throughs. Nevertheless, use of the proposed definition of "complex trade" would create an unfortunate precedent. In particular, the exchanges currently are considering their own definition of this term for the trade-through provision of the linkage plan, and initially deferred defining the term due to the complexities involved. Until the exchanges ultimately resolve this issue, we propose that the Commission simply limit the definition of "complex trades" to those trading strategies in which *all* legs of the trade involve options.

- *Minimum number of contracts for the Firm Quote Rule:* The Commission requests comment on whether there should be a minimum number of contracts for which market makers and exchanges should be firm at their quotes. We believe that there is sufficient competition in the options market that exchanges and market makers will disseminate quotations in reasonable size. We are not aware of the Commission imposing minimum size requirements in the other securities markets and we see no benefit in the government mandating a minimum size for options quotations.

[10] Paragraph (a)(1) of proposed Rule 11Ac1-7.

- *Use of the term "published size":* The proposed language to the Firm Quote Rule appears to describe a term contained in the definitions to that rule, but does not use the defined term. This creates unnecessary confusion. Specifically, the rule would require a broker or dealer on an options exchange to execute an order up to "the size of an exchange's or association's quotation made available to quotation vendors by such exchange" pursuant to the rule.[11] That language appears to be virtually identical to the defined term "published quotation size" already in the Firm Quote Rule,[12] with the rule requiring participants in the equity market to provide executions up to the "published quotation size." If the Commission intends to impose the same requirement in the options market, we suggest that the Commission use the same defined term. If the Commission intends for this obligation to be different, it should explain those differences, and the reasoning behind them.[13] As proposed, the requirements appear to be the same, yet the language used to describe these requirements differs.

- *Trade-through protection of unlinked markets:* Broker-dealers sending orders to an exchange participating in a "qualified linkage" would be exempt from the requirements of the Trade-Through Disclosure Rule. However, the Release states that the Linkage Plan currently does not provide sufficient protection against trade-throughs for the Commission to deem it "qualified." Among other things, the Commission states that a plan must provide some form of protection against trading through even *unlinked* exchanges to be qualified. While we recognize that this is an unprecedented and controversial position, we agree with the Commission on this issue. Key to the continued development of the options market is instilling confidence in investors that the same basic protections available in the stock market apply to the options market. Quotes with size, firm quotes and trade-through protection are all key ingredients. Ideally, all exchanges will participate in a linkage, and we believe the onerous requirements of the Trade-Through Disclosure Rule will dictate that result. But if an exchange decides not to join the linkage, the other exchanges should adopt reasonable rules and procedures to address trade-throughs of even that market. While these protections likely will not be as comprehensive as the protections available for trade-throughs involving linked markets, investors should be assured of at least a base level of protection.

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[11] Proposed section (d)(3)(i)(B)(*1*)(*ii*) of the Firm Quote Rule.
[12] Paragraph (a)(17) of the Firm Quote Rule.
[13] It does not appear that this difference is related to the proposal that members trading on an options exchange be permitted to quote in smaller sizes for non-customers. That proposal is encompassed in proposed Alternative B, Section (d)(1)(i)(B) of the Firm Quote Rule.

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

Yours very truly,

Michael J. Simon
Senior Vice President and Secretary

cc: Annette Nazareth, Esq.
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