April 11, 2000

Mr. Jonathan Katz
Secretary
United States Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609

Re: File No. 4-429 / Options Linkage Plans

Dear Mr. Katz:

The Options Committee ("Committee") of the Securities Industry Association[1] appreciates the opportunity to comment on the proposed options market linkage plans submitted by the American Stock Exchange LLC ("Amex"), Chicago Board Options Exchange, Inc. ("CBOE"), International Securities Exchange ("ISE") [2], Pacific Exchange ("PCX"), and Philadelphia Stock Exchange, Inc. ("PHLX")(collectively, "Exchanges"). The Committee represents the interests of a broad cross section of the broker-dealer community involved in the U.S. listed options industry. The Committee applauds the efforts that have been made by the Securities and Exchange Commission and the exchanges to achieve a unified industry plan to establish an intermarket linkage plan for listed options.

The Committee believes generally that the adoption of an appropriate inter-market linkage for listed equity options will allow the member firms to better serve their customers. We agree that the linkage must serve to further the goals that Congress set forth in Section 11A of the Securities Exchange Act of 1934. These goals include increasing market efficiency, enhancing competition, increasing the information available

[1] The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about the SIA is available on its home page: http://www.sia.com.)

[2] The International Securities Exchange ("ISE") had not yet been approved as a registered securities exchange at the time the plans were submitted. Accordingly, they were unable to execute a linkage plan. However, they did submit a plan and our comments apply equally to their proposal.

to brokers and dealers and investors, and facilitating the offsetting of investors' orders and contributing to the best execution of such orders.

Significant progress was made over the rather short 90-day period mandated by the Commission. The Committee had an opportunity to provide informal input to the Exchanges during the 90-day period and is pleased that several of its recommendations have been incorporated into one or more of the submitted plans.[3] Despite considerable effort at achieving complete unanimity among the interested parties, some important differences remain. We observe that CBOE, Amex and ISE have submitted identical proposals. However, both PCX and PHLX have submitted separate proposals. The most important areas of difference include (1) whether the linkage should require routing of orders based on price/time priority, (2) who should have access to the linkage, and (3) the appropriate remedy for trade-throughs. With the appropriate resolution of these differences and the addressing of our comments noted below, we support swift movement on the adoption of a uniform linkage plan.

Price-Time Priority

The division among the exchanges on the question of whether the options linkage plan should require routing of orders based on price-time priority constitutes perhaps the single most significant obstacle to achieving a unified plan. The plans submitted by Amex, CBOE, and ISE would not include any price-time requirements, allowing each exchange to step up and match or improve the best market. The PCX plan would allow a market to keep an order provided that it offered price improvement to the customer order; otherwise, the exchange would be required to route to the exchange that was first in time at the best price. The PHLX plan would require strict price-time priority for all customer and principal orders. ISE has suggested that the Commission authorize continued negotiation on a linkage plan that would, in part, require an exchange that is unwilling to match or improve an order, to route it through the linkage based on price-time priority. Amex also supports continued dialogue on ISE's proposed compromise.

We support the approach taken by Amex, CBOE, and ISE, provided it is combined with the compromise provision raised by ISE and Amex. Indeed, we previously recommended such a compromise approach to the exchanges.[4] The issue of whether price-time priority should become a mandated component of our nation's equity and options markets is a current topic of considerable debate. It is a debate that can not be completed without also addressing issues such as market fragmentation, internaliza-

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[3] See letter from William C. McGowan, Chairman, S.I.A. Options Committee to William Brodsky (CBOE), Meyer Frucher (PHLX), David Krell (ISE), Sal Sodano (Amex) and Phillip DeFeo (Amex), dated January 4, 2000.

[4] Id.

ation, payment for order flow, and more generally, how to best foster market center competition. The Commission has recently solicited comment on a broad range of issues relating to market fragmentation.[5] We would encourage the Commission to consider the views on price-time priority expressed by commenters as part of the broader market structure debate.

Our recommendation on price-time priority is also based on our view that it is appropriate to continue to preserve the ability of broker-dealers to route orders for execution to the market of their choice. This will ensure that broker-dealers will be able to consider factors other than price – such as depth, liquidity, service, capacity and speed of execution. Such factors are appropriately considered by brokers in fulfilling their duty of best execution with regard to customer orders.

We also believe it would premature to mandate price-time priority on the options exchanges while the broader market structure issues remain subject to public debate. Any such attempt would meet fierce opposition. The resulting gridlock would likely to kill the momentum that has been achieved during the last several months to accomplish an options linkage. As you are well aware, unlike the equities markets, the options exchanges have no market linkage in place today. It would be unfortunate if that opportunity were lost or delayed.

Our support of ISE's proposed compromise is based on our strong desire to achieve a plan that will be supported by all the exchanges and the member firm community. It would preserve the ability of broker-dealers to route orders to a market of their choice. In instances where that preferred market was not willing to match or improve the best bid or offer, such order would be re-routed, with the market that was first in time at the better price receiving the order. We believe this compromise solution would also serve as a means of testing the impact of price-time priority across separate markets.

Access and Limitations on Use

We believe the benefits of the linkage should apply to broker-dealer customers and non-broker dealer customers alike. The term "customer" under the submitted plans includes any person or entity other than a broker-dealer. This definition is identical to the definition of "public customer," as that term is used in the rules of the options exchanges today. Only public customers currently receive the benefit of firm quotes and access to automatic execution systems in the options markets. Now, it is proposed that only public customers will get the benefit of the inter-market linkage as well. Broker-dealers would remain ineligible for these basic market transparency and linkage provisions. We believe the distinction in treatment between "public" and "non-public" customer is not

[5] SEC Release No. 34-42450 (February 23, 2000).

supportable and we urge the Commission to direct the Exchanges to correct this unfair distinction in treatment.

The exchanges have not yet unanimously agreed on the extent to which certain options specialists and market makers (defined under the plans as "eligible market makers") should be able to use the linkage. Amex, CBOE, ISE, and PCX 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. Amex, CBOE, and ISE have proposed an "80/20" test to keep principal orders to a minimum.[6] PCX takes a stricter approach, allowing principal orders only for the limited purpose of unlocking or uncrossing markets or to satisfy trade-through liability. PHLX, on the other hand, would permit unlimited use of principal orders, provided that the order sender meets the definition of "eligible market maker." The Committee supports some form of limitation on the use of principal orders. The limitation should be designed to ensure that the linkage is used almost exclusively as a tool to assist "eligible market makers" in determining and accessing the best markets for their customers. The approaches taken by Amex/CBOE/ISE and PCX are both consistent with our general view on this subject. The PHLX approach, however, is too open-ended to receive our support. We encourage the Commission to continue to work with the Exchanges to find an acceptable resolution on the details of this issue.

<u>Linkage Operation</u>

The Amex, CBOE, and ISE plans would permit the transmission of a P/A order for execution in the automatic execution system of a participating exchange at the best quoted price as long as the P/A order is no larger than the firm customer quote size. The minimum firm customer quote size would be 10 contracts. PCX believes 20 contracts is the appropriate minimum. We believe 10 contracts is an acceptable minimum.

We also concur with the general approach taken by Amex, CBOE, and ISE with regard to the handling of orders not eligible for automatic execution through the linkage when the size of the order is larger than the firm customer quote size. In particular, we support the provisions that allow each exchange to elect whether to send all or part of an order to another exchange.[7] We also agree that a reasonable time-out provision for orders received through the linkage is necessary. Moreover, we support the provision requiring that, in the event the originating exchange determines to send a second piece of the same order, it must be for the lesser of 100 contracts or the entire remainder of the customer

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[6] The "80/20 test" would effectively prevent an "eligible market maker" from effecting more than 20% of their market maker volume in a particular class by the sending of principal orders through the linkage.

[7] We note that the Amex, CBOE, and ISE plans would allow the originating exchange to send P/A orders to any exchange showing a better price. As stated earlier, we recommend that if two or more exchanges are showing the best price, the P/A order should be routed based on price/time priority.

order. This provision should help to eliminate multiple shipments of orders that could slow speed of execution of customer orders.

Satisfaction of Trade-throughs

We support generally the trade-through provisions submitted by Amex, CBOE and ISE. Specifically, we support the fact that their plans would limit the satisfaction of a trade-through to the verifiable number of customer contracts in the market of each exchange that was traded through that were included in the disseminated bid or offer of that exchange, subject to certain limitations. In particular, if the number of contracts to be satisfied in one or more exchanges exceeds the size of the transaction that caused the trade-through, satisfaction will be limited to the size of the transaction that caused the trade-through.[8] Moreover, if the transaction that caused the trade through was for a size larger than the firm customer quote size with respect to any of the exchanges traded through, the total number of contracts to be satisfied to all exchanges will not exceed the size of the transaction that caused the trade-through and will be allocated pro rata based on the verifiable number of customer contracts traded through on each exchange. We do not support PHLX's proposal insofar as it would allow the total number of contracts to be satisfied to exceed the size of the transaction that caused the trade-through if the trade-through transaction was for a size larger than the firm customer quote size.

Cross-market Limit Order Protection

The Commission has requested comment on several questions regarding the possibility of incorporating cross-market limit order "trade-at" protection into the linkage plans. In addition, ISE has proposed an alternative proposal that would provide such cross-market limit order trade-at protection in instances where an exchange steps-up to match an away market. Like the issue of price/time priority, however, we believe that the issue of whether to mandate cross-market limit order trade-at protection should be addressed in the context of the broader ongoing market structure debate.

We believe that the proper handling of customer limit orders is best addressed through the exercise of the broker-dealers' judgement and best execution responsibilities. For example, if a broker-dealer is aware that booked orders directed to a particular exchange are not being executed while transactions are taking place at the limit price of such orders on other exchanges, that broker-dealer should re-evaluate its order routing practice. Moreover, exchanges and liquidity providers could voluntarily offer limit order protection against trade-ats. At least several of the regional stock exchanges offer such protection today.

[8] Where the size of the transaction that caused the trade-through is equal to or smaller than the firm customer quote size we interpret the plans as requiring participants to satisfy *each* market up to the size of the original trade-through order. This could result in trade-through liability in excess of the size of the original trade-through order.

We also believe that cross-market limit order trade-at protection carried out on a manual basis would be extremely difficult to administer on a “manual” basis,” given the many thousands of series quoted continuously by the options markets. For all of these reasons, we recommend that cross-market limit order trade-at protection not be forced into the current plans. It would create an unreasonable delay in achieving agreement on a uniform linkage plan.

Locked and Crossed Markets

The Amex, CBOE, and ISE plans propose language stating that locked and crossed markets must be avoided and that the participating exchanges will file with the Commission for approval of uniform rules for unlocking and uncrossing markets. PCX does not agree with the rule approach. Rather, they suggest locked and crossed markets can be adequately dealt with by, in part, allowing principal orders to be sent through the linkage for the purpose of unlocking or uncrossing markets.

We support the efforts of the exchanges to reduce the occurrence of locked and crossed markets. The Committee notes, however, that the Commission and the Exchanges should be mindful of potential practical difficulties associated with requiring a participant to unlock/uncross a market it has locked or crossed. For example, minor revisions to pricing views by specialists and market makers, which are often reflected by changed volatility assumptions entered into their autoquote formulas, can instantly lock or cross markets in fifty or more series.

Governance Provisions

The Commission requested comment on several governance issues relating to the linkage plans, including what level of discretion should be given to the Operating Committee and, in particular, whether such committee should have discretion to define plan terms such as “complex trade” as an exception to trade-through liability. We believe that it is appropriate for the Exchanges to conclude that the Operating Committee should have the flexibility to address important issues that will arise during the implementation of the linkage. A more complicated and lengthy approval process for adopting interpretations under the plan might hinder smooth operation of the linkage, particularly during the start-up phase, where we anticipate numerous issues will need to be worked out. We believe that allowing the Operating Committee to define the term “complex trade” is an example of an acceptable task for the committee.

The Commission also requested comment on whether it would be useful to require unanimous vote in order to amend the plan or whether a simple majority or super majority would be more appropriate. As proposed, the plans require unanimous approval of the participating exchanges to amend such plans (except for adding new participant exchanges, which does not require any vote). We believe that a super majority requirement is the best approach. This recommendation is based primarily on our concern that allowing a single exchange to block proposed amendments to the plan threatens the ability of our markets to respond quickly to new circumstances. As you are aware, our markets are evolving rapidly. The interests of a single entity should not stall proposed amendments that have the support of an overwhelming portion of the options industry.

Impact of Linkage Plan on Competition

The Commission requested comment on how a linkage plan between the options markets would impact competition. This is an extremely difficult question to answer, especially since we are commenting on multiple plans that have significant differences. Moreover, the linkage plans under consideration are much bolder than the linkages present in the equities markets today, so we have little real-life experience in predicting how any of the proposed linkages would work in practice. Nevertheless, we believe generally that a linkage plan that incorporates our recommendations would likely have a positive impact on competition in the options market. It would preserve existing incentives for exchanges and liquidity providers to attract business on the basis of overall service, where price would continue to be the most important (but not the sole) factor in a broker-dealer's decision on where to direct order flow. The price-time suggestion we offered for determining how an exchange should route linkage orders should also help to encourage competition on the basis of quotes. And perhaps most importantly, under the linkage, customers would more often get the best price available across all markets. This will help instill confidence that our options markets are fair, which, in turn, should serve to benefit the entire listed options industry through increased use of the product.

Necessity of Quotes with Size

The Commission requested comment on whether the linkage plan should require options markets to disseminate quotes with size. While the added market transparency afforded by quotes with size would certainly be desirable to all market participants, we do not believe it is a necessary component of a linkage plan. The submitted plans have been tailored for an environment where quote size is not disseminated, relying instead on minimum quote guarantees. We also seriously question whether the existing options quote traffic systems will be able to handle quotes with size in the near future. Therefore, requiring quotes with size could greatly delay implementation of the linkage plan. We don't think that makes sense. If quotes with size become available, we recommend revisiting the plan to see if modifications are warranted.

This concludes our comments. We expect that the Commission will provide the public with an opportunity to comment on any material amendment(s) made to the plans prior to approving such plans. We remain committed to the goal of swiftly achieving and implementing an options linkage plan and stand ready to assist the Commission and Exchanges in making that possible. If you have questions regarding our comments, please feel free to contact me at (312) 595-6725, or Scott Kursman, Assistant General Counsel, at (212) 618-0508.

Sincerely,

William C. McGowan
Chairman
S.I.A. Options Committee

cc: The Honorable Arthur Levitt, Chairman
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Laura S. Unger, Commissioner
The Honorable Paul R. Carey, Commissioner
Annette Nazareth, Director, Division of Market Regulation, SEC
Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC
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