International Securities Exchange

December 20, 2013

Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: File No. SR-PHLX-2013-113

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the Commission's order instituting proceedings to determine whether to approve or disapprove the above-referenced fee filing ("Filing") of NASDAQ OMX PHLX LLC ("Phlx").[1] The Filing attempts to increase the rebate Phlx pays for certain customer orders, doing so in an unprecedented manner. Rather than basing its tiered fee structure solely on the level of member trading in its own market, Phlx seeks to base its rebate on member options trading on three affiliated exchanges: the Phlx, the NASDAQ Options Market LLC ("NOM") and NASDAQ OMX BX ("BX").

The Filing does not meet the standards of the Securities Exchange Act of 1934 ("Act"). By basing its rebate on the trading volume on three affiliated exchanges, Phlx's proposed fee: is not an "equitable allocation of reasonable...fees"; does not "protect investors and the public interest"; permits "unfair discrimination"; and imposes "a burden on competition not necessary or appropriate" under the Act.[2] Nothing in the Filing provides a justification for the proposal under the Act. ISE therefore urges the Commission to disapprove this proposal.

The Phlx Proposal is Inconsistent with the Requirements of the Act

The Filing presents a straight-forward question with critical importance to the national market system: can exchanges that supposedly compete against each other cooperate to establish joint fees? We believe that the answer is a resounding "no." There is no precedent for this proposal, and we believe that finding otherwise would

[1] Securities Exchange Act Release No. 70940, November 25, 2013 (78 *F.R.* 71700, November 29, 2013) (the "Order"). The Commission previously published the Filing for comment in Securities Exchange Act Release No. 70866, November 13, 2013 (78 *F.R.* 69472, November 19, 2013) and ISE submitted a preliminary comment on the matter in a letter dated November 11, 2013, from Michael Simon, Secretary, ISE, to Elizabeth Murphy, Secretary, Commission.

[2] These are the relevant standards in Section 6(b) of the Act by which the Commission must judge rule changes proposed by national securities exchanges.

raise serious questions about the very foundation of the national market system and competition in the securities markets.

The Commission always has required a self-regulatory organization ("SRO") to justify its proposed rule changes, including their fees, by reference solely to that SRO's operation and governing documents. Ironically, Phlx itself forcefully makes this point in the Filing when it quotes the Commission as holding that "a proposed exchange rule must stand or fall based, among other things, on the interests off customers, issuers, broker-dealers, and other persons using the facilities of *that exchange.*"[3] The order that Phlx selectively quotes emphasizes that this is true even with affiliated exchanges. The entire quotation is as follows:

> Exchanges under common control clearly have incentives to avoid competing with each other. Each national securities exchange, however, is subject to a comprehensive regulatory structure that is designed to address anti-competitive practices. This regulatory structure limits the potential for related exchanges to act jointly in ways that would inappropriately inhibit competition by other exchanges and trading centers with each related exchange. Section 6 of the Exchange Act requires that the rules of a national securities exchange be designed to promote a free and open market. Moreover, it prohibits a national securities exchange from adopting rules that are designed to permit unfair discrimination among its customers or that would impose an unnecessary or inappropriate burden on competition. All of these requirements are applied at the level of the individual registered securities exchange, not at the group level of exchanges that are under common control. In particular, a proposed exchange rule must stand or fall based, among other things, on the interests of customers, issuers, broker-dealers, and other persons using the facilities of that exchange.

Applying this standard of review to the Filing, it is clear that the Filing fails to pass muster under the Act. Specifically, the Order identifies the three statutory standards the Commission will apply in examining the proposal,[4] and the Filing fails to meet all three of those standards: the Filing harms investors by resulting in unfair discrimination, a burden on competition and an inequitable allocation of fees.

The Proposal Results in Unfair Discrimination

The Phlx's rebate is based on a member's volume on only three of the 12 options exchanges. While this is clearly discriminatory against the nine exchanges excluded from the calculation, as well as their members, the legal question is whether this is "unfair discrimination." It is. Phlx attempts to support this discrimination by arguing that

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[3] Filing at text accompanying footnote 25. Emphasis added by Phlx in quoting the Commission. In that footnote, Phlx cites Securities Exchange Act Release No. 59039 (December 2, 2008), 73 *FR* 74770 (December 9, 2008) ("ArcaBook Order"), in which the Commission approved certain exchange market data fees.

[4] 78 *F.R.* at 71701-2.

"volume on NOM and BX Options benefits Phlx by contributing to the overall financial well-being of the exchange group of which Phlx is a part."[5] Yet that analysis is directly contrary to the Commission's ArcaBook Order framework, which the Phlx quotes to support its Filing. In that order the Commission recognized that exchanges under common control have incentives to avoid competition. The Commission addressed that concern by applying the statutory requirements on the level of the individual exchange, "not at the group level of exchanges that are under common control."

The Commission's requirement that exchanges compete at the individual level, and not at the group level, confirms the most fundamental aspect of the national market system: every exchange operates in a competitive environment, seeking to maximize the order flow on that exchange. Phlx attempts to counter that argument by arguing that different options exchanges seek to attract different type of order flow through the way in which they structure their markets and charge fees.[6] Thus, Phlx argues that market participants "fragment" their order flow among various exchanges and that this proposal permits these market participants to reduce their fees by sending all their order flow to these affiliated exchanges offering different market and fee structures.

Phlx's argument is contrary to the requirements of the Act. Since the Commission has held that the Act requires exchanges to compete at the individual level, Phlx unfairly discriminates by favoring members that route order flow to its affiliated exchanges rather than to other exchanges that also offer differing market and fee structures. Like any other exchange, Phlx can attempt to attract order flow through adjusting the market structure on the Phlx, as well as by adjusting its own fees. However, it cannot base its fees on factors related to other markets, including affiliated markets.

The Proposal is a Burden on Competition Prohibited by the Act

The bundling of fees by competing exchanges imposes an unreasonable burden on competition. A primary way in which exchanges compete against each other is via the fees they charge. An exchange with a single market structure and fee schedule cannot compete against fees that conglomerates of exchanges charge. Phlx summarily dismisses that argument by saying that exchanges always can compete by registering multiple exchanges and offering competing multi-exchange fees.

Having just registered a second exchange, ISE Gemini, we can attest to the fallacy of the Phlx's argument. An exchange can compete on fees simply by filing an effective-on-filing rule change. In contrast, to register an affiliated exchange takes years of drafting rules and related documents, filing with the Commission, awaiting publication and approval, joining multiple National Market System Plans and becoming a participant exchange of The Options Clearing Corporation. On top of these expenses are the costs of building the trading system and a regulatory program. Altogether, the overall costs of registering and beginning operations of an exchange runs into the multiple millions of dollars. It is disingenuous for the Phlx to argue that requiring an exchange to take these

[5] 78 *F.R.* at 69476, note 52.
[6] *Id* at 69478.

steps is anything but a "burden on competition that is not necessary or appropriate" in furtherance of the purposes of the Act.

The Proposal Results in an Inequitable Allocation of Fees

The Phlx must justify its fees solely with respect to the impact of those fees on its own members. Specifically, the Act requires that an exchange have "an equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities."[7] The Act's focus on "its" members and facilities underscores the ArcaBook analysis that the Commission must analyze an exchange's rules and fees on a stand-alone basis. Thus, Phlx's lengthy explanation that this fee is equitable because members may receive a "discount" by trading on affiliated exchanges is irrelevant to the Commission's consideration of the proposal.

The fee is not equitable on a stand-alone, exchange-specific basis. Phlx members who are not members of the affiliated exchanges will have no opportunity to reap the benefits of the fee discounts without incurring the additional costs of joining other exchanges. That is hardly equitable for either Phlx members or the members of the affiliated exchanges. By their very nature such cross-exchange fees cannot be an equitable allocation of fees for the members of just one of the exchanges.

The Proposal Fails to Protect Investors

For all the reasons discussed above, the proposal is harmful to investors. Generally, allowing separate exchanges to cooperate on fees lessens competition between those exchanges and harms investors. Indeed, by allowing an exchange to combine trading volume with competitors removes incentives for that exchange to broaden its offerings to attract more order flow, leading to greater Balkanization of the exchange community. The proposal also would create confusion for investors since the posted Phlx fee schedule would not fully explain the costs on trading on Phlx, which costs are dependent on trading that occurs on different, independent exchanges. While the Act certainly permits entities to own and operate more than one exchange, the Act does not permit them to operate cooperatively. Rather, the Act requires affiliated exchanges to act as full competitors in the national market system.

The Phlx Fails to Justify the Filing Under the Act

We have explained in detail why the Filing does not comply with the requirements of the Act and why the Commission should disapprove the proposal. Nothing the Phlx states in the 76 pages of the Filing leads to a contrary conclusion. Specifically, the Phlx attempts – and fails – to justify the proposal as follows:

- The ArcaBook Order fails to provide precedent for this proposal. It is surprising that the Phlx would attempt to support its Filing with precedent that expressly rejects analyzing fees on an exchange-complex basis. But, nevertheless, Phlx argues that the ArcaBook Order stands for the proposition that as long as exchanges are subject to competitive forces, any fee is acceptable. The ArcaBook Order says no such

[7] Section 19(b)(4) of the Act. Emphasis added.

thing. Rather, that order deals solely with the pricing of a monopoly or unique service, in that case the sale by one exchange of its own market data. Since only that one exchange can produce its own market data, there is no competition from competing exchanges for that specific data. When selling exclusive market data the Commission held that competition was a possible legal basis to support the market data fee. Phlx grossly distorts that ruling by stating that competition in and of itself justifies any exchange fee. Obviously, such a conclusion renders meaningless any review of exchange fees in a competitive marketplace, such as options execution services. Nothing in the ArcaBook Order supports the Phlx's proposed rebate.

- The antitrust "tying" arguments are irrelevant. Phlx argues that it is not proposing to illegally "tie" Phlx executions services to executions on NOM and BX. In basing fees on trading volume on multiple venues, Phlx argues that it will not be illegally tying services because there is no requirement that the "purchaser" buy any two products together. Furthermore, Phlx argues that tying is illegal only when it forecloses competition in the "tied" product. While we agree that there is no illegal tying in the Phlx proposal, we also see the argument as irrelevant: while illegally tying one service to another would be a basis to disapprove the Filing, a contrary finding does not provide a basis for approval. We believe that tying would be dispositive in this context only if there was a combination in the pricing of a competitive product and a monopoly product, such as an exclusively-listed product.[8] While that is not the case here, it certainly does not provide a basis for approving the Filing.

- The fee is not reasonable simply because it lowers costs. Phlx makes the general statement that the proposal passes statutory muster because it lowers fees. Indeed, Phlx goes so far as to state that "it is difficult to see how a fee decrease or rebate increase could in any set of circumstances cause fees to become unreasonable."[9] While we are generally wary of such broad overstatements, we simply reiterate that exchange fees that are tied to activity conducted on competing exchanges are impermissible, whether they increase or lower the overall fees that some joint exchange members may pay. In this case, because not all Phlx members are members of the affiliated exchanges, offering nominally lower fees that are not available to all exchange members is not reasonable.[10]

- The fee is not similar to other, Commission-approved exchange fees. The Filing cites as support for the multi-exchange fee the following accepted exchange fee structures: The NASDAQ Stock Market LLC ("Nasdaq") basing fees on combined equity and options volume; the options regulatory fee ("ORF") that a number of options exchanges charge; listing exchanges providing discounts on listing fees for companies moving from one listed exchange to an affiliated listed exchange; and exchanges treating specific products, such as options on the S&P 500 ETF ("SPY"), differently for volume and rebate purposes. Of these four fees, only the ORF is

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[8] We believe that such tying would be the basis to disapprove a fee filing even if one exchange, rather than affiliated exchanges, tied the pricing of a competitive product to a monopoly product.

[9] 78 *F.R.* at 69477.

[10] Of course, lower fees can also be unfairly discriminatory if they are not applied in a reasonable manner across an exchange's membership. As discussed above, offering this increased rebate based on volume executed on purportedly competing exchanges is unfairly discriminatory.

relevant. The Nasdaq equity and options fees and the SPY fees relate solely to the fees charged by one registered exchange and thus have no bearing on a proposal to base the fees of one exchange on the volume of trading on affiliated exchanges. The listing fee example is even more irrelevant since it has nothing to do with trading, let alone combining trading activity conducted on multiple exchanges.

With respect to the ORF, while a number of options exchange do impose that fee based on combined trading volume on all exchanges, the ORF structure is almost an exact opposite of the Phlx fee. Specifically, the ORF is a single-purpose fee by which some options exchanges recover a portion of their regulatory costs by imposing a fee on customer transactions effected on all options exchanges. The purpose of imposing a fee on transactions on all exchanges is to remove any incentive by members to avoid the fee by trading off that exchange. This is the opposite of the proposed Phlx fee, where the purpose of the cross-market fee is to encourage trading on the Phlx, the exchange collecting the fee. Moreover, the ORF is non-discriminatory since it applies to activity on all options exchanges, not just affiliated exchanges. The ORF has no bearing on the Phlx's proposal.

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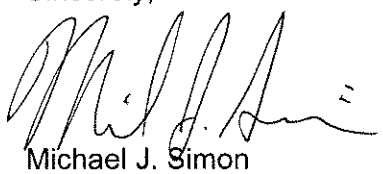
The Phlx is proposing an unprecedented fee structure that violates numerous requirements of the Act. The Phlx has not provided any legal support for this proposal, nor has it provided any precedent for such a fee. We thus respectfully ask the Commission to disapprove the proposal.

We again thank the Commission for the opportunity to comment on the Filing. If you have any questions on our comments, please do not hesitate to contact us.

Sincerely,



Michael J. Simon
Secretary

cc: John Ramsay, Acting Director, Division of Trading and Markets
James Burns, Deputy Director, Division of Trading and Markets
Heather Seidel, Associate Director, Division of Trading and Markets