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November 21,2003

**Via Facsimile & FedEx**

Kelly Riley, Esquire
Senior Special Counsel
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-1001

**Re: SR-Phlx-2003-66**

Dear Ms. Riley:

The Philadelphia Stock Exchange ("Phlx" or the "Exchange") submits the following response to the correspondence dated October 24,2003, submitted by the Pacific Exchange, Inc. ("PCX") and the correspondence dated November 10,2003 submitted by the International Securities Exchange, Inc. ("ISE") regarding the above-captioned proposed rule change.[1]

I. Introduction

On September 26,2003, the Exchange filed the above-captioned proposed rule change, which seeks approval for the listing and trading of cash-settled options (the "Options") on the Nasdaq Composite Index8 (the "Index"), a market capitalization-weighted, broad-based, a.m. settled, index composed of approximately 3,400 stocks listed and traded on The Nasdaq Stock Market, Inc.® ("Nasdaq"). The Exchange has entered into an exclusive license arrangement with Nasdaq for the listing and trading of the Options (the "Agreement"), which Agreement provides, among other things, that'the Exchange will be the exclusive marketplace for the Options. This Agreement also provides that Nasdaq will be compensated for these exclusive rights.

II. The Exchange's Proposal does not Impose a Burden on Competition

Both PCX and ISE suggest that Nasdaq's decision to license the Options exclusively to the Exchange may impose a burden on competition not necessary in furtherance of the purposes of the Securities Exchange Act of 1934 (the "Act"). **As**

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[1] See letters from Kathryn L. Beck, Esq., Pacific Exchange, Inc. to Margaret H. McFarland, Deputy Secretary, U.S. Securities and Exchange Commission ("SEC"), dated October 24, 2003 and from Michael J. Simon, Esq., International Securities Exchange, Inc. to Jonathan G. Katz, Secretary, SEC, dated November 10, 2003.

discussed below, the Agreement between the Exchange and Nasdaq does not impose any burden on competition.[2]

Index sponsors compete vigorously to develop indices that will provide alternative investment opportunities and attract the patronage of the investing public. The opportunity to capture a profit spurs the investment of time, money and effort in creating proprietary indices such as the Nasdaq Composite Index. In designing new indices, the index sponsors create intellectual property in the form of, among other things, index composition, trademarks and service marks, and trade secrets. The underlying policy of both intellectual property and competition laws is to create incentives for innovation by allowing innovators to reap the profits generated by their inventions.

Index sponsors often employ exclusive licensing of their intellectual property as a means to recoup their developmental costs, which are often extensive, and to best exploit the value of their innovations. The Commission has approved a large number of index options which trade on an exclusive basis; many of these options involve exclusive licenses from index sponsors.[3] In approving the listing and trading of these exclusive index options, the Commission has found that such arrangements do not impose an undue burden on competition.[4] The Commission has also taken explicit steps to preserve intellectual property-based incentives to innovate in the context of index-based options.[5]

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[2] The ISE also asserts that exclusive license arrangements may create "order routing biases" among order flow providers that would send orders in other products to Phlx merely because Phlx is the exclusive venue for the Options. While this is essentially an issue for order flow providers and not Phlx, Phlx contends that it should not be precluded from competing for order flow in permissible ways, such as by offering an array of superior products.

[3] See, e.g., Securities Exchange Act Release No. 48591 (October 2, 2003), 68 FR 58728 (October 10,2003) (SR-CBOE-2003-17) (Order approving the exclusive listing and trading of options on certain Russell Indexes); Securities Exchange Act Release No. 47393 (February 24, 2003), 68 FR 10287 (March 4, 2003) (SR-CBOE-2002-40) (Order approving **the** exclusive listing and trading of options on the CBOE Asian 25 Index and CBOE Euro 25 Index); Securities Exchange Act Release No. 48681 (October 22, 2003), 68 FR 62337 (November 3,2003) (SR-CBOE-2003-14) (Order approving the exclusive listing and trading of options on a Reduced Value NYSE Composite Index); Release No. 39092 (September 18, 1997), 62 **FR** 50412 (September 25, 1997) (SR-CBOE-1997-44) (Order regarding exclusive trading of options on the Dow Jones Industrial Average); Release No. 37815 (October 11, 1996), 61 FR 54693 (October 21, 1996) (SR-CBOE-1996-61) (Order regarding exclusive trading of options on the Standard & Poors 100 index) . See also Phlx/KBW Bank Index, KBW Insurance Index, Phlx Housing Sector[SM], SIG Investment Managers Index[SM], and TheStreet.com Internet Sector.

[4] See 15 U.S.C. sec. 77c(f) (In reviewing a rule of a self-regulatory organization, the Commission is required to consider, among other things, whether the action will promote efficiency, ***competition,*** and capital formation.)

[5] See In the Matter of Certain Options Exchanges, Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Securities Exchange Act Release No. 43268 (September 11, 2000) ("Order"). In this proceeding, where, among other things, the Commission considered the multiple listing of options on the several options exchanges, the Commission explicitly carved-out exclusive licensing arrangements from exchange conduct deemed anti-competitive. In Section IV.B.k of the Order, the Commission required the options exchanges to adopt the following undertaking:

One commentator, recognizing the importance of exclusive licensing in promoting innovation, has stated that:

> Index providers invest significant time, personnel, capital and other resources to develop products that they hope will meet a need within the investment community and thereby become a successful product. In some cases, these products are highly successful and become of enormous benefit to investors on a long-term basis. However, most products fail to generate a reasonable return for the index provider. Even a product that fills a vital role for investors will often lose favor and not sustain its profitability for the index provider over the long term, since the "hot" sector is traditionally a fast moving and ever changing target. The unfortunate fact for index providers is that the development and maintenance costs for its products are continuous, while trading often is not. Consequently, to account for the expense of being in the business of creating and maintaining such products, index providers obtain trademark or service mark registrations of their indices and seek to license their indices in a manner designed to enhance the return on the successful investment products that they develop. In the case of license arrangements involving option exchanges, index providers have most often determined that a reasonable return on their investment is jeopardized by market fragmentation. This has led to the practice of granting one options exchange the exclusive right with respect to options based on the index.[6]

PCX and ISE's opposition to the Agreement finds no support from the antitrust laws. The competition analysis begins with the broad principle that vertical exclusive dealing arrangements such as intellectual property licenses are lawful unless they "foreclose competition in a substantial share of the line of commerce affected."' Because the Agreement cannot foreclose a substantial share of the robust market for index products, the antitrust laws do not support PCX and ISE's opposition. In addition, the antitrust laws recognize that intellectual property regimes confer upon the property holder

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> The rule changes adopted pursuant to these undertakings [i.e., rules to make the options markets more competitive] shall not preclude a respondent exchange from exercising or enforcing an intellectual property right in an option, or a license of an intellectual property right in an option, if another exchange proposes to list or has listed the option and such respondent exchange has a good faith belief that the intellectual property right or license thereof exists and the action taken is consistent with the federal securities laws and the Commission's rules, regulations and orders.

Based on this express undertaking it is clear that the Commission recognizes that exchanges may have exclusive rights in an option under certain circumstances. Those circumstances allow exclusivity where an options exchange has intellectual property rights in an option. This undertaking goes on to exclude from the operation of the order a "license of an intellectual property right in an option," such as is present in the Agreement.

[6] Letter from SIG Indices, LLLP to Jonathan G. Katz, Secretary, SEC, dated June 30, 2003 re: Rule-Making Petition on Index Options by the International Securities Exchange, Inc. (File No. 4-469).

[7] Tamua Electric Co. v. Nashville Co., 365 U.S. 320, 327 (1961).

the right to exclude all others.[8] Given the intellectual property holder's right to exclude ail, the holder's decision *to* exclude all but one does not, as such, violate the antitrust laws.[9] This conclusion finds further support from guidelines issued by the federal antitrust enforcement agencies, which state that "[g]enerally, an exclusive license may raise antitrust concerns only if the licensees themselves, or the licensor and its licensees, are in a horizontal relationship."[10] For present purposes, Nasdaq and the Exchange are not in a horizontal relationship – they are not competitors.

Exclusive licensing arrangements do not hamper consumer access to index options. Phlx's options business consists of firms that represent virtually all of the U.S. retail and institutional options order flow and includes a variety of mechanisms designed to enhance access to its products (as it has every incentive to do so).

Phlx index options compete with other index options. The Agreement will do nothing to inhibit that competition but is part of the robustly competitive market for index options. Indeed, index options compete with other investment products such as equity options and options on exchange traded funds. The Commission should review any comments relating to the exclusive license in light of the many similar investment products, such as such as the Nasdaq-100 Index Tracking Stock®,[11] Nasdaq-100 Index Tracking Stock® Options,[12] and Fidelity Nasdaq Composite Index Tracking Stock® that compete with the Options. The existence of these similar competing products should put to rest the notion that Nasdaq's exclusive license to Phlx imposes a burden on competition. Rather the exclusive license, which maximizes Phlx's incentive to promote the product, will enhance competition.

In any event, the Commission has approved many, many index options, both subject to exclusive licensing arrangements as well proprietary exclusively-listed

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[8] SCM Corp. v. Xerox Corp., 645 F.2d 1195, 1204 (2d Cir. 1981), cert. denied, 455 U.S. 1016 (1982). See also Rite-Hite Corp. v. Kelley Co., 56 F.3d 1538, 1547 (Fed. Cir.) (en banc), cert. denied, 116 S. Ct. 184 (1995); Dawson Chemical Co. v. Rohm & Haas Co., 448 U.S. 176, 215 (1980) ("the right to exclude others from profiting by the patented invention" is "the essence" of the patent grant); Zenith Radio Corp., v. Hazeltine Research Inc., 395 U.S. 100, 135 (1969) (right to exclude others from using invention is at "[t]he heart" of the patent grant); United States v. Studiengesellschaft Kohle, m.b.H., 670 F.2d 1122, 1127 (D.C. Cir. 1981) (the "essential right" of the patent owner is "to exclude all others from profiting from the patented invention"); W.L. Gore & Assoc. v. Carlisle Corp., 529 F.2d 614, 623 (3rd Cir. 1976) (the "right to refuse to license is the essence of the patent holder's right").

[9] ABA Section of Antitrust Law, Antitrust Law Developments (5th ed. 2002) at 1055.

[10] Department of Justice and Federal Trade Commission, Guidelines for the Licensing of Intellectual Property, 6 Trade Reg. Rep. (CCH) ¶ 13,132 (April 6, 1995) ¶ 4.1.2 ("IP Guidelines"). Furthermore, Nasdaq and Phlx have limited the term of exclusivity *to* three years, preserving Phlx's incentives to promote and facilitate the sale of the Options while allowing Nasdaq *to* seek other promoters of its intellectual property should Phlx's performance fail to meet expectations.

[11] Nasdaq®, Nasdaq-100® and Nasdaq-100 Index Tracking Stock® are registered trademarks of The Nasdaq Stock Market, Inc. and are licensed for use by the Phlx.

[12] The Nasdaq-100 Index Tracking Stock® ("QQQ")options and the Nasdaq Composite Index options are very similar products because the performance of the QQQ index correlates approximately 90-95 % with the performance of the Nasdaq Composite Index.

products, without finding that such products impose a burden on competition and without questioning the exchange's statement that such product imposes no such burden. Although we understand the PCX's and ISE's petition and other letters criticizing exclusive index options, *we strongly believe that is a policy question, not to be decided or uddressed in the context of one exchange's proposed rule change*. In October, another exchange received approval for an exclusively listed index option product. One month later, the Phlx is stymied in its product development efforts. We find that patently unfair.

III. The Agreement between the Exchange and Nasdaq does not Present **a** Conflict of Interest for the Exchange

In its comment letter, PCX claims that, assuming certain facts are true, the Agreement creates a conflict of interest between the Exchange's regulatory obligations and its financial interests. PCX asserts that the Agreement may include performance standards under which Phlx would suffer financial penalties if it fails to reach certain volume thresholds. If such provisions in fact exist, PCX argues, this would create a conflict between the Exchange's financial interests and its obligations to fairly and objectively monitor trading in this product in its market.

The Agreement between Phlx and Nasdaq does not present the conflict of interest complained of by PCX. Regardless of the amount of the fees paid by the Exchange to Nasdaq for the exclusive right to trade the Options, the Phlx intends to pass these fees on to the specialist to whom the Options have been allocated.[13] Because the licensing fee is passed on to the specialist, Phlx does not experience a financial "penalty" of any kind from disappointing performance in a licensed product. Stated differently, Phlx expects to recoup the entire license fee paid to Nasdaq from its specialist, irrespective of the trading activity in the Options.

The structure of the Agreement further eliminates any conflict of interest between Phlx's regulatory and financial obligations. The Agreement provides that Phlx will compensate Nasdaq at the greater of a fixed annual fee or a variable per-contract fee. This establishes an annual floor at or above which Nasdaq is to be compensated by Phlx. In response to PCX's argument, the Agreement does not provide that Phlx would suffer financial penalties if it fails to reach certain volume thresholds.

By way of example, during the first year of the Agreement Phlx is obliged to pay Nasdaq the greater of a fixed fee or a variable fee that is based on a per contract rate. Phlx is not penalized for failing to attain a particular volume level and in any event will pay no less than the fixed fee to Nasdaq, renardless of the number of Option contracts traded by the specialist in the Options during this year. No conflict of interest exists because, under this arrangement, Phlx is not incentivized to artificially inflate volumes.

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[13] See Phlx Rule 511(b)(ii) (The Allocation Committee may condition the allocation of an options book on the specialist's undertaking to pay the Exchange and/or any third party any amounts related to the licensing of the product or any amounts related to the use of intellectual property).

Moreover, even if the Exchange were not passing the fee on to the specialist and even if the volume of Options traded were modest, the license fees under the Agreement are not so high that Phlx could not recoup them through other sources, such as transaction fees. Based on our calculations, the annual number of Option contracts that would need to be traded in order for Phlx to "break even" is roughly equivalent to that of Phlx's more popular sector index options, such as the Phlx Oil Service Sector[SM] or the Phlx Gold/Silver Sector". Even if this level of revenue were not achieved, it is outrageous and absurd to assert or imply that the Phlx would abandon its regulatory responsibilities to pump up the volume in the Options to avoid a deficit.

In sum, the perceived conflict of interest raised by PCX is not present in the exclusive licensing arrangement between the Exchange and Nasdaq. Consequently, Phlx sees no reason to change the way it regulates its options marketplace as a result of the Agreement.

IV. Conclusion

For the reasons set forth above, there is no basis to conclude that SR-Phlx-2003-66 will create an unnecessary burden on competition or an unsustainable conflict of interest. Accordingly, the Phlx's proposal is consistent with the Act, and should be approved promptly.

Very truly yours,

Mark I. Salvacion
Director and Counsel

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Jonathan G. Katz, Secretary
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Elizabeth King, Associate Director, Division of Market Regulation
Yvonne Fraticelli, Special Counsel, Division of Market Regulation
George Baranko, U.S. Department of Justice