January 18, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. SR-Phlx-2004-91
Comments From the International Securities Exchange, Inc. ("ISE")

Dear Mr. Katz:

The Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") welcomes the opportunity to respond to the ISE's comments to the Securities and Exchange Commission ("Commission") on the above-referenced filing, in which the ISE opposes the Exchange's proposal to establish a new trade allocation algorithm for Directed Orders sent to the Exchange that are electronically executed and allocated on the Exchange's electronic trading platform for options, Phlx XL.[1] As described below, the Exchange believes that that SR-Phlx-2004-91 (the "proposal") complies with the requirements for approval of a self-regulatory organization ("SRO") proposed rule change, as set forth in the Securities Exchange Act of 1934 ("Exchange Act").[2]

As described below, the Exchange believes that the proposal is appropriate and is in furtherance of the purposes of the Exchange Act by fostering a market structure that enables Exchange Directed Specialists, Streaming Quote Traders ("SQTs") and Remote Streaming Quote Traders ("RSQTs") (collectively, "Phlx directed participants") to compete not only on the basis of their relationships with order flow providers, but also the basis of price and the level of liquidity they provide on the Exchange. Accordingly, the proposal is consistent with Section 6(b)(8) of the Exchange Act.[3] In addition, the Exchange believes that, by systematically rewarding Phlx directed participants in trade allocations based on quotations priced at the National Best Bid or Offer ("NBBO"), the proposal is consistent with Section 6(b)(5) of the Exchange Act.[4] The proposal also encourages competitive quoting among non-directed Phlx participants, in that it provides an allocation algorithm for the majority of contracts in each Directed Order that would apply to non-directed Phlx market participants. Therefore, the Exchange respectfully submits that, notwithstanding the ISE's comments, the proposal is consistent with the Exchange Act and should be approved by the Commission.

---

[1] *See* letter from Michael J. Simon, General Counsel and Secretary, ISE, to Jonathan G. Katz, Secretary, Commission, dated January 13, 2005 (the "ISE Letter").

[2] 15 U.S.C 78a et seq.

[3] 15 U.S.C. 78f(b)(8).

[4] 15 U.S.C. 78f(b)(5).

The trade allocation algorithm contained in the proposal would reward Phlx directed participants based not only on their status as a directed participant, but also on the basis of price and liquidity. The ISE Letter asserts that "the proposal would provide greater allocation entitlements to a Phlx directed specialist, RSQT or SQT based *solely* on its status" as a directed participant (emphasis added). This is an inaccurate assertion. The proposal makes it clear that in order to qualify for the allocation entitlement described therein, **a Phlx directed participant would be required to be quoting at the NBBO at the time a directed order is received.** If the directed participant is not quoting at the NBBO at the time the directed order is received, there would be no allocation entitlement to the directed participant, and contracts would be allocated among Exchange participants on parity in accordance with the trade allocation rules applicable to transactions involving non-directed orders on Phlx XL.[5] Thus, the proposal does, in fact, reward participants for quoting at the best price, and considers best execution.

The ISE states that it believes that any guarantee contained in a trade allocation algorithm should reward market making firms for the obligations they provide to the market. Currently, specialists trading options on Phlx XL are required to quote continuous, two-sided markets in 100% of the series in all options in which they are assigned, while SQTs and RSQTs are required to make continuous, two-sided markets in 60% of their series in all options in which they are assigned. **In its proposal to adopt rules applicable to RSQTs,[6] the Exchange proposed rules that would require Directed SQTs and RSQTs to submit continuous, two-sided quotations in 100% of the series in all options in which they receive directed orders**. The Exchange believes that this additional obligation imposed on Directed SQTs and RSQTs, when combined with the obligation to quote at the NBBO in order to receive the proposed guarantee, constitutes a rational basis for the proposed allocation guarantee that extends beyond mere status as a Phlx directed participant. Thus, the proposal is tied to additional market making obligations (assuming this is required).

The proposed trade allocation algorithm would also reward Phlx directed participants for providing liquidity in the Phlx markets by allocating contracts based in part on their pro rata portion of the total number of contracts included in the Phlx disseminated market. Liquidity is encouraged because quoting with size is rewarded. The Exchange thus believes that the proposal does not reward Phlx directed participants solely based on their relationships with order flow providers, and the minimum guarantees to Phlx directed participants is not solely "status-based" as described in the ISE Letter.

The ISE Letter argues that the proposal "would have a significant negative impact on price competition." On the contrary, the requirement a Phlx directed participant must be quoting at the NBBO in order to qualify for the guarantee encourages Phlx directed

---

[5] *See* Exchange Rule 1014(g)(vii).

[6] *See* SR-Phlx-2004-90.

participants to submit quotations at the best price nationally, and the pro rata portion of the proposed allocation algorithm should encourage them to submit such quotations with larger size, thus promoting the best price on the Exchange and adding liquidity to the Exchange's markets.

The ISE Letter further asserts that the proposal is inconsistent with the standards and policies the Commission has applied to facilitation rules. The proposal does not, however, include rules that would apply to a "facilitation mechanism" similar to the one that is in place on the ISE.[7] On the contrary, the proposal simply includes an allocation algorithm that is distinguished from the standard allocation algorithm applicable to transactions on Phlx XL, and that is designed to provide a participation guarantee for Phlx directed participants that meet minimum standards based on price, the size of their quotation, their minimum quoting requirement, and their ability to enhance the Exchange's overall business by adding order flow to the Exchange.

Moreover, in addition to the above-mentioned guarantee that would apply to Phlx directed participants, the trade allocation algorithm contained in the proposal would also enhance the opportunities for trading in options for non-directed participants on Phlx XL. Directed orders would be allocated among all Phlx XL participants on parity, not solely to Phlx XL directed participants. Therefore, directed orders sent to the Exchange by order flow providers should give all Phlx participants more opportunities to trade against order flow brought to the Exchange, and should encourage all Phlx participants to quote at or better than the NBBO. In this regard, the proposal should encourage price competition both intra-Phlx and among the exchanges, which is wholly consistent with auction-market principles. Thus, the Exchange believes that, consistent with the Exchange Act, the proposal is designed to perfect the mechanism of a free and open market and the national market system.

We appreciate the Commission's consideration of our response to the ISE Letter. Please direct any questions regarding the matters discussed above to Richard S. Rudolph, Director and Counsel, Phlx, at (215) 496-5074.

Respectfully submitted,

Richard S. Rudolph
Director and Counsel

cc: Annette L Nazareth
Robert L.D. Colby
Elizabeth King
John Roeser

---

[7] *See* ISE Rule 717.