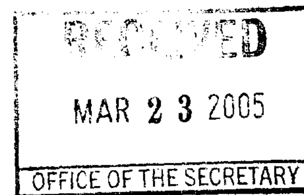


PHILIP D. DEFEO
CHAIRMAN
CHIEF EXECUTIVE OFFICER

**VIA FACSIMILE and OVERNIGHT DELIVERY**

March 22, 2005

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Mr. Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

**Re: File No. SR-PHLX-2004-91**

Dear Mr. Katz:

The Pacific Exchange, Inc. (PCX) welcomes this opportunity to comment on the Philadelphia Stock Exchange's (PHLX) proposal to allow certain options orders to be directed to a designated Specialist, Streaming Quote Trader (SQT) or remote Streaming Quote Trader (RSQT) for execution via the exchange's electronic trading platform.

The PCX believes the PHLX proposal does nothing to enhance the environment that the SEC and the options industry foster and promote. If anything, the PHLX proposal directly contradicts the long-standing belief that market participants should be awarded their allocations based on the quality of their markets and the liquidity they provide to the investing community – not simply based on special arrangements they have with certain order flow providers.

The PHLX, like all other national options exchanges, presently allocates orders based on a formula that takes into consideration both the price and size of the market participants' disseminated market. Most exchanges also award some level of guaranteed participation to the registered specialist (or, as the case may be, a Designated Primary Market Maker, Lead Market Maker or Primary Market Maker). These guarantees are established based on the obligations that each specialist must fulfill on his respective exchange. These obligations include certain minimum standards, such as guaranteed quoting and full time market participation, which exceed, not only match, the obligations required of other market participants. The PCX feels that rewarding a particular market participant with additional allocation, based on nothing more than a business agreement with a particular firm, would not be in keeping with the pro-competition, pro-liquidity approach the Commission has previously approved.

Based on increased competition within the options market, the investing public has benefited from tighter spreads, deeper liquidity and lower commissions. One could argue that almost every significant improvement in the options markets has been a result of competition between participants in the effort to attract additional order flow and increase an individual's or firm's share in the allocation process. If a directed order proposal is approved, the likely result would be that market making firms will shift their focus from competitive pricing for customer orders to competitive pricing for a broker's business.

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No longer will the best interests of the customer be in the forefront, when brokers make the decision as to where a customer's order will be routed for execution. Awarding a particular specialist or market maker additional participation guarantees, simply due to a relationship with a particular firm, is reversing the competitive policies the Commission has established on allocation entitlements.

The PHLX proposal offers absolutely no benefit to the public customer. Its only purpose is to increase order flow to a certain marketplace and chosen firms, through a payment for order flow plan that can only be viewed as detrimental to the investing community. While directed orders can be beneficial to the customer, as in the case of the price improvement mechanism available at certain exchanges, the PHLX plan offers no such opportunity for improving the execution price of an order. Without the opportunity to expose these directed orders to other market participants for potential price improvement, the customer effectively waives his right to the chance of obtaining the absolute best price available. If anything, a market participant, who has a guaranteed allocation simply based on establishing a relationship with an order flow provider, would be less inclined to price improve, knowing that his share of the trade allocation was secure, as long as his market was at least equal to, not better than, the existing market.

Nowhere within the PHLX proposal does it state how long a preferred specialist needs to be quoting at the BBO. Could a specialist or market maker actually be quoting a wider market, and then, upon notification that a directed order was being sent in, change his quote to match the BBO? If so, he could then execute the trade, getting his guaranteed allocation, and subsequently automatically fade to his previously inferior quote. This type of behavior could unfairly advantage a specialist by rewarding him with a guaranteed allocation, while not actually providing a competitive quote for anyone other than his preferred order flow provider. This practice could also provide an opportunity to take advantage of the exchange's pro-rata allocation process between competitive Specialists, SQT's and RSQT's. A sudden increase in the size of a specialist's quote could effectively game the system and provide an unfair percentage of the trade to the preferred specialist or market maker, based on a split-second quote and size. The PHLX states that directed orders sent to the Exchange by order flow providers give all participants the chance at trading against these orders. If a preferred specialist is able to garner such a large percentage of a trade, through a combination of "smart" quoting and preferential treatment, there may actually be less opportunity for other participants to interact with these orders. There are no safeguards built in to create the information barrier needed to prevent this type of abuse.

While, historically, every effort has been made to provide customers with the best execution possible, the PHLX is proposing a mechanism that could actually prevent a customer order from market exposure and a potentially better price simply to advantage certain order flow providers and market making firms. The only logical reasons a brokerage firm would direct an order to one particular market maker over another is either an affiliation with the preferred market maker or the receipt of some sort of financial consideration in return for directing the order.

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These practices, which amount to nothing more than internalization and payment for order flow, serve only to benefit the related entities at the possible expense of the public investor. The PCX or, for that matter, any exchange should not endorse such a practice.

This proposal will also disadvantage market making firms that do not have established relationships with certain order flow providers. Without the ability to compete based on the quality of their markets alone, these firms could be driven from the markets altogether. Reduced competition, leading to reduced liquidity and wider markets, can only serve to offer the customer a product inferior to what is now available. Those firms that do continue in the market making business will be caught up in a bidding war against other firms, in order to establish relationships with key order flow providers. This practice would be beneficial only to the broker receiving payment and the market making concern that receives the directed order. The customer would receive nothing in return and may be disadvantaged, if bid/ask spreads artificially widen as firms attempt to cover increased operating costs. America's options exchanges should be making every effort to provide facilities where competition thrives and, thereby, creates a better market for all investors – not proposing rules that potentially limit competition and negatively impact these same investors.

The PCX believes the SEC should not consider the PHLX's or any other exchange's proposal to introduce new policies on order allocation, unless they contain provisions that either foster competition, lead to better quality markets, or establish certain market obligations that may warrant an additional guaranteed allocation. If SR-PHLX-2004-91 is adopted, the options industry will be taking a giant step backwards. Competitive pricing, as we now know it, could be jeopardized, and the substantial benefits enjoyed by the public customer over the past five years could be seriously threatened. The integrity of the industry and the quality of the options market will suffer if non-competitive-based preference policies are adopted as a course of business.

Therefore, the PCX strongly urges the Commission to reject the PHLX new allocation preferencing proposal, SR-PHLX-2004-91.

Sincerely,

Philip D. DeFeo
Chairman and Chief Executive Officer

PDD/GG:cy

cc: Annette Nazareth, (SEC) Director, Division of Market Regulation
Elizabeth King, (SEC) Associate Director, Division of Market Regulation
John Roeser, (SEC) Assistant Director, Division of Market Regulation