

Philadelphia Stock Exchange

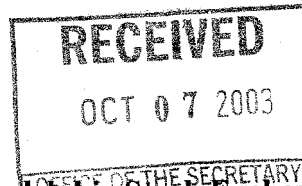
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October 6, 2003

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Jonathan G. Ratz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549



Re: Proposed Rule Change by the Philadelphia Stock Exchange to Delete the Prohibition Against the Delivery of Electronically Generated Orders Via AUTOM, File No. SR-Phlx-2003-37

Dear Mr. Katz:

The Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) welcomes the opportunity to offer our response to the comments made to the Securities and Exchange Commission (“Commission”) by the Susquehanna International Group LLP (“SIG”) concerning the above-referenced proposed rule change.’

Background

In September, 2000, the Exchange adopted Rule 1080(i), a requirement that Exchange members may not enter, nor permit or facilitate the entry of, orders into AUTOM² if those orders are created and communicated electronically without manual input.³ In that filing, the Exchange stated that allowing electronically generated and communicated customer orders to be routed directly to the Phlx Automated Options Market (AUTOM) and Automatic Execution System (AUTO-X) would give customers with such electronic systems a significant advantage over Phlx specialists and Registered Options Traders (“ROTs”). The Exchange believed at the time that this could undercut its business model, which is dependent on specialists and ROTs for competition and liquidity.

Since the time the Exchange adopted Rule 1080(i), the options industry has undergone numerous changes, for example, the emergence of the solely electronic

¹ See letter from Gerald D. O’Connell, Director of Compliance, SIG, to Jonathan G. Katz, Secretary, Commission, dated July 9, 2003 (the “SIG Letter”).

² AUTOM is the Exchange’s electronic order delivery, routing, execution and reporting system, which provides for the automatic entry and routing of equity option and index option orders to the Exchange trading floor. Orders delivered through AUTOM may be executed manually, or certain orders are eligible for AUTOM’s automatic execution feature, AUTO-X. Equity option and index option specialists are required by the Exchange to participate in AUTOM and its features and enhancements. Option orders entered by Exchange members into AUTOM are routed to the appropriate specialist unit on the Exchange trading floor. See Exchange Rule 1080.

³ See Securities Exchange Act Release No. 43376 (September 28, 2000), 65 FR 59488 (October 5, 2000) (SR-Phlx-2000-79).

International Securities Exchange, Inc. (“ISE”) as a competitor of traditional floor-based exchanges; the extension of the SEC Quote Rule to include quotations in listed options; and the anticipated launch of a new entrant in the options markets, the Boston Options Exchange (“BOX”).

In response to the numerous competitive and regulatory changes over the past three years since the adoption of Rule 1080(i), the Exchange has modified its AUTOM and AUTO-X system in several significant respects. For example, in September and October, 2002, the Exchange enhanced its Auto-Quote⁴ system to enable the Exchange to disseminate a firm quotation size of at least the sum of limit orders at the Exchange’s disseminated price,⁵ as opposed to an artificial AUTO-X-based guaranteed size. The Exchange has also expanded the eligible order types⁶ and delivery sizes⁷ eligible for AUTOM delivery and automatic execution via AUTO-X. Additionally, the Exchange has developed and deployed new electronic technology that provides for the automatic execution of eligible inbound customer and off-floor broker-dealer limit orders against booked customer limit orders at the Exchange’s disseminated price (called “Book Match”), and a new component of AUTOM, “Book Sweep,” designed to automatically execute limit orders on the book when the Exchange’s electronic options pricing system, Auto-Quote, or a specialist’s quote sent to the Exchange via specialized quote feed (“SQF”), locks (*i.e.*, 2 bid, 2 offer) or crosses (*i.e.*, 2.10 bid, 2 offer) a limit order on the book.

As a result of the foregoing, and as a competitive initiative, the Exchange has proposed to delete Rule 1080(i) to allow Exchange members to submit electronically generated orders. The Exchange’s proposal was published in the *Federal Register* for

⁴ Auto-Quote is the Exchange’s electronic options pricing system, which enables specialists to automatically monitor and instantly update quotations. Specialists may submit their own quotations by establishing a specialized connection by-passing the Exchange’s Auto-Quote system, which is known as a Specialized Quote Feed (“SQF”).

⁵ See Securities Exchange Act Release No. 46325 (August 8, 2002), 67 FR 53376 (August 15, 2002), (SR-Phlx-2002-15).

⁶ In April, 2002, the Commission approved an Exchange proposal to allow orders for the account(s) of broker-dealers to be delivered via AUTOM, and to be eligible for automatic execution via AUTO-X. See Securities Exchange Act Release No. 45758 (April 15, 2002), 67 FR 19610 (April 22, 2002) (SR-Phlx-2001-40). The Exchange then adopted rules providing for automatic executions for eligible orders at the Exchange’s disseminated size, subject to a minimum and maximum eligible size range to be determined by the specialist, on an issue-by-issue basis. See Securities Exchange Act Release No. 46886 (November 22, 2002), 67 FR 72015 (December 3, 2002) (SR-Phlx-2002-39). Most recently, the Exchange adopted rules providing an equal firm quotation size and equal AUTO-x guaranteed size for both customer and broker-dealer orders. See Securities Exchange Act Release No. 47646 (April 8, 2003), 68 FR 17976 (April 14, 2003) (SR-Phlx-2003-18).

⁷ In March, 2003, the Exchange adopted rules to increase the eligible AUTOM order delivery size for off-floor broker dealer orders from 200 contracts to 1,000 contracts for all options. At the same time, the Exchange determined to allow the delivery Immediate or Cancel orders via AUTOM. See Securities Exchange Act Release No. 47543 (March 20, 2003), 68 FR 14737 (March 26, 2003) (SR-Phlx-2003-11).

public comment in June, 2003,⁸ resulting in the receipt of two comment letters, the SIG Letter, and a letter in support of the Exchange's proposal from The Interactive Brokers Group LLC ("IB").⁹

The Exchange believes that its proposal is consistent with the Securities Exchange Act of 1934, as amended, (the "Act"), as discussed more fully in the proposed rule change.

The SIG Letter

The SIG Letter does not even attempt to make a legal or policy argument in favor of its position. Instead, the overriding focus of the SIG Letter is an assertion that electronic orders would be used by off-floor traders to take advantage of momentary errors or stale quotes generated by automated quoting systems, thus placing market makers and specialists at risk.

As stated in the proposed rule change, based on the significant changes to the Exchange's AUTOM System since the time the Exchange adopted Rule 1080(i), the Exchange believes that it has developed systems that have narrowed the gap with respect to any actual or perceived advantage an off-floor customer or broker-dealer could have over a specialist or ROT in sending electronically generated orders to the Exchange via AUTOM. The Exchange will continue to surveil for, and enforce, compliance with other rules that help specialists and ROTs in managing their risk while making markets on the Exchange.¹⁰

Accordingly, the Exchange is proposing to delete the prohibition against the delivery of electronically generated orders via AUTOM in order to attract additional order flow. The Exchange expects to monitor the effects of the deletion of this prohibition in order to readily ascertain its effects on the risk management activities of on-floor members and member organizations. In the event that the Exchange determines that such effects are detrimental to the risk management activities of on-floor members and member organizations, the Exchange expects to take appropriate action, including the filing of appropriate rules and/or systems changes, in order to address such a situation.

⁸ See Securities Exchange Act Release No. 47977 (June 4, 2003), 68 FR 35049 (June 11, 2003) SR-Phlx-2003-37).

⁹ See letter from David M. Battan, Vice President and General Counsel, IB, to Jonathan G. Katz, Secretary, Commission, dated July 22, 2003 (the "IB Letter").

¹⁰ For example, the Exchange will continue to surveil for, and enforce, compliance with Exchange Rule 1080(c)(ii), which sets forth the obligations of an Exchange order Entry Firm, defined as a member organization of the Exchange that is able to route orders to AUTOM, and a User, defined as any person or firm that obtains access to AUTO-X through an Order Entry Firm. Specifically, the rule requires Order Entry Firms to comply with all applicable Exchange options trading rules and procedures; provide written notice to all Users regarding the proper use of AUTO-X; and neither enter nor permit the entry of multiple orders in call options and/or put options in the same option issue within any 15-second period for an account or accounts of the same beneficial owner.

The Exchange believes that allowing the delivery of electronically generated orders in an increasingly competitive marketplace, given the Exchange's technological advances since the time Rule 1080(i) was adopted, together with continued surveillance and enforcement of compliance with rules concerning AUTOM Order Entry Firms and Users, should enable the Exchange to compete for an additional type of order flow.

Given the intense competition for order flow among options exchanges and the advent of purely electronic systems, coupled with the impending entry of new electronic options market participants, the Exchange believes that its proposal to eliminate the prohibition against the entry of electronically generated orders is a valid competitive initiative that addresses both present and anticipated future technological advances in the options marketplace.

* * *

The Exchange's proposal is intended as a competitive measure to capture order flow that appears certain to become more, not less, prevalent in the options markets, and is consistent with the Act. Therefore, the Exchange respectfully submits that the Commission should approve SR-Phlx-2003-37.

Please contact Richard S. Rudolph, Director and Counsel, Phlx Legal Department, at (215)496-5074 with any questions or comments you may have.

Very truly yours,



Richard S. Rudolph
Director and Counsel

cc: Chairman William H. Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Annette L. Nazareth, Director, Division of Market Regulation
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