

**THE TIMBER HILL GROUP
TWO PICKWICK PLAZA
GREENWICH, CONNECTICUT
(203) 618-5801**

David M. Battan
Vice President and General Counsel
Interactive Brokers LLC

November 16, 1999

VIA HAND DELIVERY

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

***Re: Application for Registration as a National Securities Exchange
Filed by International Securities Exchange, File No. 10-127***

Dear Mr. Katz:

The Timber Hill Group¹, respectfully submits these comments on the amendment filed by the International Securities Exchange ("ISE") to its application to register as a national securities exchange. ISE's application should not be approved unless certain preferential, anti-competitive rules -- particularly ISE's unprecedented rule against electronic creation and

¹ The Timber Hill Group includes Timber Hill LLC, Interactive Brokers LLC and other affiliates which, through the use of proprietary communications technology, trade standardized derivative investment products on organized securities and futures exchanges worldwide. Timber Hill LLC is registered with the Commission as a broker-dealer and is a member in good standing of the Chicago Board Options Exchange, American Stock Exchange, National Association of Securities Dealers, Philadelphia Stock Exchange and Pacific Exchange. Interactive Brokers LLC, also a registered broker-dealer, engages exclusively in agency trading. It is a member in good standing of the Chicago Board Options Exchange, American Stock Exchange and Philadelphia Stock Exchange, where it offers execution of customer orders in all option classes.

transmission of non-market maker orders -- are eliminated or amended to comply with the Commission's vision of an open, accessible and transparent national options market.

The most dangerous of these rules is Rule 717(f), which to our knowledge represents the first time on any exchange that customers and ordinary exchange members would be prohibited from placing orders that are created and transmitted electronically. Likewise, ISE's prohibition against transmission of two-sided orders by Electronic Access Members ("EAMs"), and its trade or fade rule will, if approved, create a two-tiered market that will benefit privileged classes of exchange members at the expense of public customers who will be denied access to better, more accurate prices. The ISE has not provided the Commission with any evidence that these anti-competitive preferences are necessary or are the least restrictive means to protect the public interest. See National Securities Markets Improvement Act of 1996 § 106; H.R. Rep. No. 104-622 (June 17, 1996)(requiring "rigorous analysis" of competitive impact of proposed rules, including "specific analysis of costs and benefits").

Indeed, the troubling argument offered by the ISE in support of most of these corrosive rules is that they are necessary because some existing options exchanges have similar rules. Even if trade or fade rules or prohibitions on competitive two-sided orders may have had some justification on open outcry floors before the advent of modern trading technology, they have no place on the technology-driven exchanges of the future. Thus, Timber Hill urges the Commission to work with the ISE to revise or eliminate preferential and anti-competitive rules and to do likewise with the other options exchanges as the Commission moves forward over the next several months. In the words of Chairman Levitt:

"We cannot forget that it is the interests of investors that ultimately must guide the Commission's actions, not the interests of individual market centers or their participants...Any rules or practices that place the interests

of intermediaries ahead of those of investors should not be part of the future of the securities markets.”²

Specific Comments

I. ISE’s Prohibition Against Creating and Transmitting Orders Electronically Would Set a Dangerous Precedent and Must Be Disapproved

The most serious barrier to open and fair competition on the ISE, and an extremely dangerous precedent for the securities markets as a whole, is Rule 717(f), which states:

”Members may not enter, nor permit the entry of, orders created and communicated electronically without manual input (*i.e.*, order entry by Public Customers or associated persons of Members must involve manual input such as entering the terms of an order into an order-entry screen or manually selecting a displayed order against which an off-setting order should be sent)...”

To the best of our knowledge, ISE Rule 717(b) is the only rule of its kind on any options or other derivatives exchange anywhere in the world. It is remarkable on many levels:

- It prevents customers and outside members from sending electronic orders to an exchange that bills itself as the electronic exchange of the future;
- It distorts the exchange price discovery function and fosters wider spreads by preventing customers and EAMs from using pricing programs that might be faster and more accurate than those of the protected Primary Market Makers (“PMMs”) and Competitive Market Makers (“CMMs”);
- It creates bizarre incentives for customers and firms to introduce artificial and potentially inaccurate manual steps into the order process simply to comply with the terms of the rule; and
- It is fundamentally at odds with twenty-five years of Commission and Congressional policy calling for the deployment of advanced technology to create “better, quicker, and cheaper access to markets.”³

² Hearing Before the Senate Subcomm. on Securities, Comm. on Banking, Housing, And Urban Affairs Concerning Market Structure Issues Currently Facing the Commission (Oct. 27, 1999)(statement of Chairman Arthur Levitt)(“10/27/99 Levitt Testimony”).

³ See e.g., Order Execution Obligations, Exchange Act Release No. 34-36310, 60 SEC Docket 919 (Sept. 29, 1995).

ISE is bracingly honest about the motivation for the rule: “fear that automatic order-generation systems will hit [market maker] quotes . . . before the market makers’ own automatic quotation system is able to react to a change in the underlying price.”⁴ In other words, customers and EAMs are denied the opportunity to use any technology that might result in faster, better prices than those of the market makers. In light of some of the regrettable past practices of the options exchanges, this is noteworthy.

A publicly chartered national securities exchange is not intended to be a casino, where players know they will lose money in the long run because the house builds the slot machines. Options exchanges have a unique public purpose in providing a forum for hedging and discovery of future prices for the underlying securities. The sophisticated participants in these markets – both customers and members -- depend on lightning-fast markets that adjust to changes in the value of the underlying instruments as rapidly as possible so that prices are accurate and hedges are precise. Market makers should be expected to have highly advanced systems based on sophisticated pricing models that generate fast, accurate prices for users of these critical markets. If they do not, and a sophisticated customer or EAM has a better, faster price, it would severely disservice the public interest to prevent that price from being posted, simply to guarantee a profit for the market maker.

As discussed above, the Commission and the Congress have been urging the deployment of advanced technology in the securities industry for decades. As early as 1975, Congress noted:

“The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the

⁴ ISE’s Response to Comments on its Application to Register as a National Securities Exchange at 40 (Sept. 23, 1999)(“Response to Comments”).

information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.”⁵

The Commission repeatedly has stressed this theme, most recently in speeches and

Congressional testimony by the Chairman and the Commissioners:

“Advancing technology and innovation do not allow us the luxury of standing still. Although the landscape of tomorrow’s markets may not resemble today’s, the fundamental Exchange Act objective that will guide the Commission – a national market system characterized by transparency, competition, and linkages – remains the same.”⁶

If ISE is allowed to prevent customers and public members from using any technology that might improve prices of the market makers, other exchanges surely would follow and customers and the public would pay the price in perpetuity. This is not where our markets should be heading.⁷

Under the National Securities Market Improvement Act the Commission must rigorously “analyze the potential costs and benefits of any rulemaking initiative.”⁸ ISE’s one-paragraph attempt to justify its ban on electronic creation and transmission of orders is unsupported by a single shred of data, and provides the Commission no evidentiary foundation upon which to approve the rule.

* * * *

⁵ 15 U.S.C. 78k-1(a)(1)(D).

⁶ 10/27/99 Levitt Testimony.

⁷ The rule is also impractical. With the growth of Internet and other on-line trading, it will be very difficult for broker-dealers to police whether their customers are creating and communicating orders electronically with no manual input.

⁸ See H.R. Rep. No. 104-622 (June 17, 1996).

II. Other Anti-Competitive Rules

A. Limitation on Entry of Two-Sided Orders by Electronic Access Members

Another serious barrier to open and fair competition on the ISE is proposed rule 717(b), which prohibits ordinary ISE members (EAMs) from entering two-sided limit orders into ISE's system, either as principal or agent, on a regular or continuous basis. The clear purpose of this rule is to prevent outsiders from posting bids and offers that might equal or better those of the ISE-designated PMMs and CMMs and that would narrow spreads and lower the volume of transactions that these privileged members capture. However effective the rule might be in protecting favored exchange members, it is flatly inconsistent with the fundamental purpose of the markets: to provide the most liquidity to the investing public at the lowest possible cost.

The prohibition against EAMs submitting two-sided limit orders on a regular or continuous basis is reminiscent of similar rules established as part of pilot programs at the Chicago Board Options Exchange and the Pacific Exchange -- under which brokers using hand-held terminals in certain trading crowds are prohibited from using those terminals to enter two-sided limit orders. See Exchange Act Release 34-38054, 61 Fed. Reg. 67365 (Dec. 20, 1996)(approving CBOE pilot program prohibiting, in one options class, use of hand-held terminals to enter two-sided orders because exchange claimed off-floor market making would entice market makers to leave the floor); Exchange Act Release 34-39970, 67 SEC Docket 211 (May 7, 1998)(approving Pacific Exchange pilot program prohibition on same grounds).

In a floor-based environment, these rules restricting so-called "upstairs" market making had at least an arguable rationale sufficient to justify their implementation on a trial basis, although we understand that the Department of Justice is investigating these restrictions as part

of its inquiry into competitive practices on the options exchanges.⁹ In any event, ISE's graft of this anti-competitive rule from the pen-and-ink environment to the electronic trading arena – where everyone is “upstairs” is not supportable and will lead inevitably to less competition and wider trading spreads.

The only justification offered by ISE for stifling price and volume competition is that protective measures are necessary to entice firms to become CMMs and PMMs so that they will provide liquidity to the exchange in difficult markets.¹⁰ However, as the Commission has noted recently, global computing and telecommunications systems are eliminating the inefficiencies of the past and bringing pools of liquidity together in ways that were inconceivable in the floor-based trading world. Likewise, European derivatives exchanges have proven that when customers and broker-dealers have open and fair access to exchange electronic trading systems from around the globe, there is sufficient liquidity to maintain orderly markets without paying a privileged few for the mostly theoretical obligation to be steadfast in rough markets.

The ISE has not made the required showing under the National Securities Market Improvement Act that maintaining artificially high spreads by excluding outside two-sided orders is the least restrictive and anti-competitive method of assuring sufficient liquidity on the exchange. As we noted in our initial comment letter, even without Rule 717(b)'s ban of outside market making, PMMs and CMMs are given plenty of generous incentives to participate in the ISE, including the right to participate in all trades within an options group that exceed a

⁹ After three years, the justification for these pilot programs should be revisited, and, without new analysis, the pilot programs cannot stand as precedent for permanent rules barring competitors from offering narrower spreads to exchange customers.

¹⁰ See Response to Comments at 40.

minimum size, and a limitation on the number of CMM memberships.¹¹ Moreover, there is no evidence that providing PMMs and CMMs with artificial freedom from competition in favorable conditions will encourage them to act fairly or not use this same artificial advantage in unfavorable conditions.¹² Especially in light of the Commission’s recent concerns about best execution and price improvement, access to new markets “should not be frustrated by unreasonable fees or other barriers that have an anticompetitive effect.”¹³

B. ISE’s Trade or Fade Rule

Our final objection relates to the ISE’s proposed trade-or-fade rule, which ISE retained in its amended application notwithstanding negative commentary. For the reasons explained at length in our initial comment letter, “trade or fade” is a concept whose time has long passed. By authorizing a market maker or trading crowd to refuse to honor its quotes if the prospective counterparty is a broker-dealer, trade or fade rules distort the exchange pricing mechanism and undermine the integrity of the marketplace. ISE seems to agree with this, calling trade or fade rules “unfortunate” and “troublesome” but defending its trade or fade rule on the ground that the other exchanges do it.¹⁴

When the options exchanges first proposed their “trade or fade” rules to the Commission, they jointly represented that the rules were necessary to minimize “trade-throughs” in multiply listed options. A trade-through occurs when an order is filled at one exchange at a price that is

¹¹ For the reasons articulated in our initial comment letter, we continue to object to the limited number of CMM memberships contemplated by ISE rules, and feel that this, combined with barring ordinary members from making markets, will lessen the chance for the narrower spreads that would result from more vigorous competition.

¹² There is no evidence that ISE even considered, let alone “rigorously analyzed,” less restrictive alternatives to Rule 717(b) -- such as allowing ordinary members open access to make markets but placing certain market making responsibilities on them. See H.R. Rep. No. 104-622 (June 17, 1996).

¹³ 10/27/99 Levitt Testimony.

¹⁴ Response to Comments at 29-30.

inferior to the price available elsewhere. According to the exchanges, trade-throughs were occurring not because better prices were in fact available at another exchange, but merely because the competing exchange had allowed its disseminated quotes to grow stale.¹⁵ Trade or fade rules were offered as the solution to this problem.

Again, trade or fade rules might have made sense in the time before advanced computing technology became widely available and updating prices was not automated. In today's world, however, it is difficult to see any justification for trade or fade. If specialists and market makers – who are compensated highly for the obligation to post accurate two-sided markets – are posting stale or bait-and-switch quotes, the solution is not to allow them to disavow those quotes but to make them honor them. We suspect that the problem of stale quotes and trade-throughs would disappear very quickly if specialists and market makers were held firm to all their quotes.

In any event we hope that this issue is moot. On October 19, 1999, the Commission ordered the exchanges to propose a plan to create a linkage arrangement that would prevent trade-throughs. The Commission further noted:

“As part of the implementation of trade-through rules, the Options Exchanges should submit to the Commission proposed rule changes repealing existing trade or fade rules that become unnecessary with the adoption of trade-through rules.”¹⁶

¹⁵ See generally Exchange Act Release No. 34-34431, 57 SEC Docket 591 (July 22, 1994).

¹⁶ Order Directing Options Exchanges To Submit an Inter-Market Linkage Plan, Exchange Act Release No. 34-42029, 64 Fed. Reg. 57674-01 (Oct. 26, 1999).

In light of the Commission's rightful desire to eliminate exchange trade or fade rules, it is self-evident that the Commission should disallow ISE's Rule 804(d)(2).¹⁷

Conclusion

We urge the Commission to consider the ISE rules discussed above in the context of the Commission's vision for the open, fair and transparent exchanges of the future. The negative impact of exchange rules creating preferences for a limited class of exchange insiders at the expense of others is felt not only by outside members who are prevented from competing on a level playing field, but by public customers who pay the hidden costs of higher bid ask spreads and less accurate prices because of barriers to competition.

Sincerely,

David M. Battan
Vice President and General Counsel
Interactive Brokers LLC

cc: Hon. Arthur Levitt
Hon. Isaac C. Hunt, Jr.
Hon. Norman Johnson
Hon. Paul R. Carey
Hon. Laura Simone Unger
Annette L. Nazareth, Esq.
Sheila Slevin, Esq.
Christine Richardson, Esq.
Joseph Morra, Esq.

¹⁷ In the event that the ISE begins to operate before the other exchanges' linkage plans are finalized, we urge the Commission to end trade or fade on those exchanges pending final resolution of the linkage issue.