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New York
Stock Exchange, Inc.

November 5, 1998

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

Re: File No. 4-208; Release No. 34-40204

Dear Mr. Katz:

The Pacific Exchange, Inc. ("PCX") and OptiMark Technologies, Inc. ("OptiMark") jointly have submitted a letter presenting their views on the Commission's proposed amendments to the ITS Plan to accommodate the PCX Application.¹ That letter purports to respond to the NYSE's initial comment letter on this matter.² P/O's central theme is that it intends to operate a "call market facility" separate from the PCX's traditional floor market and that the ITS Participants should treat this as a distinct market under the ITS Plan. Based on that analysis, P/O urges the Commission to conclude that the P/O's proposal complies with the "probing" requirement in Section 8(a)(v) of the ITS Plan. Furthermore, P/O now argues that *no* "formula" is necessary to permit the PCX to send commitments generated by the PCX Application through ITS.

The issue in dispute does not involve linking a "call market" to ITS. Rather, the Commission is proposing amendments to the ITS Plan to expand the current linkage between the PCX, as a whole, and ITS. The P/O Letter contains numerous inaccuracies that cloud relatively straightforward issues. In this letter we explain the fallacy of the "call market" analysis and respond to a number of the more significant inaccuracies in the P/O Letter.

Rather than continue this public debate in a Commission proceeding, we urge the Commission to instruct the parties to attempt to resolve this matter through continued negotiations.

¹ Letter dated October 5, 1998 from William Langley, PCX, and William Lupien, OptiMark, to Jonathan G. Katz, Secretary, Commission (the "P/O Letter").

² Letter dated August 21, 1998 from James E. Buck, Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission ("NYSE Letter"). Unless otherwise noted, all defined terms in this letter use the definitions in the NYSE Letter. We refer to the PCX and OptiMark together in the singular as "P/O."

I. The P/O "Call Market" Analysis is Faulty

A. P/O Misstates the "Probing" Issue

The key open issue involves the "probing" requirement in the last sentence of Section 8(a)(v) of the Plan, which provides that "[r]easonable efforts to probe the market to achieve a satisfactory execution there are expected to be taken before the order is reformatted as a commitment to trade and rerouted to another market through [ITS]." P/O's current plans do not comply with this requirement.

As explained in its filings, letters and Petition, the PCX will receive orders from OptiMark's proposed matching system (the "OptiMark System") through its "PCX Application." These orders will be generated in periodic OptiMark System "Cycles." Upon receipt of any order, including an order generated by the OptiMark System, the ITS Plan requires that the PCX then "probe" potential trading interest in its market for a possible execution prior to automatically reformatting that interest into an ITS commitment. Because the PCX proposes to reformat these orders into an ITS commitment automatically, without a probe, the PCX will be violating the ITS Plan.

The intent of the probing requirement is to ensure that a market does not use ITS as a proprietary order routing system. While the P/O Letter vehemently denies that OptiMark or the PCX intend to use ITS as a proprietary order routing system, it does not deny – nor even address – the fact that its proposal is being marketed to the institutional community as such. Moreover, it neither denies nor addresses the fact that the link it proposes between the PCX Application and ITS could be utilized by OptiMark Users as a proprietary order routing device.

There are three circumstances in which PCX would send an ITS commitment generated by the PCX Application to another ITS Participant, and would be subject to the Plan's current probing requirement. Explained more fully in both our and PCX's prior submissions to the Commission, these are:

- "Trade-Through" commitments: commitments where the PCX executes an OptiMark System trade of non-block size at a price inferior to another Participant's quote and the PCX is satisfying that Participant's quote at the quote price.
- "Block Policy Trade-Through" commitments: commitments where the PCX executes an OptiMark System trade in size of 10,000 shares or more (or in value of \$200,000 or more) at a price inferior to another Participant's quote, and is satisfying that Participant's quote at the price of the block trade.
- "Trade-At" commitments: commitments where the PCX, following an OptiMark System Cycle, is not trading through another Participant's quote, but is simply matching an OptiMark System Profile against another Participant's quote, and seeking to execute the order resulting from the OptiMark System Profile in that other market.

Our focus is on probing in the Trade-At situation. Specifically, we presented P/O with the following situation: The NYSE market in a stock is 50 to 50 1/8 (the NBBO) and the PCX's.

market is 50 to 50 1/4. During the time these quotes are disseminated, the PCX has been executing buy orders at 50 1/8 to match the NYSE quote, which is a regular practice on the PCX. In an OptiMark System Cycle, the only matched trading interest is between an OptiMark System "User Profile" to buy at 50 1/8 and the NYSE's offer at the same price. In this situation, P/O seeks to automatically send an ITS commitment to the NYSE to trade at 50 1/8. The ITS Plan requires that the PCX first must probe its market to attempt to execute the order there.

In our prior discussions with P/O, we have agreed to amend the ITS Plan so that the PCX need not probe its market at all in Block Policy situations, and at least not initially in Trade-Through situations. In the above example, if the OptiMark System also matched trading interest to buy stock at 50 1/4, the PCX could execute that order at 50 1/4 (trading through the NYSE offer), and send an ITS commitment to the NYSE – at 50 1/8 to satisfy a Trade-Through or at 50 1/4 to satisfy a Block Policy Trade-Through – without first conducting a probe. We recognized early on that we must balance the PCX's obligations under the national market system ("NMS") against the possibility that the PCX Application could be used as an inappropriate vehicle to access the NYSE and the other ITS Participants. We highlight this distinction because the P/O Letter continually misrepresents our positions on probing.

B. P/O's "Call Market" Analysis is Irrelevant

P/O's "response" to the NYSE Letter is that it is proposing a "call market," and that this call market will operate in compliance with the Plan. Specifically, the P/O Letter states that the PCX is proposing to operate a "call market facility" and that it will probe all "available trading interest expressed by the PCX members and their customers" by including such interest in a "call." P/O concludes that such a "probe" is reasonable for a call market.

This P/O analysis is incorrect. While it may be possible to characterize an OptiMark System Cycle as a "call," that is irrelevant to any discussion involving ITS.³ If OptiMark were to register as a national securities exchange and seek to participate directly in ITS, we would be pleased to discuss with it any unique issues that may arise regarding such participation. However, that is not the course that P/O chose. Rather, in an apparent effort to avoid the need to register a new entity as an exchange, the PCX itself filed rule changes with the Commission to establish the PCX Application as a facility of that exchange. Thus, the PCX itself must continue to comply with all requirements applicable to it, including the requirements of the ITS Plan.

³ The characterization of an OptiMark System Cycle as a call is an argument of convenience. The PCX's rule filing that proposed the PCX Application does not refer to any "call market." The Commission's approval order uses the term only in passing, and only in discussing the need to integrate certain OptiMark trading interest with the disseminated PCX quotation. It was not until somewhat later in our correspondence on the P/O proposal, and in our negotiations with P/O, that it referred to an OptiMark Cycle being a "call."

C. The P/O "Call" Does Not Satisfy the Plan's "Probing" Requirement

1. P/O Previously Made Clear That the OptiMark System Does Not Receive Orders, But Generates Orders

Regardless of how P/O characterizes the nature of the PCX's market, the Plan's probing requirement, on its face, applies only when an exchange receives an "order." On numerous occasions, P/O has made clear that any Cycle, or a "call", that will occur in the OptiMark System will occur prior to the generation of an "order." Indeed, P/O seeks to codify the fact that no order occurs until after a "call" in its proposed definition of the term "PCX Application" in the ITS Plan, which the Commission has included as part of its proposals in the Release. The PCX version of this definition provides:

PCX Application means the computerized facility of the PCX, as defined in PCX Rule 15.1, *that receives orders generated by the OptiMark System*, a patented electronic matching system based on an optimization algorithm that, on a periodic "call" basis, processes certain qualifying expressions of trading interests called satisfaction Profiles *The orders received by the PCX Application will be processed by the PCX to permit . . . in the case of those orders reflecting a match between a non-CQS Profile and a CQS Profile, appropriate transmission to [ITS] . . .* (Emphasis added.)

P/O's definition makes clear that what the OptiMark System processes in a Cycle are "expressions of trading interest" or "Profiles," and not "orders." This is fully consistent with the PCX's previous position on this issue:

Profiles are similar to an institutional investor's "*indications of interest*" that it may be a large buyer of XYZ stock in a range of acceptable prices, depending on such factors as the size of the block, timing and market momentum. Until such an indication is further refined (in the case of the OptiMark System, through central processing with other Profiles), it simply cannot be acted on for purposes of consummating a transaction. Under Rule 11Ac1-1(c)(4) (as amended), the terms "bid" and "offer" do not include "*indications of interest.*" Because Profiles represent similarly inchoate trading interest, they should not be treated as a bid or offer.⁴ (Emphasis added)

The PCX also has stated:

Profiles are analogous to "*indications of interest*" and not "bids" or "offers" within the meaning of the Quote Rule. The [PCX] notes that the existing auction market process similarly allows for certain indications of interest on certain conditional orders to be held undisplayed *until the interest is directed to become an order or until the conditions are met.* For the same reasons, we disagree with the NYSE's

⁴ Letter dated May 19, 1997, from John C. Katovich, PCX, to Richard R. Lindsey, Director, Commission's Division of Market Regulation, seeking interpretive guidance on the Firm Quote Rule. A footnote to this discussion stated: "This may be particularly true for indications of interest expressed by those who do not constitute 'members' or responsible broker dealers' within the meaning of the Quote Rule."

claim that Profiles with a satisfaction value of 1 must be incorporated in the PCX quotation.⁵ (Emphasis added)

The Commission agreed with the PCX and determined that Profiles are generalized expressions of trading interest "with conditions attached" that can be canceled at any time prior to a Cycle.⁶ Thus, what P/O describes as its "probe" is not a probe by an "order," but merely the interaction of declared trading interest in the OptiMark System. Only upon completion of an OptiMark System Cycle is there an order. It is upon the PCX's receipt of such an order that the ITS Plan requires the probe.

2. The P/O Letter Further Mischaracterizes What Constitutes an "Order" for Purposes of the Probe

Faced with this long history of arguing that Profiles -- the trading interest entered into the OptiMark System -- are not orders, P/O now disingenuously argues that the output from the OptiMark System also are not orders subject to the Plan's probing requirements. Thus, P/O effectively is arguing that nowhere in the process of executing trading interest arising from the OptiMark System is there an "order" subject to the Plan's probing requirement. Specifically, the P/O Letter states that the NYSE "confuses these pre-processed 'orders' generated by a call as regular 'orders' sent today to the PCX's continuous auction market for execution." The P/O Letter further states that:

As a call market, the PCX Application receives for execution only those pre-processed "orders" resulting from a call. Naturally, such "orders" are fundamentally different from those found in a continuous auction market. The former [*i.e.*, call market interest] consists of matched trading interest from the opposite sides of the market *whose terms and conditions can be immediately satisfied*, while the latter [*i.e.*, an auction market order] is sent specifically to *search contra-side trading interest*. The ITS Plan does not require a second probe of these specialized call market orders received by the PCX Application. (Emphasis added.)

This argument fails because an OptiMark System "User Profile," when matched with a "CQS Profile" (such as the NYSE quote) in a "call," and transformed into an order, is *not* "matched trading interest . . . whose terms and conditions *can be immediately satisfied*" (Emphasis added). OptiMark "User Profiles" that are matched one to another and sent to the PCX Application are immediately satisfied by automatic execution. However, an order representing a "User Profile" matched with a "CQS Profile" that is reformatted into an ITS commitment "is sent [to another market] *specifically to search contra-side trading interest*" represented in the other market's published quotation. (Emphasis added)

⁵ Letter dated August 1, 1997, from John C. Katovich, PCX, to Jonathan G. Katz, Secretary, Commission.

⁶ The P/O Letter at pages 11 and 12 quotes excerpts from the Commission's Approval Order and then, seemingly disagreeing with the Commission, states that there "is no basis for claiming that a Profile is 'merely indicative' and equating it with an 'indication of interest' found in a continuous market". This is a convenient but transparent argument.

The OptiMark System order priced at the CQS bid or offer is not "fundamentally different" from other orders received by the PCX, whether via a floor member or through its P/COAST system, and whether executed there or rerouted via ITS for possible execution. The party entering the order (whether a person, or, in the case of the OptiMark System, a computer) prices the order or "matches" it with the published quotation and routes it to the PCX. The order may or may not be filled on the PCX or through ITS based upon the continued existence of the bid or offer.

Having argued that nowhere is there an "order" to probe the market in the context of executing OptiMark System trading interest, P/O nevertheless argues that an OptiMark System Profile is sufficiently like an order that the "call market" interaction meets the Plan's probing requirement. Specifically, the P/O Letter states that "the fact that a Profile is not an 'order' as used in the context of a continuous auction market does not mean that it lacks the 'requisite elements of definition and firmness' to meet the valid probe requirement under the ITS Plan." Yet in a May 19, 1997 letter, the PCX argued that OptiMark System Profiles were *not* firm, and could not be subject to the "firmness" requirement of the Firm Quote Rule. Specifically, PCX argued that:

No such "firmness" requirement [of the Firm Quote Rule] could be possibly imposed on any broker-dealer User with respect to any Profiles submitted to the OptiMark System -- including those Profiles that may resemble traditional limit orders to some degree in that they represent expressions of interest to buy or sell with full satisfaction up to the designated size at a price equal to or better than the limit price.⁷

That letter continued as follows:

Accordingly, we request the Commission to confirm our understanding that Profiles are not required to be included in the public quotation stream, because they are not bids or offers within the meaning of the Quote Rule or customer limit orders within the meaning of the Limit Order Display Rule.⁸

P/O cannot have it both ways. P/O cannot escape the need to expose Profiles to the market as firm quotes by arguing they are merely "expressions of trading interest," yet have the same "expressions" be sufficiently firm to be "orders" under the ITS Plan. The Plan's probing provision simply does not apply to OptiMark System Profiles. It applies only to "orders received within the market of an Exchange Participant." Because ITS is designed for, and limited to, commitments priced at-the-market or at the bid or offer of the receiving Participant, an order, at the time of reformatting into an ITS commitment, is, by its terms, marketable and capable of execution. A Profile, by its terms, does not have these characteristics until an OptiMark System Cycle transforms it into an order. Upon this transformation, the order is "fundamentally" like any other order received by the PCX that might be sent via ITS, except that the P/O would automatically generate an ITS commitment, without the order ever being seen on the PCX floor.

⁷ Letter dated May 19, 1997 from John C. Katovich, PCX, to Richard R. Lindsey, Director, Division of Market Regulation, Commission, at 10.

⁸ *Id.* at 12.

Apparently recognizing its own internal inconsistency on the issue, the P/O Letter states that the ITS Plan "does not require a second probe of these *specialized call market orders* received by the PCX Application." (Emphasis added.) While the Plan never requires a "second" probe of anything, it most certainly requires a first probe by any order an Exchange Participant receives prior to that Participant automatically reformatting that order into an ITS commitment. The Plan does not contain an exception for "*specialized call market orders*."

Finally, P/O raises a question regarding the use of the word "market" in the ITS Plan's requirement of a probe of "the *market* to achieve a satisfactory execution" (Emphasis added.) P/O claims that this use of the term "market" is not defined, and speculates that it could mean the PCX's floor market. Based on that reasoning, P/O contends that the probing requirement may not be applicable to a "call" market, "with the result being automatic compliance with the ITS Plan." This argument fails upon even a rudimentary analysis of the context of the term "market" in the last sentence of Section 8(a)(v). The preceding sentence states that "most orders received within the *market* of an Exchange Participant are expected to be executed within that *market*." (Emphasis added.) This context makes clear that the probe in the next sentence applies to the *entire market* "of an Exchange Participant." The result is even worse for P/O if its interpretation were correct and the PCX's "market" is limited to the PCX's floors. In that case, the PCX Application would not be considered part of the "Exchange (Participant's) Market" under the ITS Plan, which is specifically limited to the floors of all Exchange Participants other than the CSE. In that case, the PCX would have argued itself into a position of no right to access ITS via the PCX Application at all!

In addressing the need for a probe, we seek only to ensure that the PCX operates in a manner consistent with the Plan. We recognize that the PCX has amended its auction rules so that there is an immediate execution of an OptiMark System order when the PCX receives that order, regardless of whatever other trading interest may then be resident on that exchange. The PCX is free to propose modifications to its internal auction rules, and the Commission has approved those rules as being consistent with the Exchange Act. However, that is irrelevant to the ITS discussion. The Commission's approval did not have any effect on the PCX's obligations under the ITS Plan.⁹ As a Participant in ITS, the PCX must comply with the ITS Plan and must ensure that there is a probe of its *entire* market upon receipt of that order, and prior to reformatting that order into a commitment. The PCX will not be complying with this requirement.

⁹ P/O trumpets such approval, including Commission statements regarding the potential for increased liquidity and PCX order flow that may arise from this system, as somehow indicating that the PCX will be complying with the ITS Plan. However, in approving the PCX's proposal two days prior to the PCX first presenting it to the ITS Participants, the Commission made clear that the ITS Participants were continuing to discuss the impact of the P/O proposal on ITS, and that it was not rendering any judgment on that issue. Moreover, if the PCX's intent truly was to increase its liquidity and order flow, we would expect the PCX to take extra steps to execute OptiMark System order flow in its own market, rather than simply provide a conduit for that order flow to pass through to ITS.

D. There is a Policy Reason to Mandate a Probe

In addition to the argument that there is no OptiMark System "order" with which to probe under the ITS Plan, P/O also argues that the interaction among the trading interest within the OptiMark System effectively is a proxy for the probe required under the ITS Plan. The NYSE Letter addressed that issue at length. In addition, P/O apparently believes that, because the PCX automatically now must include a specialist's displayed quotation in an OptiMark System "call," there is no policy reason to mandate that the PCX comply with the Plan's probing requirement.

The ITS Participants did not adopt the probing requirement to promote interaction with disseminated trading interest. Other agency-auction market rules address that issue. Moreover, in a separate comment letter on the PCX's proposal to mandate specialist participation in a call, we explained how that proposal was irrelevant to the ITS probing issue.¹⁰ In addition, we note that the PCX only will be requiring inclusion of a specialists' *disseminated* quotations, which most often will be only "one-by-one" autoquoted markets. A specialist still has discretion on whether to include any actual liquidity not reflected in the quote -- such as limit orders away from the current market and other, undeclared, trading interest not required to be quoted -- in a Cycle. Thus, it is incorrect to assume that all PCX trading interest will be included in an OptiMark System Cycle.

P/O correctly notes that specialists have the ability, but not the requirement, to include their own trading interest in an OptiMark System call. That fact, however, ignores the reality of trading on the regional exchanges: specialists view incoming order flow and have the first opportunity to trade against that order flow. They react to the order flow. Upon seeing the order flow, a specialist decides whether to trade against the order, send it out via ITS or use another vehicle, such as SuperDOT, to execute the order. Specialists make these decisions, in part, based on inventory and trading opportunities presented to them. PCX specialists currently do not declare all their principal trading interest and it is unrealistic to expect those specialists to change the way they do business with the advent of the OptiMark System. While they might utilize the OptiMark System, they can still be expected to react to order flow opportunities presented to them. Thus, complying with the ITS Plan's requirement that the OptiMark System order probe the PCX market should produce tangible benefit to the PCX, i.e., greater opportunity for increased execution of PCX orders on the PCX in lieu of sending ITS commitments.

II. The P/O Letter Contains Numerous Inaccuracies and Misstatements

Based in large part on its "call market" analysis, the P/O Letter mischaracterizes various NYSE positions and various sections of the ITS Plan and the Exchange Act. While it is impossible to catalogue all the infirmities in the P/O Letter, we address some of the more substantial problems in the letter:

¹⁰ Letter dated September 16, 1998, from James E. Buck, Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission.

A. P/O Mischaracterizes Section 6(a)(ii) of the ITS Plan Describing ITS Transactions

The NYSE Letter explained why an ITS Plan amendment is necessary to authorize the PCX to generate ITS commitments automatically.¹¹ The P/O never rebuts that analysis. Rather, it quotes selectively from Section 6(a)(ii) of the ITS Plan as "evidence" that the Plan contains no requirement for exploring the depth and liquidity beyond a disseminated quote. P/O is wrong. First, the probing requirement has its basis in Section 8(a)(v) of the Plan, not Section 6(a)(ii). Moreover, the language that P/O quotes from Section 6(a)(ii) deals with the manner in which the NYSE generates ITS commitments, which is not on an automated basis. Only one ITS Participant, the CSE, currently is authorized to automatically generate ITS commitments, and the P/O Letter ignores the provisions of Section 6(a)(ii) that deal with the CSE.

In authorizing the CSE to generate commitments automatically, the ITS Participants amended Section 6(a)(ii) of the Plan to specify that, prior to the CSE sending an ITS commitment, the CSE must process an order "in accordance with CSE Rule 11.9," with a reference to a specific description of such order processing in a CSE rule filing. CSE Rule 11.9 contains the CSE's "probing" provisions and the Plan specifically requires the CSE to follow its rules and probe its market for an execution beyond the CSE's disseminated quote prior to automatically generating an ITS commitment. As was the case with the CSE, the NYSE is specifically seeking an amendment to Section 6(a)(ii) to include in the Plan the manner in which the PCX will generate commitments automatically, including how the PCX will probe its market.

B. P/O Mischaracterizes a Probe as "Dealer Intervention"

P/O misstates the issue before the Commission as to whether an exchange, as a condition precedent to using ITS, must "jeopardize the execution of an investor's order by providing an opportunity for dealer intervention . . ." Similarly, P/O raises the straw men of "frontrunning" and "trading ahead" by saying that "dealer intervention through order exposure" gives rise to such concerns. Furthermore, in discussing dealer intervention, the P/O Letter states that the NYSE "equates the concept of a reasonable probe under the ITS Plan with broker-dealer intermediation in the order execution process – in particular, intermediation by specialists in the course of their market making responsibilities of providing continuity to the market." The PCX misrepresents the NYSE by taking statements out of context. We also note that the P/O Letter continuously refers to "dealer intervention" in the pejorative, rather than simply referring to the Congressional standard encouraging the opportunity for investor orders to be executed without the intervention of a dealer – a strange position for the PCX to take, given that the vast majority of its trades involve dealer intervention.

We neither seek to jeopardize the execution of an investor's order nor to encourage or discourage dealer intervention on the PCX. As discussed above, there are strong policy reasons to probe the PCX market following the generation of an OptiMark System order. Indeed, the intent of a probe

¹¹ In particular, the attachment to the NYSE Letter emphasized many of the points the NYSE made in its December 11, 1997 letter to the PCX on the requirements of the ITS Plan and responded to certain points the Commission staff had raised. The P/O has never provided a written rebuttal of our December 11, 1997 letter.

in "Trade-At" situations is to encourage executions within an Exchange Participant's own market, rather than sanction an Exchange Participant's use of ITS as an order-routing vehicle to access other markets. Furthermore, we fail to understand the link between a probe and "dealer intervention."

In context, the NYSE Letter stated that the intent of probing is, in part, to elicit possible contra-side trading interest that market participants have not communicated to the market. We then used the *example* of exchange specialists often trading with orders at prices superior to their quotes, which is a common practice in all markets and a prevalent one on the PCX. Indeed, the ITS Plan's probing requirement, as with most Plan provisions, is crafted to fit within the existing market structure. In this regard, all exchange ITS Participants have an agency-auction market structure, with all members, acting as agent or principal, eligible to participate in the auction. It just so happens that the PCX today has mostly specialist trading, with the likely result of a probe being that dealers would interact with the OptiMark System orders. However, an objective of the PCX is to evolve and to attract order flow, even beyond that generated by OptiMark. The Commission recognized this objective when it stated in the Approval Order that:

The PCX Application is likely to promote competition among market centers because it has the potential to attract new market participants and to increase order flow to the Exchange. By attracting order flow, the Application may provide a new and enhanced source of liquidity for investors.

Nevertheless, the intent of the NYSE Letter was to note the extent to which PCX specialists today step up to trade at prices better than their own disseminated quotations. They do so not only to fulfill their small order execution responsibilities mandated by their rules, but also when presented with other orders that offer them trading opportunities. For example, many regional specialists are the recipients of not just orders in size subject to automatic execution, but of all the order flow of the brokerage firms they represent, including large orders not subject to that exchange's automated execution guarantees. This provides the regional specialist with the first opportunity to trade with all this order flow. The overall practice reflects situations where there is latent undisclosed trading interest available to trade with incoming orders. While some PCX specialists may, to support the P/O position, express a willingness to forego receiving an OptiMark order probe, we know of no reason why PCX specialists generally would reject the opportunity to have OptiMark Trade-At orders exposed to them.

We also note that P/O's arguments are internally inconsistent. By automatically formatting an OptiMark System order into an ITS commitment, there will be an "exposure" of the OptiMark System order, in the form of a commitment, at another ITS Participant. This would seem to give rise to the same "frontrunning" and "trading ahead" concerns and, of course, would involve broker-dealer intermediation, and perhaps dealer intermediation, in the receiving market.¹² P/O seems to believe that order exposure on the PCX via a probe presents problems that do not arise when orders are exposed as commitments in other markets. If P/O has legitimate concerns in this

¹² If P/O truly believes that an OptiMark order's probing the PCX market gives rise to frontrunning and trading ahead concerns, these concerns would also appear relevant to other PCX order flow and should be addressed through PCX's surveillance efforts.

area, it can best address those concerns by foregoing "Trade-At" matches in the OptiMark System, and thus preserve the confidentiality of User Profiles.

Finally, in support of its position that there is no policy reason for a probe, P/O cites to a single letter from a PCX specialist who demonstrates a remarkable ignorance of his order handling obligations under the Commission's rules.¹³ He expresses concern about his order handling responsibilities during the "15 second window" of a possible probe. He asks if he must "reflect this OptiMark-generated buy or sell interest, like all other orders, in the BBO and effectively lock other markets during this 'second probe'?" The answer, of course, is no. As with *all* incoming orders, if he wants to trade with the OptiMark-generated order at the price of the order – on behalf of a customer or his own position – he can do so. Alternatively, he can determine not to trade against the order, at which time the PCX Application would automatically reformat the order into an ITS commitment. In any event, the order could be treated in the same fashion as an ITS commitment, i.e., on an "immediate or cancel" basis, which by its terms would not result in a published quotation.

After raising this straw man, the specialist then raises yet another when he inquires whether he must hold *all* of his orders for 15 seconds before routing them to the BBO. We fail to understand that question, which appears to show the same confusion over the concept of the probe as does the P/O. The NYSE has never suggested that a PCX specialist has to wait for 15 seconds to pass before taking action on an order, whether it comes from an upstairs trading desk or an OptiMark Cycle. We would expect that a PCX specialist would handle an incoming OptiMark System-generated order as discussed above.

C. P/O Improperly Rejects the Probing Precedents

P/O disparages as irrelevant the two "models", or precedents, of probing we discussed in our letter: the CSE "flash" to dealers and the practice of the regional exchanges, including the PCX, to expose order flow internally on their exchanges as part of their small order processing systems. P/O takes our comments out of context. We noted these precedents only to show that there is latent trading interest in a market available to interact with incoming orders. Indeed, the depth and liquidity of a market almost always extends beyond the disseminated quote.

On a substantive level, we agree with P/O that there can be more than one way in which a Participant can comply with the probing requirement of Section 8(a)(v), and that these "models" are not the exclusive methods of probing. Indeed, we agree that the CSE probing requirement was tailored for that market given the unique fully-automated nature of the CSE.

Our policy goal is to achieve an appropriate "probe" of the PCX market in compliance with the ITS Plan. While we are more than willing to consider other possible "models" of probing, we categorically reject the P/O position that the OptiMark System "call" results in a probe complying with the ITS Plan. As discussed, the PCX must probe its market for an execution upon receipt of an OptiMark System order. Whether it does so pursuant to a "flash" similar to the CSE probe

¹³ Letter dated August 14, 1998 from Daniel Turner, President, Rubicon Securities, Inc., to Jonathan G. Katz, Secretary, Commission.

and P/COAST system or some other means is a subject that is open for discussion and that we are sure can be resolved.¹⁴

D. P/O Misconstrues Section 8(b) of the ITS Plan Regarding Internal Trading Rules of a Market

P/O properly cites Section 8(b) of the Plan for the proposition that each Exchange Participant retains control of its trading rules regarding the issuance of ITS commitments. That provision simply states that an Exchange Participant can determine the extent to which its trading rules apply to the issuance of ITS commitments. For example, NYSE Rule 15.20 implements Section 8(b) of the Plan by specifying precisely which NYSE rules apply regarding the sending of commitments from the NYSE's Floor, such as by stating when the issuance of a commitment is deemed to be the initiation of an order on the NYSE Floor and subject to NYSE rules. This is fully consistent with Section 8(a)(v), which imposes on Exchange Participants the requirement that each Exchange itself establish a probe of its market before it can automatically generate a commitment. P/O seems to imply that Section 8(b) gives each Exchange Participant the unilateral right to establish what it considers to be a probe. There is no support for such a reading of the Plan, which would effectively eliminate the probing requirement.

E. P/O Misstates the Positions of the Other ITS Participants

P/O states that "other ITS [P]articipants have agreed with PCX's position." While "other participants" have agreed with P/O, in fact the ITS Participants twice rejected P/O's proposed amendments to the ITS Plan to authorize the enhanced ITS linkage with the PCX Application, by votes of 5-4 and 6-3 against P/O.

F. P/O Mischaracterizes the NYSE's Competitive Plans

P/O is "disturbed to read in the financial press that the NYSE may be developing an order routing system designed, in part, to compete with the PCX's call market facility – one that would entail a change in the NYSE's own internal 'probe' requirements." The NYSE continually seeks to enhance its market and to meet the needs of its varying constituents. If we were to offer a new system that requires changes to our rules, we would file such proposals with the Commission and P/O would have an opportunity to register any comments that it may wish. While we are not sure what P/O means by a change in our "probing" requirements, we can assure P/O that any NYSE proposal will comply fully with the ITS Plan and that we will not be proposing any system that will rely on using ITS to access the PCX or OptiMark for liquidity.

Furthermore, we take issue with P/O's implication that we are seeking to delay the launch of the OptiMark System for our competitive advantage. We note recent press reports indicating that

¹⁴ P/O's negotiating "technique" has been to argue against the need for the protection the NYSE seeks, while simultaneously complaining that the NYSE refuses to elaborate on the type of protection we seek. Even prior to the commencement of our negotiations, P/O argued that no Plan amendment was necessary while, at the same time, complained that the NYSE refused to provide the specifics of the Plan amendment we sought. We have no interest in unilaterally raising a possible probe suited to the PCX market so that P/O can reject it. Once P/O acknowledges the need for a probe, we can discuss what form of probe makes the most sense for the PCX market, consistent with the requirements of the Plan.

OptiMark continues to test its system, and that the planned introduction is now anticipated for January 1999.¹⁵ This projected implementation date is more than a year later than the start-up date the PCX initially indicated was likely when the PCX first began discussions regarding the PCX Application with the other ITS Participants. None of this slippage can be attributed to those discussions or to ITS issues in general.

We similarly disagree with P/O's characterization that the NYSE is seeking "protection" from its competitors. In particular, based on relative ITS volume, P/O ridicules the NYSE for seeing the PCX as a "serious threat." While this criticism does not warrant a lengthy response, we must reiterate that our only interest is ensuring that PCX complies with the requirements of the ITS Plan. In an effort to foster the development of the NMS, the NYSE has agreed with all other registered exchanges and associations to provide limited non-member access to the members of the other markets. ITS provides the single exception to the general rule that only members of the NYSE have direct access to trading in our market -- and this is not unique to the NYSE.

The PCX is free to fashion any competitive initiative it chooses as long as the initiative does not seek to misuse ITS to provide liquidity to its competitive system. We recognize our NMS responsibilities, and we are willing to amend the ITS Plan to eliminate the need for a "probe" in legitimate price-protection situations. However, we are not willing to amend the Plan to provide P/O with an unobstructed path into our market for its competitive benefit.

An example dramatizes our access concerns. Not mentioned in the PCX filing, or in its letters to the Commission, is the OptiMark System feature called "pegging". OptiMark literature describes this feature as follows:

Rapidly changing market conditions often test traders' ability to keep a close eye on every stock they are working and make manual changes to existing orders. With OptiMark, Profiles can be "pegged" to automatically adjust as chosen benchmarks move. This keeps traders in sync with the market. Traders can adjust a Profile to account for price, quantity or strategy changes. Simple graphic editing tools permit rapid and easy Profile modifications.¹⁶

This feature will allow an OptiMark System User to enter a Profile to, for example, sell 100,000 shares of a stock "pegging" the Profile's price and size to the price and size of those CQS Profiles representing the national best bid included in a Cycle. The NYSE bid is the national best over 90 percent of the time. During a Cycle, the User is guaranteed that its Profile will receive a match whether or not another User had entered a corresponding contra-side buy Profile -- the CQS Profile representing the NYSE bid will always be present. While there is some chance of two User Profiles matching, there is 100 percent certainty of a match due to the presence of the CQS Profile, which is most likely the NYSE quote.

¹⁵ See "OptiMark Delays PCX Launch", *Securities Industry News*, October 19, 1998, at p. 1.

¹⁶ "The Optimal Market." (1998)

The PCX Application is simply providing an access vehicle to another market to provide executions for OptiMark System Users.¹⁷ While the P/O Letter claims that the issue is access to ITS, and not access to the NYSE -- as if the road is more important than the destination -- as a practical matter, the PCX's access to ITS is 85 percent of the time to the NYSE.

G. P/O Mischaracterizes the NYSE's Proposal Regarding Probing

P/O sets out a lengthy example of how what it characterizes as a "second probe" will "destroy the integrity of the call." Only well after P/O presents that example does it acknowledge a startling fact: the NYSE already has agreed that the PCX need not conduct a probe in the situation P/O sets out! Indeed, as we have emphasized throughout our negotiations and in the NYSE Letter -- and as discussed in detail above -- we are prepared to limit the probe to "Trade-At" commitments. PCX would not need to probe its market prior to sending a commitment to satisfy a quote in a Trade-Through or Block Policy Trade-Through situation. Thus, the only time PCX would need to probe its market is when there is the most danger that the OptiMark System, coupled with the PCX's ability to generate ITS commitments automatically, could be used as an order routing device.

Rather than address the substance of our concern, P/O gives an example of a Trade-Through situation when we would not require a probe. P/O then dismisses our proposal to limit the probe to "Trade-At" situations by saying that the OptiMark System's "advanced super computer" . . . "cannot tell whether a potential match with [an NYSE quote] will be followed by an internal match between PCX trading interests at an inferior price." While this does not appear to be a difficult programming effort, we believe that computer programming considerations should not drive the policy considerations regarding probing, especially when we raised these concerns over a year and a half ago. We also note press reports that the launch of the OptiMark System already has been delayed due, in part, to the need to reprogram its "advanced super computer" to handle odd lots.¹⁸ P/O could have avoided any additional programming delay in implementing the probe by spending the last year addressing its processing limitations rather than debating the requirements of the ITS Plan.

H. P/O Mischaracterizes the NYSE's Position on the Need for a Formula

Regarding a "formula" limiting the amount of order flow the PCX can automatically generate as ITS commitments, P/O claims that "the ITS Plan confers no such entitlement on the NYSE." We agree. However, the corollary to that statement is that the ITS Plan confers no entitlement on the PCX to generate ITS commitments automatically. As discussed in detail in the NYSE Letter and in our previous correspondence, the ITS Plan is a contract among the Participants providing the

¹⁷ In this regard, the P/O Letter asks whether an exchange may "restrict access to an NMS facility in order to restrict access to the public quotation disseminated from its market?" The answer to that question is "yes." While we do not know what P/O means by a "public quotation", all quotations that an exchange disseminates are available only through members of that exchange or for limited purposes through ITS. When the PCX simply matches incoming orders against the quote of another market, such as the NYSE, the PCX has no inherent right to automatically generate an ITS commitment to access the NYSE without first attempting to execute the order in its own market.

¹⁸ "OptiMark Trading Debut Delayed Again at Pacific Exchange," Dow Jones New Service, October 28, 1998.

markets with limited non-member access to their competitors. No Participant has a right to access another Participant through ITS other than as specifically granted under the Plan. While P/O has the right to propose and negotiate access through the automated generation of commitments, it has no such entitlement. We are perfectly within our rights to seek adequate protection in the nature of a formula in exchange for granting P/O the enhanced access it seeks. The Commission effectively approved this policy position when it approved the CSE amendments. Furthermore, the P/O Letter fails to address any of the substantive issues we raised in our letter regarding the need for a formula and our proposed basis for a formula.

I. P/O Misconstrues the Congressional National Market System Directives

Rather than debate the specifics of a formula, the P/O Letter repeats the central theme of our negotiations with the PCX and OptiMark: "ITS is an NMS facility, full access to which must be encouraged to foster the development of a more efficient and effective NMS." In other words, P/O believes that regardless of the provisions of the current Plan, the Commission must provide it with access to any other market in any way it chooses. Once again, it is arguing for the Commission to read the probing requirement out of the Plan.

P/O's position on access seriously misstates the Congressional NMS directives. Contrary to P/O's belief, it has no right to use ITS as an order-routing device to provide initial liquidity for its competitive trading system. P/O cites three NMS provisions in Section 11A of the Act that it believes gives it the right to unfettered access. Even a cursory examination of those sections shows that P/O is wrong:

- Section 11A(a)(1)(B) states Congress' finding that "new data processing and communications techniques create the opportunity for more efficient and effective market operations." We agree with that finding, and acknowledge that it is possible that P/O's proposal could add efficiency to the market. However, this finding does not give PCX any inherent rights to access its competitors' markets.
- Section 11A(a)(C)(iv) states Congress' finding that it is in the public interest to assure "the practicability of brokers executing investors' orders in the best market." It is precisely for the policy reasons underlying this finding that we agreed to limit the need for a probe to Trade-At situations. In Trade-Through and Block Policy Trade-Through situations there are "best execution" concerns, and in weighing those concerns against the possible use of the OptiMark System as an order-routing device we were willing to forego the need for a probe. However, in Trade-At situations there are no best execution concerns. Investors can send their orders directly to the market with the best quote, and there are no NMS directives that confer upon P/O the right to use the OptiMark System and the PCX Application as a proprietary order routing vehicle to reach other competing markets.
- Finally, Section 11A(a)(1)(D) states Congress' finding promoting market linkages. As a charter member of ITS, we agree with that finding. However, in our negotiations P/O continually relied on that provision as a basis for providing the PCX with unfettered access to all other ITS Participants in any manner that the PCX chooses. P/O refuses to acknowledge that each SRO continues to be a membership organization competing with the other SRO's for order flow. Congress specifically rejected an NMS based on a "black

box" that would eliminate the concept of membership organizations competing for order flow. Rather, Congress decided that the NMS should be built on the existing foundation of competing SROs, with market linkages to enhance pricing and market efficiency.¹⁹

The P/O Letter also cites in support of its position a 1983 Commission release encouraging the development of automated commitment entry procedures for the NASD.²⁰ While we acknowledge the Commission's policy position favoring computer generation of ITS commitments, it is also clear that the Commission, from the inception of that policy position, has allowed the Participants to address the specifics of automated commitments and to resolve any access concerns this type of processing may present. The only Participant prior to the PCX to propose the use of computer generated commitments was the CSE, in 1986. The Participants negotiated acceptable Plan amendments to authorize the CSE to generate commitments automatically, which amendments included: Section 8(a)(v) providing for the computer generation of commitments, subject to the probing requirement; Section 6(a)(ii) describing how the CSE would generate ITS commitments (after first probing its market); and Section 8(e)(iv) establishing the CSE "formula." The Participants accomplished these difficult negotiations without direct involvement of the Commission. If P/O were to negotiate in good faith, we could resolve the OptiMark-related access issues as well.

J. P/O Continues to Impede Progress Towards a Negotiated Solution

Following the Commission's publication of the Release, we have continued discussions with OptiMark on a possible resolution of our differences. One possibility OptiMark raised regarded the use of the NYSE's SuperDOT system as a means to route OptiMark orders to the NYSE in lieu of ITS in Trade-At situations. We discussed certain issues raised by such a proposal, and OptiMark agreed to consider those issues and talk further on the matter. While OptiMark did raise technical questions regarding the use of SuperDOT, it never provided a substantive response to the proposals we raised. Indeed, only recently did they return our calls and e-mails and agree to continue meeting. Moreover, it was only through receipt of the P/O Letter that we learned that it believes the SuperDOT alternative is "impracticable". P/O failed even to send us a copy of its letter, which we ultimately found in the Commission's Public Reference Room.

While we have attempted to be flexible and raise new alternatives, P/O has not shown the same flexibility. While we have proposed limiting "probing" to those areas in which we have the greatest concerns, it refuses to consider any of our proposals. While we have expressed a

¹⁹ P/O fails to mention that a primary purpose behind Congress' adoption of the Securities Acts Amendments of 1975 (the "1975 Amendments"), which added Section 11A to the Exchange Act, was to eliminate inappropriate barriers to exchange membership that limited access to exchange markets. There currently are many ways for both members and non-members to access the NYSE market, including the use of the Exchange's SuperDOT system, which the Exchange adopted in direct response to Congressional concerns regarding access. As noted below, we have discussed the possibility of using SuperDOT as a way to route OptiMark orders to the NYSE.

²⁰ Release No. 34-19456 (January 27, 1983). The principal source of this Commission policy position is Release No. 34-18713 (May 17, 1982) adopting amendments to the ITS Plan to include the NASD as an ITS Participant.

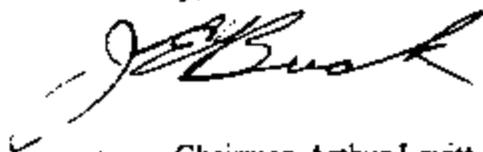
willingness to compromise on a formula, it now argues that no formula is needed.²¹ We continue to believe that a negotiated resolution is the best way to resolve the open issues. However, unless the Commission instructs P/O to conduct serious and good faith negotiations, we are not optimistic that we can be successful in that endeavor.

III. Conclusion

The P/O Letter adds nothing new to the discussion of possible ITS Plan amendments necessary to accommodate the OptiMark System and the PCX Application. P/O long argued that no Plan amendments are necessary. When that argument failed, it has argued for only the most minimal changes necessary to authorize its endeavor, without in any way addressing the legitimate access concerns of the majority of the ITS Participants. The only "contribution" of its current letter to the debate is raising the call market "red herring." For the reasons discussed, this argument is without merit.

Continuing this academic debate before the Commission will not resolve any of the issues. The best way to move forward is for the parties to meet and negotiate in good faith. Unfortunately, P/O has shown no inclination to do this. Based on our discussions with other ITS Participants, P/O's decision not to continue discussion may be based on a misperception that the Commission staff had already concluded that the PCX rule filing requiring the inclusion of specialist quotes in an OptiMark System Call would resolve the probing issue. Until the staff instructs P/O to negotiate, the current stalemate will continue. We urge the staff to inform P/O that the most appropriate way to move forward is through a negotiated settlement and not through Commission rule-making. We stand ready to continue our discussions with P/O as soon as the parties are willing to return to the negotiating table.

Sincerely,



cc: Chairman Arthur Levitt
Commissioner Norman S. Johnson
Commissioner Isaac C. Hunt, Jr.
Commissioner Paul R. Carey
Commissioner Laura S. Unger
Mr. Richard R. Lindsey, Director, Division of Market Regulation
Mr. Robert L. D. Colby, Associate Director, Division of Market Regulation
ITS Operating Committee

²¹ Similarly, P/O now offers "to provide relevant information for review by the Commission and other ITS participants during the initial stage of operation" as a means to address our access concerns. This again is a significant step backwards from P/O's commitment in our negotiations (as codified in Section 8(h)(v) of the ITS Plan amendments that P/O included in its petition) to provide monthly statistics on access-related matters on an on-going basis, not just "during the initial stage of operation."