Information Circular IC 03-11

Date: January 29, 2003

To: CBOE Members

From: Bill Brodsky
Mark Duffy
Ed Joyce

RE: SEC Letter On Payment For Order Flow And Internalization

On January 24, 2003, the Exchange received a letter from SEC Chairman Harvey Pitt regarding payment for order flow and internalization practices in the options industry. We understand that the SEC sent the same letter to the other options exchanges. In the letter Chairman Pitt expresses his concern that payment for order flow and internalization create serious conflicts of interest that can compromise the attainment of best execution. He asks the options exchanges to eliminate exchange-sponsored payment for order flow programs (or, in CBOE's case, not to reinstate it) and any exchange rules that guarantee members the right to internalize some proportion of their customers' order flow. In light of the existence of these programs and rules, he also asks that CBOE explain how it monitors for, and evaluates whether, its members are satisfying their best execution obligations. He suggests that options exchanges' payment and internalization rules may compromise their ability to enforce best execution and asks for our view on whether the NASD should assume best execution examinations for options members. Finally, Chairman Pitt asks for our views on any structural changes to the options markets that would address the impact of internalization and payment for order flow on aggressive quote competition.

We are pleased that the SEC has begun to address payment and internalization; and the Exchange continues to make clear its willingness to work with the SEC on resolving these matters. While the Chairman's January 24th letter is a promising start, we urge the SEC to go one step further and ban all payment for order flow, not just so-called "exchange sponsored" payment for order flow programs.

Attached is CBOE's initial response letter to Chairman Pitt, which will precede a more detailed report to the Commission shortly.