Information Circular IC03-22
February 14, 2003

To all CBOE Members:

This week CBOE sent two important letters to the SEC: 1.) CBOE's response to SEC Chairman Harvey Pitt's letter of January 24, 2003 regarding payment for order flow (PFOF), internalization and whether the NASD should assume examination responsibility for best execution for options, and 2.) CBOE's comment letter regarding a rule filing submitted by the Boston Stock Exchange to operate an electronic options exchange called BOX (Boston Options Exchange). The letters are summarized below; copies of the complete text of each are available in the member's lounge and on the CBOE website.

CBOE has pressed the SEC for several years to address comprehensively the issue of PFOF; additionally, we have lobbied Congress to look into this matter. Our response letter to Chairman Pitt reiterates CBOE's position that the SEC should ban PFOF entirely from the options markets, and implores the Chairman to refrain from halfway actions that would do more harm than good, such as solely eliminating exchange-sponsored programs.

CBOE's letter also addresses the SEC's long held belief that a ban on PFOF would cause increased internalization, which could then raise additional regulatory concerns. Our letter states that CBOE would consider revising its rules that guarantee the rights of firms to internalize order flow, as Chairman Pitt suggested. Such revisions would still permit firms to internalize some portion of their customers' order flow, but *only* after exposing those orders to a meaningful opportunity for price improvement. We also urge that the SEC ensure that internalization rules are uniformly applied by all options exchanges.

Our letter rejects the SEC's suggestion that our compliance responsibilities in this area be transferred to the NASD. CBOE has made clear to the SEC its longstanding concerns with PFOF and internalization, and we have devoted substantial resources to our Best Execution Assurance Program. Moreover, transferring the examining authority to the NASD (or any other entity) does not address the potential conflicts of interest inherent in PFOF and internalization; the practices themselves must be addressed with a cogent plan that is uniformly enforced at all options exchanges.

CBOE's comment letter on the BOX exchange expresses our serious concerns with the proposed structure of the BOX and with the fact that the rule filing would permit the proposed exchange to operate, virtually unimpeded, as an internalization mechanism. This structure, by allowing order providers to avoid exposing their customers' orders to meaningful price discovery, would serve the interests of professionals, not those of the customer. CBOE argues vigorously that if allowed, the proposed exchange would fragment and undermine the entire options marketplace.

As always, I welcome your thoughts and comments. You will be advised of any important developments.

Sincerely,

Bill