April 16, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities & Exchange Commission
450 5th St NW
Washington, DC 20549

Re: Competitive Developments in the Options Markets: File No. S7-07-04

Dear Mr. Katz:

CBOE welcomes the opportunity to submit this comment letter in response to the Commission's concept release entitled "Competitive Developments in the Options Markets" ("Release").

The competitive landscape of the options industry has changed drastically over the past several years. Competition has increased and, as a result, so has the number of marketplace innovations. For instance, CBOE was the first floor-based options exchange to disseminate dynamic quotes with size. Most recently, CBOE introduced its Hybrid Trading System, which, as the Commission notes in its Release, greatly expanded the amount of intra-exchange competition, which in turn resulted in a "dramatic narrowing of quoted and effective spreads." Concurrent with CBOE's marketplace innovations, the Commission implemented numerous regulatory changes designed to strengthen the integrity of the markets, including, but not limited to: the introduction and application of a firm quote rule to options; application of Rule 11Ac1-6 (disclosure of order routing information) to options transactions; and the development of an intermarket linkage system. Underpinning the adoption of each of these enhancements by the Commission was the desire to strengthen the competitiveness and integrity of the options markets and to enhance fair treatment and best execution of customer orders. Unfortunately, payment for order flow ("PFOF") and certain types of internalization are muting the desired effects of the SEC's recent regulatory initiatives and run counter to SEC's efforts to attack conflicts of interest in the securities industry that may harm investors.

Since January 2000, CBOE has expressed its concerns with payment for order flow to the Commission and has urged the Commission to prohibit it in the options marketplace. PFOF raises serious conflicts of interest that can compromise a broker's fiduciary obligation to achieve best execution of its customers' orders, while at the same time it creates strong disincentives for all market participants to quote competitively. The same kind of conflicts may also arise with respect to internalization, since whenever a broker seeks to cross a customer's order that it represents as agent without first exposing that order for meaningful price discovery, there is a risk that the broker's self-interest may conflict with the interests of the customer. If the broker internalizes a portion of the customer's order as principal without adequate market exposure, the conflict results from the fact that an advantageous price to the broker is less likely to be attractive to the customer.

Over the past year the Commission has been vigilant in communicating a strong message to the securities industry: practices that create fundamental conflicts of interest between a broker's fiduciary duty of best execution to its customers and its own self-interest (e.g., directed brokerage, analyst

"independence" or mutual fund breakpoints[1]), not only jeopardize specific investor transactions, but also undermine public confidence in the integrity of the markets as a whole, and thus will be dealt with severely by the Commission. Payment for order flow and certain forms of internalization likewise create fundamental conflicts of interest, contribute to a degradation of quote quality, and are no less harmful to investors than other practices under attack by the Commission. It is time for the Commission to take appropriate steps to eliminate these conflicts by banning all forms of PFOF and limiting certain forms of internalization in the options markets.

Below is an executive summary of CBOE's responses to each of the issues raised in the Release. A detailed response to all of the questions posed in the Release is attached as Exhibit A. If CBOE may be of further assistance in this matter, please do not hesitate to contact the undersigned. We look forward to continuing to work actively with the Commission to address these profound and complex issues.

Sincerely,

William J. Brodsky
Chairman and Chief Executive Officer

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

[1] *See, e.g.*, Chairman Arthur Levitt, "Best Execution: Promise of Integrity, Guardian of Competition," Speech before the Securities Industry Association, November 4, 1999; Letter from Chairman Harvey L. Pitt, January 24, 2003; Annette L. Nazareth, Remarks Before the 2002 Options Industry Conference, May 3, 2002; Elizabeth King, Remarks at 2003 Options Industry Conference, April 25, 2003. *See also* Commissioner Cynthia A. Glassman, Remarks at the SIA Compliance & Legal Division's 35th Annual Seminar, March 23, 2004 (discussing conflicts of interest as at the heart of current industry scandals); and *see also*, Chairman William Donaldson's remarks given during his testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (April 8, 2004) in which he discussed conflicts of interests in the mutual fund industry in that the use of broker commissions to compensate broker-dealers for distribution of a fund's shares "potentially compromises the best execution of a fund's portfolio trades, increases portfolio turnover, and corrupts broker-dealers' recommendations to their customers."

Executive Summary of
Chicago Board Options Exchange's
Responses to SEC Concept Release
"Competitive Developments in the Options Markets"

Payment for Order Flow

1. In a world where PFOF does not exist, order routing considerations are generally based on important factors that are designed to benefit the execution of orders for customers, such as price, speed of execution, and execution quality. The entry of PFOF into the mix changes the order routing considerations from these customer-based factors to a factor designed to benefit customers' brokers, with the result that order flow may be routed in large part based on which specialist pays the most for the order.

2. The routing of orders based on PFOF serves as a disincentive for all market participants, whether they won or lost the payment arrangement, to quote competitively. Moreover, it imposes one more cost on market participants, which also is not conducive to narrower quote spreads.

3. PFOF is inconsistent with the basic concepts of agency law and creates fundamental conflicts of interest between a broker's duty of best execution and its own self-interest. Such conflicts not only jeopardize specific investor transactions, but also undermine public confidence in the integrity of the markets as a whole.

4. There is no practical difference between cash payment and non-cash payment as both present the exact same conflicts. Moreover, the difficulty, if not inability, to effectively value all non-cash payment is one more reason why all forms of PFOF should be abolished.

5. Exchange-sponsored and non-exchange sponsored forms of PFOF (to the extent there is any validity to the distinction – a proposition with which we take issue) raise the exact same conflicts of interest and both should be eliminated completely from the marketplace. The Phlx's assertion that non-exchange sponsored PFOF is an acceptable practice is nothing more than a thinly veiled attempt to garner order flow at the expense of those exchanges that offer significant intramarket competition. Differentiating between exchange and non-exchange sponsored PFOF would also create unequal regulation and actually amplify the harmful effect of payment for order flow.

6. Reliance on decimalization to eliminate PFOF is not the answer and instead raises significant issues that make the cure worse than the disease (i.e., quote capacity concerns as described below under section entitled "Decimal Quoting"). The only way to eliminate PFOF is through direct prohibition of all types (soft and hard dollars) and forms (exchange- and non-exchange sponsored) of PFOF.

Internalization

1. Internalization in the options markets originally began as a means for firms to provide supplemental liquidity for larger orders so that they might obtain a better price for such orders.

2. Today, internalization increasingly occurs at prices where there is already sufficient liquidity in the marketplace to execute customer orders and at price points that do not improve upon existing

quotes by a meaningful amount. In these instances, the firm's participation does not add to (and in the long-term may actually detract from) the price discovery process.

3. Firms seeking to "participate" in the execution of their customer orders may direct those orders to an exchange where the firm has the greatest likelihood of maximizing its participation (i.e., the "path of least resistance"). This practice can deny the customer order a more meaningful chance at price improvement because it usually involves the exchange least likely to offer price improvement. In those cases where price improvement might be available elsewhere, brokers are cognizant that a better price for the customer necessarily is a less favorable price for it, which could lead some firms to avoid price discovery (and hence potential price improvement) rather than seek it.

4. This conflict of interest is only muted when a firm provides the order with meaningful exposure and opportunity for price improvement before trading against it at a price point in which no other market participants have an interest (i.e. a price where, otherwise, there would be insufficient liquidity) or at a price point that is superior to a trading crowd's original market (i.e. where the firm initiated meaningful price improvement for the customer).

5. Widespread internalization that does not provide meaningful price improvement for customers likely results in degradation of market quality and less favorable executions for all orders. If firms increasingly see internalization as a profit center and seek ways to participate in the most favorable orders, market makers are denied an opportunity to interact with a representative segment of order flow, which could cause them to cease making markets or widen spreads to accommodate this increased trading risk.

6. The SEC should reinforce the best execution obligations of firms internalizing customer orders, require meaningful order exposure, and provide guidance to exchanges and firms on enforcement against shopping orders to find the exchange with the "path of least resistance."

Specialist Guarantees

1. CBOE's current "specialist guarantee" rules enhance competition and allow it to attract and retain well-capitalized DPMs.

2. The current "specialist guarantee" percentages strike an effective competitive balance between the need to attract and retain well-capitalized specialists while at the same time helping to preserve intramarket competition by leaving non-specialists a significant portion of an order for which they may compete.

Extension of Commission Rule 11Ac1-5 (reports that measure order execution quality) to the Options Markets

1. CBOE believes that both the approach and the data elements contained in Rule 11Ac1-5 are unsuitable for options. There are scores of series for each options class, which would result in enormous amounts of data for options. That, in turn, would impose an enormous data collection and processing obligation upon the exchanges that would dwarf that of the equity markets.

2. If, however, order flow firms strongly recommend that Rule 11Ac1-5 extend to options, then any resulting proposal would need to be tailored to the unique characteristics of options.

Decimal Quoting

1. CBOE is skeptical that penny quoting alone would eliminate the problems of payment for order flow or have the same spread-reducing impact as in the equities markets. Even if this were to be the case, a conversion to penny pricing could cause significant disruptions to the options markets that might far outweigh any possible benefits. With penny pricing, each change in the price of the underlying could generate literally thousands of new option quotes being sent to OPRA for dissemination.

2. The cost to expand OPRA's market data system and network to handle the huge number of options quotes would be substantial and would have to be borne by the options exchanges and, ultimately, by their members. Similarly, most broker-dealers would have to expand their own systems to be able to accommodate the huge volume of quotation messages that OPRA would be sending.

3. The potential for penny jumping and other dislocations from penny pricing would be exacerbated in the options markets because liquidity is spread over numerous series per option class. If the SEC were to move to penny pricing in the options markets, it must first address difficult issues of cost, competition, effect on transparency, and market practices.

Extension of the Commission Limit Order Display Rule to Options Markets

CBOE currently requires its members to comply with the requirements of the Limit Order Display Rule. To the extent this obligation is not uniform across all exchanges, it should be.

SRO Oversight for Best Execution

1. CBOE does not believe its status as a self-regulatory organization and its interest in maximizing order flow to the exchange impacts in any way its ability or determination to carry out fully its regulatory responsibilities. To the contrary, CBOE has continually taken steps to enhance its best execution oversight.

2. CBOE believes it is imperative for there to be uniform and equal regulation of best execution practices among all of the options exchanges to avoid regulatory forum shopping.