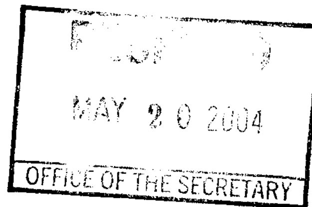

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6

May 20, 2004

By FEDEX and Fax to (202) 942-9651

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

Re: SR-PHLX 2003-75

Dear Mr. Katz:

The Chicago Board Options Exchange ("CBOE") appreciates the opportunity to provide the following points to follow-up upon PHLX Rule filing SR-PHLX-2003-75 (also referred to herein as the "STU proposal"), and expand upon the recent phone conversation on this subject that senior Commission staff members held with senior CBOE Officials including CBOE Vice Chairman Ed. Tilly and General Counsel Joanne Moffic-Silver.

For the reasons set forth below, we continue to believe the proposal should not be approved. If however, the SEC is inclined to approve it in some form, we urge the Commission to at least require the amendments set forth in #4 below.

1. Firms will not necessarily provide quicker or more efficient options executions for their customers by "tying" such orders to stock.

Supporters of PHLX 2003-75 are not accurate in claiming that "stock tied up orders" ("STU orders") will allow quicker and more efficient executions of customer orders.

Actually, the STU order procedure will often have exactly the opposite effect by allowing firms to take a straightforward options order and slow it down by "tying" it to a stock hedge.

In many cases, slowing down an options order to allow the executing firm to hedge it with stock will only benefit the executing firm. Hedging the order does make it more attractive for some other segment of the market, whom the firm may be able to solicit to take the other side of the transaction. In this way, the STU procedure enables the firm to

collect commissions on both sides of the transaction, from their original customer as well as from the solicited parties interested in the hedged order. However, the delay to hedge does not serve the firm's original customer, who may simply want their options order filled as soon as possible.

Many such "tied up" orders could be executed more rapidly by simply bringing them to a genuinely competitive options exchange (*i.e.*, an exchange with enough participants to provide competitive liquidity, not just an exchange used to effect crosses). Often, these liquidity providers have the experience and tools to hedge more efficiently without having to delay the execution.

2. ***Stock Tied Up Orders Will Promote Greater Internalization to the Disservice of Both Customers and Market Professionals.***

The interests of public customers, and the marketplace as a whole, will always be best served by rules that promote competitive, two-sided, firm, liquid markets that are accessible by **all** market participants. SR-PHLX-2003-75, by contrast, is fundamentally anti-competitive because it proposes a ***classic*** example of internalization: one market participant at one firm gets to 1) set the price for his customer, 2) execute his hedge (and in the process tying up stock that other market participants might have used to hedge a better offer), and 3) only then present it to the rest of the marketplace as a *fait accompli* that others can participate in or ignore, but not really change. This is a brazen move away from transparent and competitive markets.

Because PHLX's proposal relies on internalization, even if other more competitive SROs copycat PHLX 2003-75, the stock tied up orders will always gravitate toward the shallowest, least competitive liquidity pools (where such orders will be sent ***precisely because*** there they will encounter the ***least competitive resistance***), resulting in order routing decisions that in and of themselves will harm the customer and those who seek to offer competitive markets.

Increasing internalization also harms the marketplace for trading floor professionals, who will increasingly find it more profitable to 'go upstairs' and trade from off of the floor with the internalizers. As the trend toward internalization accelerates with approval of proposals like SR-PHLX-2003-75, the depth and liquidity needed for truly competitive markets will inevitably be eroded.

3. ***SR-PHLX-2003-75 is far too vague to protect customers and the marketplace.***

Numerous key provisions of the SR-PHLX-2003-75 are unenforceably vague as currently drafted.

For example, SR-PHLX 2003-75 specifies that the hedging stock order must be "transacted promptly upon receipt of the option order and, if brought to [PHLX], [be] brought without undue delay to the crowd."

Given the substantial discretion that the STU proposal grants firms to tie an order to stock, why shouldn't the firms' performance in executing such hedges be subject to specific standards. How will "promptness" be monitored and ensured by PHLX – the PHLX filing offers no such assurances, but they should be required to do so.

The STU proposal also needs much greater specificity in terms of defining how it will be determined and enforced that "the hedging stock position does not exceed the options order on a delta basis." Unless the STU proposal contains a fairly specific method for calculating the "deltas" of an option order,[1] which in turn defines how much stock is required to hedge that order, firms will be free to define for themselves when they have completed the hedge and are ready to bring the STU order to the options trading floor. Thus, unless the PHLX specifies a methodology for determining deltas with some precision, firms executing STU orders will be able to scalp in and out of partial stock hedges, earning profits for themselves without bringing their customers options orders to the floor. In this way, the firms would be given great potential to unfairly profit based upon nonpublic knowledge of their customers' option orders, with no obligation to share any of those gains with the customers.

4. ***This proposal should not be approved, but if the SEC is inclined to do so, the Commission should first insist upon significant amendments.***

This proposal should be disapproved because it abandons well-established prohibitions on anticipatory hedging that have long safeguarded the fairness of the options marketplace. However, if the SEC nevertheless decides to approve such a filing, it should insist on at least the following amendments to increase the fairness of the STU proposal for all market participants:

a. First and foremost, the SEC should prohibit firms from "tying up" an options order with stock whenever the order can be satisfied on the displayed National Best Bid and Offer (NBBO). A firm would violate its fiduciary obligations by delaying the execution of an immediately fillable customer order simply to enable the firm to participate as principal in the transaction.

b. For very similar reasons, the Commission should consider whether to limit the tied up procedure only to significantly larger than average option orders (for instance, 1,000 option contracts or more). Smaller orders, even if they cannot be immediately filled at the NBBO, can almost always be executed more

[1] For a more detailed discussion of deltas, see Securities Exchange Act Release No. 48875 (SR-PHLX-2003-75), 68 F.R. 70072, 70074 n. 6; and January 14, 2004 Joyce (CBOE) Letter to Katz re: SR-PHLX-2003-75 at 3 nn. 3-5 and accompanying text.

quickly by sending a regular order to an options crowd than by tying up such an order with stock.

c. Because of the potential for delay and conflict of interest between the customer's interest in a fast fill and the firm's interest in getting an additional commission on the other side of the transaction, all firms wishing to use the STU procedure should be required to first obtain informed consent from customers before they "tie up" any of their orders with stock, after informing the customers in detail that this procedure could change the nature of their order and delay how the order is executed.

d. In addition, the firms should always be required to "stop" their customers (*i.e.*, guarantee them a "fill" on their order) at the NBBO price for the quantity of options that were available to fill the customer's original order at the time that the firm began executing the order as a "STU" order. This will help protect customers from inferior fills through the STU procedure, and also give their firms a strong incentive to execute any stock hedges as rapidly as possible.

e. PHLX should be required to define and quantify "promptly," "undue delay" and how deltas for such orders will be calculated and monitored by the firms and the PHLX.

f. Again because of due diligence and conflict of interest concerns, the executing firms should be required to share any profits they make trading in and out of partial fills of the stock hedge with the customer whose options order is being tied-up with that stock, particularly when a STU order is not fully executed due to delay in completing the hedge.

g. Even with all the above, the STU procedure for PHLX and any other exchanges that copy the proposal should be authorized only as a temporary pilot that is subjected to further review based on experience and further SEC action on the subject of internalization.

For all the foregoing reasons, the CBOE again urges the Commission not to approve this proposal.

If you would like to discuss this letter, or have any related questions or comments, please call Joanne Moffic-Silver at (312) 786-7462 or the undersigned at (312) 786-7310.

Sincerely,

Edward J. Joyce
President and Chief Operating Officer

CC: Annette Nazareth
Robert Colby
Elizabeth King