April 13, 2004

BY E-MAIL AND CERTIFIED MAIL

Mr. Jonathan G. Katz
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

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

Dear Mr. Katz:

The Board of Trade of the City of Chicago, Inc. ("CBOT®" or "Exchange") appreciates the opportunity to comment upon the Securities and Exchange Commission's ("Commission") Concept Release: "Competitive Developments in the Options Markets" published in the Federal Register on February 3, 2004.

In particular, the CBOT wishes to express its views regarding payment for order flow and internalization. These two methods of inducing brokers to direct customer orders to a particular exchange puts the brokers in an inherently conflicted position vis-à-vis their customers. Obviously, the goal should always be to ensure, insofar as possible, that the customer receives the best available price on each transaction. Payment for order flow or internalization programs can obstruct the achievement of that goal since it can put a broker in a situation where it is forced to choose between maximizing the profit it derives from its customer order (either through direct payments from a particular exchange or by being able to take the other side of the customer order) or complying with its best execution obligation. For this reason, the CBOT believes that it would be in the best interests of the investing public for the SEC to prohibit such programs.

I note that the CBOT is not alone in its belief that these types of trade inducements are incompatible with the fiduciary obligations that a broker has for its customers' orders. Former SEC Chairman Arthur Levitt first expressed concern about the practice in 1999, when he said, "I worry that best execution may be compromised by

payment for order flow, internalization and certain other practices that can present conflicts between the interests of brokers and their customers."[1]

In July of 2000, SEC staff undertook a study of the then current payment for order flow and internalization practices and the impact that such practices had on order routing decisions and the execution quality of customer options orders.[2] The Commission staff concluded that:

> [P]ayment for order flow and internalization create conflicts of interest for brokers because of the tension between the firms' interests in maximizing payment for order flow or trading profits generated from internalizing their customers' orders, and their fiduciary obligation to route their customers' orders to the best markets. The revenue generated from payment for order flow and internalization have the potential, as seen in the equity markets, to be partly passed on to investors in the form of reduced costs. To date, however, few firms are passing along the benefits of payment for options order flow to their customers in the form of either reduced commissions or rebates.[3]

More recently, former Chairman Harvey Pitt sent a letter to each of the options exchanges on January 24, 2003, in which he expressed his concern that internalization by member firms, along with payment for order flow, could create serious conflicts of interest that could compromise the firms' fiduciary obligation to obtain best execution of their customers' orders.[4] In those letters, he also stated his belief that all of the options markets should eliminate the programs and rules that encourage or permit these practices.

In responding to Chairman Pitt's letter, both the Philadelphia Stock Exchange and the Chicago Board Options Exchange requested that the Commission ban payment for

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[1] Speech by Arthur Levitt, Chairman, SEC, to Securities Industry Association (November 4, 1999).

[2] Office of Compliance Inspections and Examinations and Office of Economic Analysis, SEC, "Special Study: Payment for Order Flow and Internalization in the Options Markets" (December, 2000) ("SEC Staff Special Study").

[3] SEC Staff Special Study at 4.

[4] *E.g.* Letter from Harvey Pitt, Chairman, SEC, to Meyer Frucher, Chairman, Phlx (Jan. 24, 2003).

order flow programs.[5] Both exchanges argued that all such programs are inappropriate for options markets, whether exchange-sponsored or not.

As all of these commentators have observed, payment for order flow and internalization programs create the appearance that a broker is routing an order to a particular venue not because that order will receive the best price there, but rather because the broker will generate the most revenue. Moreover, as the SEC staff noted, the brokers appear to using the revenue from these programs to enhance their own bottom line, instead of rebating the revenue to their customers or lowering their commission rates.[6] Thus, the allegations of self-dealing appear to be grounded in fact.

An even more troubling aspect of these types of inducements is that they impair the functions of the marketplace. The primary responsibilities of an exchange are to gather a pool of liquidity in one place, to allow that liquidity to yield broad and accurate price discovery and to distribute those prices back to market participants. These exchange functions combine to provide market transparency. Transparency for all market participants ensures that all orders are exposed to competing market makers, whose competition for the order will make certain that every order is bought or sold at the best possible price. This, in turn, vests investors with the confidence necessary to enable them to commit their capital to the marketplace. In effect, transparency ensures strong, viable and fair marketplaces.

Internalization of orders – and to a lesser degree payment for order flow programs – are incompatible with continued market transparency because they disrupt the functions of the marketplace. In marketplaces that permit these practices, brokers are presented with three choices of execution. First, the broker can fill the order himself instead of submitting it to the market for execution. Second, the broker can direct the order to the exchange that will pay him the highest price for the order flow, even if that market does not provide the best bid or offer. Finally, the broker can route the order to the exchange

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[5] Phlx Petition for Rulemaking, Options Exchange Payment for Order Flow Programs (Feb. 3, 2003); Letter from William J. Brodsky, Chairman and CEO, CBOE, to Harvey Pitt, Chairman, SEC, (Feb. 10, 2003).

[6] In contrast to the payment for order flow programs discussed in the Concept Release, the CBOT has a tiered pricing structure for its transactions fees that promotes the passing of the transaction fee volume discounts from the intermediary to the actual customer. In our program, the discount applicable to customer orders is based on the number of transactions executed for each customer's account as opposed to the aggregate volume executed by the intermediary on the Exchange. As a result of that transparent discount method, our customers are able to calculate the amount of the discount that is attributable to their own trading and to compel their brokers to pass the discounts through to them, either in the form of discounted future commissions or rebates on past commissions already paid.

that will provide the best price. While this is obviously the best choice, and the one that is most consistent with the broker's best execution obligation, it may result in the broker's generating less revenue from his customers' orders than if he elected either of the first two options.

It is important to emphasize that the first two alternatives would not exist in a truly transparent marketplace. The decision to profit at the customers' expense rarely presents itself in a transparent marketplace because the self-serving behavior is immediately exposed.

In addition to undermining complete market transparency, internalization also weakens the price discovery function of an exchange since it permits a substantial number of orders to be executed out of sight. Moreover, internalization deprives the market of liquidity, making those regulated public markets less efficient and effective for all market users. Above all else, internalization and payment for order flow programs tend to direct trading activity into the hands of a few powerful market participants motivated by significant self-interest. Such practices discourage the broad participation that the marketplaces should foster, as many potential investors decide that they are disadvantaged by trading on exchanges that support these inherently unfair practices.

Internalization and payment for order flow are not permitted at the Chicago Board of Trade. The CBOT's prime mission is ensuring that every order is exposed to the entire marketplace so that it derives the benefit of real price competition. For the CBOT, transparency has been the foundation of our existence since our founding more than 155 years ago. Market participants come to the CBOT's centralized pool of liquidity to assess the market and determine the best price, based on bids and offers that are posted for all to see. Our transparent markets make price discovery faster and more efficient, simply because there is no smoke or mirrors to obscure the real price of our products. To allow internalization and payment for order flow practices is to replace time-tested transparency with conflicts of interest. Investors' confidence in the fairness of our markets is crucial to the success of those markets, and anything that undermines that fairness should not be permitted in either the futures markets or the options markets. Accordingly, the Commission should bar all payment for order flow and internalization programs in the Options Markets.

In addition to the conflict that these programs pose for brokers, economic inducements to order flow providers create at least an apparent conflict for the exchange that sponsors or promotes the program while at the same time being charged with ensuring that the brokers that avail themselves of the programs are still complying with their best execution obligations. These programs can be seen as providing a disincentive for the exchange in its capacity as a self-regulatory organization to police its members in complying with those obligations. Even if these perceptions are not valid, investors may nonetheless decline to participate in these markets because of their understandable concerns about fairness. If that were to happen, it would be a dramatic blow to the value

that equity options provide in spreading risk broadly across participants in the equity markets.

The difficult policy issues surrounding payment for order flow and internalization are important to the commodity futures industry as well as to the securities industry. The CBOT appreciates this opportunity to provide its comments to the Commission with regard to these issues.

Sincerely,

Bernard W. Dan