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VIA ELECTRONIC DELIVERY

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

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

Dear Mr. Katz:

The Chicago Mercantile Exchange Inc. ("CME") welcomes the opportunity to comment on the Securities and Exchange Commission's (the "Commission" or "SEC") Concept Release: "Competitive Developments in the Options Markets" (the "Release"). CME is the only publicly traded financial exchange in the United States. It invented financial futures contracts more than 30 years ago and is currently the largest futures exchange in the United States and the largest derivatives clearing organization in the world. CME is also notice-registered with the SEC as a special purpose national securities exchange solely for the purpose of trading security futures products.

CME embraces the principle that financial market regulation should promote competitiveness, and that exchanges should be permitted to compete for order flow on terms that do not harm or discriminate against market users. As discussed more fully below, we believe that the Commission should ban payment for order flow programs (including indirect payments in the form of permitting brokers to internalize all or a portion of customer orders), to the extent that such programs are likely to influence the broker's placement of customer orders.[1]

[1] The Commission has defined payment for order flow as "any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer's unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or

The SEC and its staff have long been critical of payment for order flow programs. For example, in November 1999, SEC Chairman Arthur Levitt stated at a Securities Industry Association Conference: "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."[2] In July of 2000, Chairman Levitt directed the SEC staff to prepare a report describing current payment for order flow and internalization practices, and outlining how the practices have affected order routing decisions and the execution quality of customer options orders.[3] The Commission staff found 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*.[4]

In January, 2003, former SEC Chairman Harvey Pitt sent a letter to the five U.S. options exchanges, urging them voluntarily to abolish exchange-sponsored plans that encourage payment for order flow and internalization. In the letter to the exchanges, Chairman Pitt stated:

> I am seriously concerned that economic inducements to order-flow providers and internalization by member firms create serious conflicts of interest that can compromise a broker's fiduciary obligation to achieve best execution of its

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dealer routing a customer order that exceeds that fee, expense or financial obligation." 17 CFR 240.10b-10(d)(9). CME does not believe that traditional volume discounts, rebates or similar incentive programs that reduce exchange-related fees are within the definition of Section 10b-10(d)(9) or that such programs should be banned. Rather, such programs, as employed by many companies across many industries, are an appropriate competitive response to marketplace demands that do not violate or implicate statutory or common law duties.

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

[3] See 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).

[4] Id. at 4.

customer orders.[5]

In response to Chairman Pitt's letter, the Philadelphia Stock Exchange ("Phlx"), on February 4, 2003, petitioned the SEC to ban exchange-sponsored payment for order flow programs. In its rulemaking petition, Phlx stated that it "strongly agree[s] with Chairman Pitt that exchange-sponsored payment for order flow programs are deleterious to the options markets," and that the practice has "put unfair burdens on market makers and place exchanges . . . in the uncomfortable position of administering payment arrangements between specialists and order flow providers."[6] Shortly thereafter, on February 7, 2003, Phlx submitted a letter to former Chairman Pitt requesting the SEC establish "clear and consistent guidelines for the practice of internalization in the options markets."[7]

As the Commission, its staff and many commentators have noted, a broker that routes customer orders to secure benefits for itself creates an appearance that the broker is compromising the interests of its customers. Even if the broker could demonstrate that the market to which it routed the order was equal in every respect to the market that did not pay, the broker has nonetheless accepted payment that more properly belongs to its customers. The broker is behaving like a corporate executive who takes a side payment from a third party when his employer enters into a transaction with that party. The executive is a fiduciary for the shareholders and the payment belongs to them. In this case, the broker is acting as an agent for its customer, who is paying a commission to fully compensate the broker for his services. The customer is entitled to all of the benefits of the transaction, including the discounted execution

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[5] Letter from Harvey Pitt, Chairman, SEC, to Meyer Frucher, Chairman, Phlx (Jan. 24, 2003). See also, Anne Nazareth, Director of Market Regulation, SEC, Remarks before the 2002 Options Industry Conference (May 3, 2002) ("Permitting a firm to internalize its customers' orders is merely a less overt way than payment for order flow to attract order flow to an exchange on a basis other than competitive pricing. Exchanges invariably claim that they need to permit their members to internalize an ever-growing proportion of their order flow to compete with other exchanges. While I understand the competitive pressures, my concern is that exchange proposals—which are efforts to compete for order flow with other exchanges—could potentially reduce competition based on prices").

[6] See Phlx Petition for Rulemaking, Options Exchange Payment for Order Flow Programs (Feb. 3, 2003). In response to Chairman Pitt's letter, the Chicago Board Options Exchange also requested the Commission to "ban [payment for order flow] of all types in the options market." See Letter from William J. Brodsky, Chairman and CEO, CBOE, to Harvey Pitt, Chairman, SEC, (Feb. 10, 2003).

[7] See Letter from Meyer Frucher, Chairman, Phlx, to Harvey Pitt, Chairman, SEC, (Feb. 7, 2003).

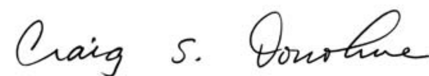
[8] Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments, at Study V, p. 1 (1994); see also, NASD Conduct Rules, Rule 2320 ("[A] member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.").

fee implicit in the payment for order flow.

The Commission has recently taken significant steps to alleviate conflicts of interest by equity analysts, corporate officers and directors, and others, all to the benefit of investors. For the same reasons, the Commission should now act to eliminate the conflicts of interest created by payment for order flow programs involving customer orders.

Thank you for the opportunity to comment upon the proposed rule change. If you have any questions or comments, please do not hesitate to contact me or Matthew F. Kluchenek, Director and Associate General Counsel, at (312) 338-2861.

Respectfully submitted,



Craig S. Donohue
Chief Executive Officer

cc: Hon. James E. Newsome, Chairman of the CFTC
Hon. Walter Lukken, Commissioner of the CFTC
Hon. Sharon Brown-Hruska, Commissioner of the CFTC
Mr. Patrick McCarty, General Counsel, CFTC
Mr. Michael Gorham, Director of Market Oversight, CFTC

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[9] A plethora of SEC rules govern the disclosure obligations of broker-dealers. See e.g., Rule 10b-10 of the Act, which requires broker-dealers to disclose on confirmations whether they received payments for order flow, and that the source and nature of the compensation will be provided upon request; Rule 11Ac1-3 of the Act, which requires broker-dealers to disclose for each new account and annually thereafter on an annual account statement, the broker-dealers' policies regarding receipt of payments for order flow, including a detailed description of the nature of the compensation received and information about their order routing policies, including whether orders can be executed at prices superior to the best bid and offer; and Rule 11Ac1-6 of the Act, which requires broker-dealers to make publicly available a quarterly report regarding their routing of orders for execution.

[10] Concept Release at 13 (emphasis added).

[11] See Phlx Petition for Rulemaking, Options Exchange Payment for Order Flow Programs (Feb. 3, 2003).

[12] Comment Letter, AMEX, in response to the SEC request for comment on Concept Release #34-42208, "Regulation of Market Information Fees and Revenue" (May 16, 2000).