Responses to SEC release, File No. S7-07-04: Competitive Developments in the Option Markets; April 12, 2004

Question 1. All things being equal, payment for order flow (PFOF) widens a specialist's and a market maker's spreads, therefore decreasing the incentive to quote aggressively.

a. Presently, I quote at the CBOE on Hybrid. I use Actant software, which allows me to set my market spreads and minimum profit needed to execute a trade. I trade in the Merck pit. Recently, I have heard rumors that our exchange may consider forcing the entire floor to PFOF. I immediately spoke with a CBOE official and told him that if I were forced to PFOF by the exchange it would affect my minimum profit needed to execute a trade. This means I would need more profit per trade to cover this new expense. Therefore, if my minimum profit were set at $.02 without PFOF I would need to increase it to $.0255 or $.03 with PFOF. My market spreads would increase. As an example: since the city of Chicago has a higher tax on gasoline than the western suburbs, which location sells gas more cheaply? The obvious answer is the suburbs. Both locations purchase the basic commodity wholesale at the same price, but the Chicago location sells the gas at a higher price to cover the tax. Therefore, the tax increases the spread in the Chicago location. I concluded my conversation with the CBOE official by telling him that if I am forced to PFOF, I will have to increase my minimum spread and, therefore, adversely affect all customers, especially those that DO NOT accept PFOF. Not only will this impact the customer's price, it may even do significantly more damage. If the customer is 1.05 bid and my computer is calculating a value of 1.03 with .02 minimum profit necessary to execute the trade and there is no PFOF, the customer's bid is executed. If I am forced by our exchange to PFOF, I will need to increase my minimum profit necessary to execute the trade to cover the additional expense of PFOF. Therefore, I would not hit the customer's bid in the above example and the customer would not be filled. If the stock were to move away from the customer's order and the option increased in value to $4.00, how would the customer feel? If I were the customer, I would feel cheated. This is not fair to these customers. Why should they have to carry the burden for the cost of PFOF? Please take action and end this unfair practice.

b. Since our pit does not PFOF we have to quote very aggressively in order to get any orders. Furthermore, since our pit's markets are consistently equal to and sometimes tighter than the other exchanges', one would expect our pit to maintain one of the larger market shares in comparison to the other five exchanges. This, however, is not the case. PFOF orders do not flow to the tightest market; instead they flow to those who PFOF. The other exchanges' market widths could be 100% greater than our market widths and they would still get the order (PFOF). Therefore, the order is being directed based on payment rather than a competitive factor. For example, if exchange A (does not PFOF) is quoting a call at 2.05 – 2.15 200X200 and exchange B (does

PFOF) is quoting 2.0 -2.2 100X100, the PFOF order will almost always go exchange B. If an order is sent to B to sell 75 at the market and the order is received at B and 1 second later the stock down ticks .04 and the market on the call at A changes (due to a lower stock price) to 2.0-2.10 500X125 (which gives linkage no opportunity to execute the order at 2.05) the order is executed at 2.00. (It is important to note that linkage is both faithfully and diligently being used on the CBOE to fill customers at the best available price.) The customer is filled, at exchange B, at 2.0. Now, if the order were initially sent to A instead, the customer would have been filled at 2.05. This is one of the reasons I have strongly opposed PFOF and have stood my ground by voting "no" when our pit had the opportunity to embrace the practice (even when it cost me business). To my knowledge, our pit is the only equity pit on the CBOE (and probably in the US) where both the DPM and market makers have never chosen to PFOF.

c. I am willing, as I have done in the past, to quote different markets for those who receive PFOF and for those who don't receive PFOF. Thus, the quality of market is worse as a direct result of PFOF.

Question 2. The wording of this question assumes there are no other factors that influence the width of a specialist's or market-maker's spread. This is a poor assumption, since there are obviously numerous factors that affect the width of spreads. Advancements in technology and multiple listing options have had the greatest impact on narrowing market spreads. Technology examples: linkage, CBOE Hybrid, speed of stock execution which reduces hedging risks, market maker's use of computers in the pit, NYSE & NASDAQ trading in pennies, and sophisticated quoting systems (Actant). Don't fool yourselves by excluding all of these factors which have helped to significantly narrow spreads. The economics behind determining market widths is much more complex than your question implies. PFOF widens spreads (see question 1 response).

Question 5. Internalization is a VERY BIG problem. The gravity of the problem is not given enough weight. I will explain, as best I can, and would appreciate the opportunity to meet with you in person to more clearly inform you of the devastating impact internalization is having on customers.

Industry wide, uniform regulatory action is desperately needed, since the expansion of multiple listing options has created an opportunity for firms thru the use of the IF THEN ORDER to find the marketplace of least resistance to facilitate the firms own financial interests (not customers) at the expense of possible price improvement. If the market makers or DPM demand the firm abide by exchange crossing rules, the order ceases to exist and the cross takes place on the exchange with the least resistance, at the firm's designated price. If a market maker quotes too aggressively, he is despised by the firm and will lose future opportunities to trade orders from that firm. Therefore, the firm will avoid quoting future crossing orders in that pit because they (market makers) don't play the game.

As of February 1, 2004 the CBOE has indirectly contributed to this problem by using a minimum option market share volume percentage requirements (15% over a 3 month rolling period) as a factor in determining the performance of a pit. If a pit fails to meet the

minimum 15% requirement (per individual stock) they (pit) could potentially lose the individual stock in question. (It is important to note that the first rolling 3-month period will end April 30, 2004 and no individual stock has, as of today (April 12, 2004), been removed from a pit due to this performance evaluation factor.) Factors used in determining pit performance should be based on market widths and depths, not on market share. This is because market share can easily be increased by a pit thru the practice of allowing uncompetitive facilitation trades to take place that adversely affect the customer. If the pit's percentage of market share is near or below the 15% threshold (individual stock) and since crosses can add 5-7% to a pit's volume, this then can produce a TREMENDOUS temptation on a pit to prostitute itself and allow these uncompetitive crosses to go up. The practice of attempting to increase an exchange's market share thru the use of the 15% rule leads to the possibility of improper behavior, which adversely affects the customer. Exchanges need to evaluate pit performance based on market width and depth and avoid all forms of market share evaluation.

The firms use of both the "If then order" and the facilitation of orders on the exchange of least resistance are the two main methods used to cheat by the firms. There are not uniform rules established which enable the CBOE to stop these practices. The CBOE has continually and diligently enforced the rules of our exchange. New uniform rules need to be written to empower the CBOE and other exchanges to stop the firms from using the "if then rule" and facilitating customer orders on the exchange of least resistance.

What are the underlying causes that produce this ugly practice? The firm receives an order from a customer to sell 500 spreads (X). The spread has a value of 2.00 and the NBBO screen market on the spread is 1.80-2.20. The customer is a market seller of the spread. The customer pays $.45 commission per side of the spread ($.45 X 2 X 500 = $450 total commission). The firm has basically three choices or a combination of the three.

First, the firm can buy the entire order from the customer at $1.80 on a cross at whichever exchange is least resistant (least interested in making a competitive market due to various reasons (see response to question 13)). The firm will not ask for a market before the cross, since the pit would probable give a narrower market width than the NBBO. The broker would walk in the pit and say "IF I had an order on spread X, THEN could I cross it at 1.80?" The firm will search for the exchange of least resistance and cross the order. Exchanges that evaluate pits based on market share indirectly create an incentive to not quote aggressively. Another method that has been used is to lower the exchange transaction costs to a pit if they meet a certain percentage of market share for a listing. The weaker exchanges have a greater tendency to cave into these pressures.

Secondly, the firm could call their list of broker dealers, DPM's or specialists and tell them that they could purchase spread X for $1.80 on exchange Y (exchange of least resistant) but they would have to pay a $2.00 commission on both sides of the spread ($2.00 X 2 X 500=$2,000 total commission (this does not include the customer's commission)). If the firm believes the spread market will be tightened by any exchange, they will not quote the spread on those exchanges.

Third, the firm could quote the spread on all the exchanges and end up with two exchanges: $1.95 bid and one exchange offering at $2.00. This is where the benefits of a floor based exchange can significantly enhance value to the customer thru price

improvement above and beyond NBBO. Daily, I witness floating floor brokers use the competitive aspect of the trading floor to the benefit of the customer.

What regulatory action can the SEC take at this time? 1) Ban exchanges from evaluating pits based on market share and shift the evaluation to market width and depth. 2) Establish a new, uniform SEC rule that a firm cannot enter a pit and say, "If I had an order then….". Either there is an order or there is no order. 3) Establish a new, uniform SEC rule to prevent firms from facilitating on exchanges of least resistance by mandating a firm to quote a potential cross order on at least the three largest exchanges based on the previous 3 month volume for the listing in question, excluding crossing and intra pit volume. If all three exchanges are not interested in trading the spread, then the firm can cross the entire spread in the middle of the three exchanges NBBO market. For example: exchange A is $1.95-$2.10, Exchange B is $1.90-$2.05 and exchange C is $1.90-$2.10, therefore NBBO is $1.95-$2.05. The firm can sell the spread at $1.95 to exchange A and the firm can facilitate 20% according to the current 20% rule. If the firm wants to cross the entire order at $2.00 and all three exchanges have no interest in the spread then the firm can cross 100% of the order at $2.00. If two exchanges are $1.95 bid and the firm does not want to facilitate the entire spread at $2.00, then the firm can choose which exchange it wants to sell the spread to or the firm can split the order between the two exchanges. However, the firm can only facilitate 20% of the spread at $1.95. 4) Establish a new, uniform SEC rule stating that in the above example that since exchange A gave the best and only bid of $1.95 the firm cannot cross the order (at $1.95) on any other exchange but exchange A. This rewards all exchanges to quote aggressively. 5) Establish a new, uniform SEC rule that the executing firm must record the market given by the three exchanges on time and sales. This disseminated information will help maintain cross-market surveillance.

Again, internalization has been unfair to customers. The SEC needs to step to the plate and take regulatory action and create these new rules to empower exchanges to prevent firms from hurting the customer. With fair rules in place, internalization can help the customer. Also, it is important to note that if the firms read my comments they would say these proposed rule changes would add more time in the execution of a customer's order. My response to this is that these orders presently are shopped off the floor before they come to the floor. Presently, a significant amount of time is already spent by the firm to find a commission-paying broker dealer off the floor to help facilitate the trade. A firm can simultaneously quote the spread on the three exchanges and come back with a quote faster than finding an off the floor, broker dealer. The US option exchanges are unable to regulate most internalization orders, since these orders have the ability to levitate to another exchange, which is outside of their jurisdiction (CBOE regulation department is unable to regulate internalization trades that originated on the CBOE as an "if then order" but eventually traded on the Philly and visa versa). The US option exchanges need the SEC to establish a uniform method to regulate internalization across exchanges. Our exchanges are attempting to apply regulation practices designed for single (exchange) listed options in a multiple listed option environment.

Question 6. Yes, see response in Question 1.

Question 10. Yes. See response in Question 1. Banning PFOF would reduce transaction costs per trade for market makers and, therefore, reduce market widths. This would have the same effect as the city of Chicago banning the mandatory gas tax that would reduce the transaction costs per gallon for the gas station owners and, therefore, reduce the market width (difference between wholesale commodity and price at the pump) per gallon of gasoline.

Question 11. See response to question 5

Question 13. See my response in question 5 regarding the CBOE evaluating individual pit performance based on a mandatory 15% minimum market share factor per listing on a three month rolling period. The use of this factor in evaluating pit performance indirectly creates a lack of incentive to aggressively compete for price improvement. Furthermore, this tempts market makers to collude (not formal, no discussions between parties involved regarding the act of collusion) with firms to execute customer trades outside of their best market (but on or inside of NBBO). This temptation is driven by the fear in the heart of the CBOE market maker that the CBOE may relocate the listed stock to another pit if the listing does not maintain a 15% market share (one factor used by the CBOE in measuring market performance). Since this occurs in the heart of the market makers and firm, there is no exterior evidence and, therefore, no obvious (cannot be seen by the regulation department) exchange rules are broken. Thus, the CBOE can continue to do an exceptional job at effectively regulating the exchange. Who benefits and who loses? The pit benefits by keeping their listed stock and perhaps receiving a small piece of the very profitable trade. The firm benefits by facilitating more than 20% on the bid or more than 40% inside the market. The exchange benefits from the transaction fees. The only one who is hurt is the customer who receives a noncompetive market. I have fought this practice. I believe it is wrong. I have met with numerous CBOE exchange officials and have shared my complaints and dissatisfaction with the use of this performance factor (minimum 15% market share). The best form of pit evaluation is market width and depth. I will continue to oppose these methods regardless of whether or not my pit loses a listed stock. I suspect that similar methods of pit performance evaluations based on market share are being used by other exchanges. Please lead and establish fair regulation practices and eliminate this obvious conflict of interest.

Question 17. No. I included these changes in other responses.

Question 18. Customers would continue to receive inferior execution of their orders in comparison to my proposed regulatory changes.
No!!

Question 21. All inducements would have to be banned. Also very significant fines would need to be established and enforced if illegal PFOF arrangements were discovered. All firms should then be required to send a letter to their customers stating they do not receive any forms of PFOF. This puts them in a position to be sued by their customers if they break the rules. This will give the firms a strong incentive to be honest.

Question 22. No, as long as the SEC follows my proposed rule changes regarding internalization (see response to question 5).

Question 23. Ban PFOF. Change internalization to my proposed response in Question 5.

Question 24. Tighter markets.

Question 28. No this would not address the concerns listed.

Question 29. Yes, see response in question 5.

Question 30. No. There is no opportunity for price improvement. See response in question 5.

Question 31-33. See response in question 5.

Question 37. With the introduction of quoting in penny increments, PFOF would cease in highly liquid option markets, but would continue in illiquid option markets. The best solution to the PFOF problem is to ban the practice industry wide.

I would appreciate interacting personally with a SEC official to elaborate on my responses. Thank you for this opportunity to respond to your questions.

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