JPMorganChase

JP Morgan Securities, Inc.
277 Park Avenue, 9th Floor
New York, NY 10172

Joseph K. Ghartey
Managing Director
Tel : (212) 622-2974

April 7, 2004

Jonathan G. Katz, Secretary
United States Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-0609

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

Dear Mr. Katz:

J.P. Morgan Securities, Inc. ("JPMSI") welcomes the opportunity to comment on the Securities and Exchange Commission's ("Commission") concept release concerning the above-referenced matter ("Concept Release").

The following is a brief summary of JPMSI's views concerning some of the issues raised in the Concept Release:

- JPMSI believes that payment for order flow ("PFOF") reflects and contributes to economic inefficiencies in the trading of options. In addition, such practice induces additional distortions by discouraging aggressive price-based competition. Accordingly, we believe that PFOF should be banned.

- JPMSI urges the Commission to avoid grouping PFOF and dealer participation trades in the category of "internalization." Dealer participation trades usually involve large size transactions for which upstairs firms compete. This type of trade allows upstairs firms to better manage risk, thus enabling upstairs firms to quote more aggressively on large customer orders. The practice of dealer participation trades does not preclude interaction with other market participants, thus requiring "exchange crowds" to either match or improve the crossing price to participate in the print. Such competition is beneficial to investors.

- JPMSI believes that, with respect to the options markets, quoting in penny increments might be beneficial to customers, but is not currently feasible given the multiplicity of options contracts and the resulting strains on quoting and market data systems that such a change would create. We believe that the increased quote messaging traffic resulting from penny quotes would diminish the timeliness and quality of quotation information. In addition, because penny increment quoting would make it difficult to see true market liquidity, a move to penny increment quoting should include consideration of transparency in the dept of liquidity provided by market participants.

The following are JPMSI's answers to some of the questions raised in the Concept Release:

Question 1. To what extent, if any, does payment for order flow in the options markets affect a specialist's or market maker's incentive to quote aggressively?

It is our opinion that PFOF arrangements decrease a market maker's incentive to quote aggressively. All option exchanges except BOX have PFOF arrangements. There is little or no incentive for these exchanges to better NBBO because they are guaranteed order flow. Market makers in a non-PFOF exchange that want to receive flow cannot simply match NBBO because order flow firms will direct the flow to exchanges with which they have a PFOF arrangement. Hence, market makers in non-PFOF exchanges must and do quote more aggressively in price than market makers on other exchanges.

PFOF arrangements also are directly contradictory to a broker-dealer's best execution obligations to its customers and therefore represent a serious conflict of interest between the broker-dealer (which will tend to route orders to exchanges with PFOF arrangements) and its customers (who want their broker-dealer to actively pursue price improvement opportunities regardless of PFOF arrangements). This conflict is not resolved by merely disclosing it to customers, and should be banned in order to enhance true competition and ensure that the customer's interests are always paramount.

Question 2. If commenters believe that payment for order flow diminishes a specialist's or market maker's incentives to quote aggressively, why have spreads narrowed over the past few years while payment for order flow increased?

It is our opinion that the increase in PFOF has not resulted in narrower spreads. Instead, JPMSI believes that spreads have narrowed due to the following factors:
- multiple listings,
- increased market transparency,
- increased competition by recently organized electronic access markets such as the ISE and the BOX,
- increased aggressiveness in facilitation prices by upstairs firms, and
- increased market presence of sophisticated proprietary trading capital.

Question 6. Do customer orders that are routed pursuant to payment for order flow arrangements ever receive less favorable executions than orders not subject to such arrangements? To what extent do exchanges' rules requiring that members avoid trading through better prices on other exchanges ensure that any order, regardless of the reason for its being routed to a particular exchange, receives at least the best published quotation price?

JPMSI believes that PFOF arrangements lead to systemically wider NBBO spreads. Market makers in PFOF exchanges have less incentive to narrow quote spreads, because they can rely on their PFOF arrangements. Market makers in non-PFOF markets, such as the BOX, need to rely on improved NBBO spreads to attract order flow.

In practice, customer orders are not executed at prices worse than NBBO even in PFOF exchanges. If PFOF were banned, however, market makers would have to compete on price rather than on unrelated market arrangements to attract order flow. We believe that banning PFOF arrangements would result in tighter NBBO spreads, increased competition and ultimately in price improvement to the investor.

Question 9. Are market makers willing to trade with non-professional orders at prices better than their quote?

It is our opinion that market makers are willing to trade with non-professional orders at better prices than their quote. We believe this is evidenced by the activity executed at the PIP facility in the BOX during the time frame ending the first week of March. During that period, it is our understanding that the average PIP contract size was seven contracts and the average price improvement was $0.0208 per contract.

Question 10. If the Commission were to eliminate payment for order flow would non-professional orders get better prices?

JPMSI believes that professional and non-professional orders would generally get better prices if PFOF arrangements were banned. Eliminating PFOF would cause more competition among exchanges quoting the NBBO. If exchanges were no longer guaranteed order flow based on PFOF arrangements, its market makers would need to quote more aggressively to attract order flow.

Question 11. Do customer orders that are internalized in whole or in part on an exchange receive less favorable executions than orders that are not internalized? If so, why?

It is our opinion that the practice of allowing dealers to participate in order flow based on upstairs competition, if properly regulated, enables customers to receive better execution. On the BOX, the PIP data appears to support this conclusion: for the time frame ending the first week of March, the average price improvement was $0.0208 per contract over NBBO.

Question 23. Should the Commission ban some or all specialist guarantees and internalization (i.e., dealer participation arrangements) in the options markets?

JPMSI believes that the Commission should not ban dealer participation trades. Dealer participation trades enable upstairs firms to manage their risk more efficiently. Accordingly, this practice facilitates the ability of upstairs firms to quote aggressively on large customer orders.

It is common for upstairs firms to quote a bid or offer at the NBBO level for many times the size displayed by the sum of all exchanges. Such firms take significant risk and commit capital on orders that exchange market makers will not and do not want to handle. Generally, upstairs firms can do so because they can manage the risk over the life of a particular trade by facilitating and participating in risk mitigating trades. Banning dealer participation trades would cause dealers to widen their quotes for large customer orders in order to avoid unmanageable risk.

Question 30. Do the options exchanges' current rules requiring that an order first be exposed to an auction before a firm can internalize it provide a meaningful opportunity for price improvement?

The practice of dealer participation trades does not preclude interaction with other market participants, thus requiring "exchange crowds" to either match or improve the crossing price to participate in the print. This participation can be for a large part of the order (e.g., 60%), thus promoting price competition on a significant portion of the order. JPMSI believes that such competition is beneficial to investors

Question 41. If exchanges required brokers to pay directly for the capacity that they use, would the brokers quote more efficiently, and thereby make a move to penny pricing in the options markets more feasible?

Jonathan G. Katz, Secretary
United States Securities and Exchange Commission
April 9, 2004
4

JPMSI believes that structures relying on exchange quoting capacity charges are not feasible solutions to implementing penny increment quoting. If exchanges "charged" for updating a quote, this would simply cause market makers to widen quotes so that they would not have to update them as often. Such reaction would offset some of the NBBO spread improvement due to penny increment quoting.

JPMSI appreciates the opportunity to comment on the Concept Release and would welcome the opportunity to discuss its views in more detail. Please do not hesitate to contact Julius R. Leiman-Carbia at 212-622-6592 or Darleen Solebello-Fenton at 212-622-5226 if you have any questions regarding the views expressed in this letter.

Very truly yours,

Cc: Annette Nazareth, Director
        Division of Market Regulation

        Robert Colby, Deputy Director
        Division of Market Regulation

        Elizabeth King, Associate Director
        Division of Market Regulation

        Richard Strasser, Attorney Fellow
        Division of Market Regulation