KNIGHT

John H. Bluher
Executive Vice President
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April 15, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

Re: File No. S7-07-04; Concept Release on Competitive Development in the Options Markets
<u>Release No. 34-49175 (Feb. 3, 2004), 69 FR 6124 (Feb. 9, 2004)</u>

Dear Mr. Katz:

Knight Trading Group, Inc.[1] ("Knight") welcomes the opportunity to offer our comments to the Securities and Exchange Commission ("Commission") on its Concept Release on Competitive Developments in the Options Markets ("Concept Release"). Through our subsidiary, Knight Financial Products LLC ("KFP"), Knight is a leading options market maker and specialist in the U.S. for listed options on stocks, stock indices and ETF's and makes markets in interest rate and commodity futures and options thereon. As of January 31, 2004, KFP was registered as a specialist in 490 options classes on the Chicago Board Options Exchange ("CBOE"), International Securities Exchange ("ISE"), Pacific Stock Exchange ("PSE"), and Philadelphia Stock Exchange ("Phlx"). KFP is also a registered market maker in over 260 option classes on the exchanges listed above as well as the Boston Stock Exchange Box facility ("BOX"). Knight also provides execution services in listed options to broker-dealers and institutions through our subsidiary Knight Execution Partners LLC ("KEP"), which is a NASD member and a member of all U.S. equity options markets. In 2003, KEP routed over 46 million option contracts.

[1] As the Commission is aware, Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets, Inc., Knight Execution Partners, LLC, Knight Financial Products, LLC, and Knight Securities International, Ltd., all of whom are registered broker-dealers. Knight and its affiliates, makes markets in equity securities listed on Nasdaq, the OTC Bulletin Board, the New York Stock Exchange, American Stock Exchange, and in options on individual equities, and equity indices, both in the United States and Europe. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary. Knight is a major liquidity center for the Nasdaq and listed markets. As a dealer we make markets in nearly all equity securities and approximately seventy percent of all option classes. On active days, Knight executes in excess of one million trades, with volume exceeding one billion shares. Knight's clients include more than 850 broker-dealers and 600 institutional clients. Currently, the eight year old publicly traded company employs nearly 1,000 people.

OVERVIEW

The advent of widespread multiple listing of options in the fall of 1999 followed shortly thereafter by the commencement of trading on the ISE in the spring of 2000 dramatically altered the competitive landscape for listed options. Investors have greatly benefited from this enhanced inter-market competition as exchanges and market makers compete for investors' orders through price competition and technological innovations. This competition has resulted in narrower spreads, speedier executions and reduced transaction costs. These benefits have occurred in an environment that has included specialist participation guarantees, internalization of customer orders and payment for order flow. Thus, Knight sees no compelling need for the Commission to take regulatory action to alter or eliminate these practices. The competitive forces unleashed by multiple trading will continue to force options exchanges and market makers to seek ways to reduce spreads, increase market depth and improve execution speeds. Thus, Knight believes that there would be little if any benefit to be gained by additional regulatory initiatives in these areas, particularly forcing the options markets to quote in smaller increments than nickels and dimes. This type of change will divert critical technological resources in order to handle the exponential increase in quote updates while adding little to overall liquidity.

Knight believes the Commission's efforts would be better directed towards other regulatory initiatives that will enhance the competitive forces at work through greater market transparency, notably its proposal to extend quality of execution reporting to listed options.

SPECIFIC COMMENTS

A. Payment for Order Flow

Knight does not believe that banning payment for order flow will enhance competition among the options exchanges. Competition will continue to be driven by market forces and technological innovations, not by the payment programs used by exchanges and specialists to attract order flow.

As the Commission noted in the Concept Release, studies have shown that options spreads have narrowed notwithstanding a significant increase in payment for order flow arrangements. This is not surprising since broker-dealers have an affirmative obligation to provide customers with best execution, regardless whether they receive any payments for their order flow. Thus, order sending firms closely monitor options prices available through exchange auto-execution systems and will generally only route an order to a market if it is quoting the best price at the time. Moreover, investors have access to broker-dealer reports prepared under Rule 11Ac1-6 describing how their orders were handled.

If the Commission determines to ban payment for order flow, Knight believes that it should apply the ban to all forms of payment. The Commission should not differentiate between exchange sponsored payment programs and specialist programs. Both types of programs reflect comparable economic models. Banning exchange sponsored programs but not all forms of payment will simply create an unlevel playing field.

B. <u>Specialist Participation Guarantees Promote Liquidity and Price Competition</u>

Specialists in the options markets have certain responsibilities that differentiate them from other types of market makers. For example, specialists are responsible for handling the limit order book and representing customer orders as agent. In addition, specialists have historically been responsible for establishing the prevailing quote in a market and thereby led the inter-market price competition that has resulted in enhanced customer executions. Specifically to ensure these services specialists have been held to higher levels of performance in regard to quote support. Specialists are also generally responsible for maintaining service relationships with order flow providers, driving the market to deliver increased transaction speed and higher levels of customer satisfaction.

In return for these responsibilities, exchanges have established rules that permit specialists to participate in trades at the 40% level, similar to that of facilitators. While the role of specialists and facilitators is obviously different, given the importance of both types of market participant to the competitive position of an exchange, it makes sense to treat them comparably. Intra-exchange competition has been enhanced with increased participation in streaming quote and competitive electronic market-maker models. This phenomenon has appropriately diluted the value of the specialists' entitlement as market-markers have begun to share in the responsibility of price determination.

The Box has embraced an open structure that omits the role of specialist. This direction suggests that exchanges are equipped to determine the value and potential of specialist firms' contributions to the marketplace. Entitlement is only one variable in this determination. The decision of the other five exchanges to maintain their commitment to the specialist paradigm is an endorsement of specialists' collective contribution.

C. <u>The Commission Should Extend Rule 11Ac1-5 to Options</u>

Knight supports increasing the transparency of execution quality for the listed options markets. For several years now, equity market centers have been required to provide monthly statistical reports on the quality of the executions they provide to the equity orders they receive, based on measures such as execution times, spreads and trade prices relative to the national best bid and offer ("NBBO"). As the Commission notes, these reports provide market participants with a valuable tool for comparing the execution quality offered by competing market centers and, in particular, aid brokers in deciding where to send customer orders consistent with their duty of best execution. The derivative nature of the options market would require several mechanical changes to Rule 11Ac1-5, to assure that it is an effective tool for the option markets. The most basic change relates to the current requirement to list each security separately since there may be literally hundreds of options series with respect to any one underlying stock.

SIA member firms have been working with the options exchanges to determine what specific information order routing firms require to evaluate execution quality.

Extension of Rule 11Ac1-5 to the options markets would thus institutionalize what is already occurring, ensuring compliance and uniformity of information concerning all market centers.

Knight also appreciates the progress that the Options Price Reporting Authority ("OPRA") has made towards developing an official consolidated NBBO for listed options. This information is an essential element for preparing meaningful statistical reports on options execution quality. Knight believes it is important, though, for OPRA and the exchanges to continually monitor the manner in which quotes from the exchanges are consolidated and ranked to determine the market responsible for the NBBO. Without an accurate procedure for determining the responsible market, inter-market price competition will suffer. In addition, Knight believes it is important for OPRA and the exchanges to use a centralized or synchronized time stamp mechanism for capturing important timing information used in the preparation of the Rule 11Ac1-5 reports. Precise information such as when an exchange receives a quote, when it sends the quote to OPRA and when OPRA receives the quote are all necessary improvements to today's data. Accurate timing data will also allow firms to monitor their trade execution performance on a real time basis against meaningful pricing benchmarks.

D. <u>The Commission Should Not Require Options Markets to Quote in 1¢ Increments and Should Ban Subpenny Quoting</u>

Knight is opposed to reducing trading increments for options from the current standard to 1¢. First, implementation of a 1¢ trading increment would necessitate the industry participants and exchanges to being required to reallocate capital, at significant levels, to accommodate the exponential increase in quote traffic that would result. Secondly, Knight believes that a change to penny increments would result in less liquid markets and flickering quotes that could not effectively be accessed. It could also effect the ability for the markets to handle quote traffic for order flow routers to verify the accessibility of the quote. We have witnessed this phenomenon in the market for equities, where penny spreads have caused a reduction in the size associated with the NBBO and the dissemination of quotations that are available for several seconds or less. These results do not add to the liquidity of the markets and in fact reduce transparency by generating meaningless quotation information.

Interestingly, we note that William G. Christie, one of the authors of the original study exposing overly wide spreads in Nasdaq stocks, has recently published an article in which he advocates returning to nickel spreads. (Traders Magazine, November 1, 2003). In Mr. Christie's view, public limit orders are disadvantaged by penny spreads because it is so economical for professional traders to step ahead of them. Thus, public limit orders, the very orders the Commission has historically sought to protect are harmed without any concomitant benefit to the markets.

Knight appreciates the Commission's attention to the important issues identified in the Concept Release. We would be happy to meet with you to discuss our views. Thank you for providing us an opportunity to comment.

Sincerely,

John H. Bluher

cc: William H. Donaldson, Chairman
Paul S. Atkins, Commissioner
Roel C. Campos, Commissioner
Cynthia A. Glassman, Commissioner
Harvey J. Goldschmid, Commissioner
Annette Nazareth, Director, Division of Market Regulation