CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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September 16,2003

Via Facsimile and DHL

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

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Re: Securities Exchange Act Release No. 48355; File No. SR-BSE-2002-15

Dear Mr. Katz:

This letter and the attached document set forth the comments of the Chicago Board Options Exchange, Incorporated ("CBOE") with respect to the referenced release and rule filing regarding a proposal by the Boston Stock Exchange, the Bourse de Montreal Inc., the Interactive Brokers Group, and, to a lesser extent, other brokerage firms, to trade listed options via an entity called the Boston Options Exchange ("BOX"). CBOE previously commented on this controversial proposal in a letter dated February 14,2003, from the undersigned, to the Secretary of the Securities and Exchange Commission ("Commission").[1] In that letter we observed, among other things, that the cornerstone of the proposal was to garner business by adopting rules that would greatly increase the practice of "internalization".[2] This would be accomplished, in large part, by allowing internalized orders to trade in a very limited, three-second auction in a one-cent increment that is not used in options trading today and that is not proposed to be used for quoting and trading on BOX except in the case of internalization. The recent amendment to the proposed BOX rules does not correct the deficiencies previously identified by CBOE.

The attached comments address numerous concerns we have with the proposal, but our primary focus is the danger posed to the marketplace when internalization is allowed to become even more prevalent than it is today in options trading, as well as the danger of allowing trades in one-cent increments for internalization purposes when five and ten-cent increments are not only used universally throughout the options industry, but are the proposed BOX standard. These *are* complicated issues, and the way they are handled by the Commission will have far-reaching implications for the options industry and for investor protection. In fact, Chairman William Donaldson and previous Commission Chairmen have expressed concern with the growing practice of internalization:

> "Like payment for order flow, internalization can discourage markets from competing on the basis of price and pose a conflict *of interest for broker-dealers.*" -*Then Chairman* Designate, William

[1] The BOX proposal has been bifurcated into essentially two rule change filings, the captioned filing and a second filing regarding the governance structure of Boston Option Exchange Regulation. The CBOE also commented on the "governance" filing in a letter to the Commission dated August 26,2003.
[2] Internalization involves brokerage firms selectively trading against their own customers' orders because they represent profitable trading opportunities for the firms even though brokers are obligated to seek the best execution possible for customers in return for the commissions they charge.

Donaldson, in a written response to the **U.S.** Senate Banking Committee during the confirmation process

"...internalization practices and the current exchange-sponsored payment for order flow programs not only create a significant conflict of interest for agents, but also may discourage the display of aggressively priced quotes." -Then Chairman Harvey Pitt in a January **24, 2003** letter to **CBOE** and other options exchanges

"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." -Then Chairman **Arthur** Levitt in a November **1999** speech

Because of the complicated nature of the issues involved and the fact that our comments will be publicly available on the Commission website, the attached 9-page document will attempt to explain what internalization is, how the internalization component of BOX will work, and why the issues posed by BOX need serious examination before certain aspects of BOX are allowed to proceed.

Although we are troubled that what amounts to **a** new options exchange is being proposed through a standard rule change filing **(as** opposed to an exchange application) by a stock exchange that has never traded options and that only partially owns the proposed new exchange, we are not necessarily opposed to the addition of BOX **as** an options exchange. Instead, our concerns primarily relate to the BOX's proposed internalization mechanism, the Price Improvement Period ("PIP"), and we strongly believe that the PIP should not be approved. At a very minimum, the issues raised by the PIP, namely increased internalization, increased payment for order flow, and the use of penny pricing for internalization purposes only, need to be further examined before the consequences of approving the PIP and the various competitive responses to the PIP that will be filed by other options exchanges are unleashed on the marketplace.

CBOE believes it would be unwise to allow the PIP to proceed (even **as** a pilot-program) before the Commission follows through on its previously stated intention to issue a concept release on the effects of internalization and payment for order **flow** in the options markets. It does not make sense to allow what are universally considered controversial practices to manifest themselves even more in the options markets before a planned study on those practices is complete. Only the Commission is in a position to adopt a comprehensive policy concerning these complicated issues, and that policy should not be dictated by piecemeal decisions in response to different exchange rule filings. Indeed, in an interview with ***Institutional Investor*** magazine (August ***2003,*** Volume XXXVII, No. **8,** page **37)** Chairman Donaldson indicated that, with respect to market structure issues, the Commission should adopt an overall philosophy so that individual decisions do not lead the markets in unintended directions. We couldn't agree more.

The consequences of allowing the PIP go beyond approval of a rather novel but anti-competitive and non-transparent internalization scheme that will likely increase options volume on the BOX exchange at the expense of best execution obligations of broker/dealers who introduce their order flow to BOX. It is likely that other exchanges, including CBOE, will be incented to respond with their own internalization mechanisms to satisfy the demands of internalizers thereby continuing BOX's escalation of the "conflicts crisis" on Wall Street? The Commission will then be forced **to** either approve these proposals, with the concomitant

[3] This term, referring to conflicts of interest in the securities industry generally, was introduced by Stephen Cutler, Director, Division of Enforcement, in a September **9,2003** speech.

degradation of execution quality for investors, or be forced to engage in ad hoc line-drawing as each new internalization iteration is proposed. Either set of actions would certainly be damaging to the markets.

Similarly, exchanges will rush to quote and trade options in pennies (or subpennies) to negate the one-cent increment component of the PIP. With the effects of a penny minimum price variation in the stock market (which was initially only intended as a pilot program) still being debated, and the looming issue of subpennies facing the Commission, it is dangerous to thrust the options market into these trading increments through approval of the PIP. We strongly believe that the issues faced in the stock markets will be compounded significantly in the options markets where hundreds of thousands of options series exist, all with their own quotes. Moreover, the potential impact of one-cent increments on options message traffic and capacity has not been studied since the conversion to decimals, and the potential adverse impact to quote vendors and the options markets generally should be considered before BOX is allowed to introduce pennies into the options markets.

We recognize that the Commission's task in considering the BOX proposal is a difficult one. Nevertheless, the dangers from the PIP are so clear and real that we urge the Commission and its staff to require that the BOX proposal be amended to eliminate the PIP before BOX can be approved![4] Then the Commission can consider these significant market structure and investor protection issues in a comprehensive manner rather than through an isolated filing.

As the original options exchange we fervently believe that approval of the PIP will lead the options markets into a place where internalization is the rule and fulfilling best execution% obligations is the exception. We stand ready to work with the Commission and its staff to address these difficult issues. Any questions regarding our comments should be directed to Joanne Moffic-Silver, General Counsel & Corporate Secretary, at 312-786-7462, Angelo Evangelou, Senior Attorney, at 312-786-7464, or the undersigned.

Sincerely,

William J. Brodsky

William J. Brodsky

cc: Chairman William Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette Nazareth, Director, Director Division of Market Regulation
Lori Richards, Director, Office of Compliance Inspections and Examinations
Stephen Cutler, Director, Division of Enforcement
Lawrence Harris, Office of Economic Analysis
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Elizabeth King, Associate Director, Division of Market Regulation
Stephen Williams, Economist, Division of Market Regulation

[4] It is troubling that BOX has already announced it will be operational this October.

CBOE
CHICAGO BOARD OPTIONS EXCHANGE

September 16,2003

Chicago Board Options Exchange Comments on File No. SR-BSE-2002-15

Introduction

The Boston Options Exchange ("BOX") consortium (comprised primarily of the Boston Stock Exchange ("BSE"), the Bourse de Montreal Inc., and the Interactive Brokers Group) proposes to add a sixth options exchange which would be characterized as a "facility" of the BSE. BOX would be an all electronic options marketplace with no real "membership" structure, no specialists or primary market makers with greater obligations than regular market makers,[1] and, generally, a price-time priority sequence that makes no distinctions between public customer and professional orders when matching orders (CBOE currently requires customer priority). If these were the only unique components of the BOX proposal, the approval of BOX might well add new and interesting features to the active competition that already exists among options exchanges.

The primary purpose behind BOX, however, is to maximize trading volume and profitability by embracing a controversial practice called internalization. Recognizing that certain brokerage firms are increasingly eager to capture the value from their customers' options orders by either taking the other side of such orders when it would be profitable for the firm to do so based on pricing models and market conditions (*i.e.* internalize the orders) or by selling the execution responsibility for the orders in bulk to certain liquidity providers/market making firms,[2] the BOX proposed the Price Improvement Period ("PIP") which would allow internalizing brokerage firms and market making firms that pay for order flow to take internalization to a new level.

This would be accomplished, in large part, by allowing such firms the ability to internalize orders in a rapid-fire three-second process that can occur at a price that is only one cent better than the prevailing market price (as opposed to more meaningful and standard five and ten-cent increments). This "improvement" is how BOX is marketing its internalization machine as a "win" for customer orders while masking the detrimental effects the PIP will have on such orders and the options markets in general. In explaining those detrimental effects, CBOE believes it is important to fully understand not only how the PIP works but how internalization works.

Internalization Explained

With the growth in the listed options business over the past several years, certain brokerage firms have developed significant options trading expertise that has motivated them to attempt to capture the returns available from options market making without taking on the various

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[1] Market makers are individuals and firms that provide liquidity in assigned securities. They make markets and are required to meet numerous obligations so that customers can always buy or sell securities when the markets are open, thereby accepting a transfer of risk from the customer. Designated Primary Market makers and/or specialists are market makers with even greater obligations like providing continuous quotes at all times during market hours and acting as agent for customer orders.
[2] This equally controversial practice is called payment for order flow.

obligations required of market makers. Most notably, their efforts in this regard have been concentrated in their taking of the other side of customers' orders.

Internalization arose, initially, in response to periodic liquidity needs driven by large customer orders. While this type of internalization still exists, the practice has since expanded to now take on one of three different forms: accommodative internalization, selective internalization or systematic internalization.

Accommodative internalization occurs when a broker/dealer responds to the needs of a customer to effect a large or complex options transaction that exceeds the liquidity available in the market. The broker/dealer steps in to provide additional depth by offering to take the other side of the customer's order, performing what is known as "facilitation," which is the committing of firm capital to execute a customer's order. It is important to note that the primary purpose of this type of internalization is not to pursue a profit opportunity commensurate with the contra-position, but instead to assist a customer in filling an order. The customer may or may not be charged a fee of some kind, depending on the relationship.

Selective internalization is a practice that has emerged more recently as broker/dealers realized that they could pre-select transactions that hold greater profit potential for the contra-party (a practice characterized by some market participants as "cherry picking") and take the other side of those orders. In making this assessment, broker/dealers may be increasingly focused on a profit-oriented approach. A consequence of this practice has been to increasingly exclude professional liquidity providers (exchange market makers with statutory obligations to make markets and provide liquidity for all eligible orders whether potentially profitable or not) from a meaningful opportunity to participate in trades.

Further, since most option classes are listed on more than one options exchange, broker/dealers have the ability to play one marketplace off against another by seeking a greater share of participation from market maker trading crowds, indicating that in order to receive any part of an attractive order, market makers have to compete with other exchanges in terms of how much of an order they would be willing to give up to the broker/dealer. More recently, this practice has evolved to include so-called "if-then" orders, in which broker/dealers may delay transmission of an order to any marketplace until they have determined in which venue their participation will be greatest. The concerns raised by this practice have been exacerbated by a lack of uniformity among the exchanges in dealing with "if-then" orders thereby creating a regulatory arbitrage situation that is not favorable to investors.

Systematic internalization is the newest form of the practice and is similar to the practice of selective internalization described above. However, in this case the broker/dealer's assessment of profit potential is not limited to a single order, but includes an entire stream of orders (for example, all small retail orders from a specific source). This order flow may be directed, en masse, to a liquidity-providing firm either owned by the broker/dealer or one with which a profit sharing agreement exists. Typically, order flow is also routed to a venue where the participation level for that affiliated liquidity provider is the greatest, whether by rule or by virtue of the paucity of competing participants. BOX proposes to offer the most lucrative participation level via the PIP. Indeed, the BOX proposal evidences a trend among new options entities to create business models predicated on encouraging, institutionalizing, and servicing internalization.

Internalization on Existing Options Exchanges

While internalization is far more limited on the existing exchanges than it would be on the proposed BOX exchange, it is currently a growing practice and CBOE urges the Commission to conduct a comprehensive review of selective and systematic internalization as well as payment for order flow before they are allowed to expand further. Nevertheless, because internalization does exist today, it is constructive to explain how it works on the existing options exchanges. The options exchanges generally have adopted some form of a 20/40 standard for internalization based on what has been approved by the Commission. This means a firm can internalize at least 20% of a customer order (for which it is supposed to try to get the best execution) at the prevailing market price (the best bid/ask quoted by market makers and other participants) or a firm can automatically internalize at least 40% of the order if it improves on the prevailing market price by at least one minimum increment. Today, the minimum increments are five cents for options priced under **$3** and ten cents for options **$3** and over?[3] The 20/40 percentages are ***minimum*** guarantees, and it is possible for the firm to internalize a larger percentage if no other market participants are interested in matching the internalized price. Also, currently, **only** orders larger than 50 contracts may be subject to the 20/40 guarantees. Here is **an** example ***of*** how these guarantees work:

> Example: Assume a brokerage firm has determined that it stands to profit by trading against a 100-contract order to buy option XYZ it has received from a public customer. The firm's broker requests a market in the options series. The CBOE market in that series, which happens to be the national best (NBBO), is a \$3.50 bid and a **\$3.80** offer. The firm could participate in 20% of the order at **3.80.** In order to attain the higher participation amount of 40%, the firm would have to quote an offer of **3.70** which could be matched by other market participants. Thus, to get a higher percentage, a ten-cent improvement is required.

Alternatively, **a** brokerage firm may choose to not utilize the 20/40 rules and may attempt to internalize orders in larger percentages by identifying the quote prices and sizes at the various options exchanges trading the product and assessing the likelihood of market makers at each exchange expressing an interest in participating with the firm. If it determines that little resistance will exist at a particular price point on a particular exchange, it may seek to internalize as much as possible on that exchange. This may result in a larger percentage for the firm than had the firm invoked the 20/40 rule, but making such assessments on a case-by-case basis involves a significantly slower and more cumbersome process than what is proposed by BOX. This sort of practice also calls into question whether a firm is living up to or ignoring its obligations **as** agent for the customer. It is important to note that, in connection with these practices, CBOE has initiated disciplinary actions in instances where firms failed to exercise due diligence in handling these types of customer orders. Nevertheless, without the involvement of the Commission in defining the ground-rules, the result is regulatory arbitrage among the exchanges.

Under either alternative, it is possible that brokerage firms that internalize are not always obtaining the best price possible for the customer order (*e.g.* why not start trying to get the customer to buy at 3.60 instead of **3.80, 3.70,** or **3.79 as** we will see in the case of BOX). This

[3] These increments were approved by the Commission as the industry standard during 2000 as part of the securities industry conversion to decimal pricing. A major concern at the time of the conversion was the impact of decimals and finer increments to the message processing capacity of the options industry.

raises the question of why would brokerage firms have an interest in seeking the most favorable price for the customer if they are on the other side of the trade. It is evident that the practice is fraught with conflicts of interest. **BOX** now seeks to expand and systematize this conflict.

PIP Explained

Like every other options exchange, the **BOX** will trade and quote in five and ten-cent increments. However, when it comes to internalization, **BOX** will allow internalized orders to trade in one-cent increments. The process will be very fast, secretive, automated, and free of many of the impediments to internalization that exist today on other exchanges. Here is how it will work and save the internalizer (while costing the customer) **4** cents or **9** cents per "improved" order.

Assume the best market in option **XYZ** on **BOX** is **$3.50 - $3.80** and is also the best price nationally. A brokerage firm (or a market making firm that has purchased order flow from a brokerage firm) that seeks to internalize a customer order to buy 100 contracts of option XYZ may initiate a PIP.[4] Instead of exposing the customer buy order at **3.60** to gauge interest at a price more favorable to the customer, the PIP would allow the *firm* to enter a **3.79** offer for **100** contracts. This offer would not be posted in the **BOX** quote which is visible to the public (nor would this liquidity be available to the public or anyone else). Instead it would only be visible to certain **BOX** participants including BOX market makers registered in XYZ. Further, this limited "exposure" would last for exactly three seconds. During that three-second period, the **BOX** participants that are privy to this particular PIP would be allowed to match the **3.79** PIP offer or improve on it in one-cent increments. With the exception of a "Market Maker Prime",[5] they participate at the end of the PIP in price/time priority.

As long **as** the introducing firm matches the final price by the end of the three-second time period, it is guaranteed no less than **40%** of the order. Because the process is so fast and because it takes place in penny increments, the introducing firm could easily end up with 100% of an order at only one cent better than the best offer (***i.e.*** **$3.79).** A customer paying **3.79** would rather pay **3.70,** but that is irrelevant to **BOX.** Even though **a** customer may be said to have benefited by paying **3.79** instead of **3.80,** the PIP will have deprived the customer of **an** opportunity to have his order exposed for a meaningful time period in a public auction market that could have resulted in the customer's paying **3.70** or even less.

To complete the example above, assume two **BOX** market makers (A and **B)** match the **3.79** offer within the three-second period each for 100 contracts with Market Maker A getting there first. The 100-contract customer order would be executed at **3.79** with the introducing firm trading **40** of those contracts and Market Maker A trading **60.** Market Maker **B** gets nothing because its computer system is not as fast as Market Maker A's. In many cases, it may be that no market makers match a firm's PIP offer (the fastest market making firms need not quote every product listed on **BOX)** and the firm will get 100% of the order by only bettering the quote by a penny. Either way, the introducing firm will always have the last "look" and be able to match. While time priority will apply to other BOX participants, it will not apply to firms seeking to internalize as they can always match at the end of the threesecond period to participate.

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[4] **The PIP will not have a 50-contract minimum, so any size order could be internalized.**

[5] **The Market Maker Prime is a BOX market maker that was the first to quote at the national best price on BOX at the time a** PIP **is commenced. Like the internalizing** firm, **it does not have to worry about time priority, it gets a 20% participation if it matches the final PIP price. There does not have to be a Market Maker Prime for any given PIP.**

Effects of the PIP

1. Growth in Internalization.

As just illustrated, the PIP takes internalization to a new level by allowing firms to take at least 40%, and sometimes 100%, of a customer order in only three seconds at one penny better than the prevailing market price. Thus, it is easy to see why the PIP will be wildly popular with f m s that seek to internalize (some of which are BOX owners). Obtaining a ***minimum*** of **40%** at 3.79 is much better than only getting 20% at 3.80 or **40%** at the conventional 3.70 increment. Plus, the firm gets to characterize the execution as price improvement to its customer. What is next, 3.7999?

With the approval of the PIP, internalization will grow in leaps and bounds because it will be easier than ever to systematize the practice. The more systematized and entrenched internalization becomes, the greater the impact to the options industry. CBOE believes the impact will have an adverse effect on the quality of the options markets. Stated below are a number of specific concerns raised by the practice of internalization that can have detrimental effects on the future state of the market:

Erosion in the Brokers' Level of Fiduciary Efforts **–** While accommodative internalization can contribute to the liquidity of the marketplace, it is questionable whether either selective or systematic internalization does so. In fact, it is likely that the latter two bring about the unintended consequence of reducing the ability and availability of dedicated market makers to fulfill their liquidity providing functions when the marketplace needs it most.

As more options order flow is intentionally routed to liquidity providing firms having proprietary relationships with introducing brokerage f m s, or internalized selectively by the brokerage firm, the potential for a conflict of interest with customers will increase. There may be little, if any, incentive for a broker/dealer to route orders to **an** unaffiliated market, or propose a customer order facilitation to a market with a meaningful order exposure **(*i.e.*** vibrant price competition), even if that market holds greater promise of price improvement for the customer. The fact that a broker/dealer only needs a penny better than the prevailing NBBO to trade against that order may result in a lack of meaningful order exposure and may, over time, lead to an environment where price improvement is rarely found because price improvement is rarely sought. Such **an** evolution would clearly not be in the best interests of customers.

A Decline in the Power of Price Competition **–** Continuing consolidation in the options industry is creating the risk that a small number of firms, which possess both order flow and proprietary trading facilities, will eventually dominate options trading, leading to a reduction in the opportunity for real price competition and order exposure. Similarly, increasing selective internalization will further reduce exposure of a variety of orders to liquidity providers. As the value of competitive pricing erodes - due to limited exposure of orders, payment for order flow, and reliance on the published NBBO **as** a key measure of best execution - the business models of liquidity providers without captive order flow will simply collapse. Those liquidity providers are needed more in the options market because unlike the stock market, due in part to the large amount of options series, a majority of options orders end up trading with market makers or other professional participants. There will be no incentive to quote if, no matter how competitive the quote, participation is so limited as to be unprofitable. This will lead to a reduction in overall liquidity and the opportunity for price competition in the marketplace.

A Reduction in Market Efficiency during Volatile Periods – Among the underlying principles that make exchange derivative markets efficient is that risk avoiders seek out other parties willing to assume risks in return for a profit opportunity. In the options marketplace, this structure is encouraged through the use of market maker privileges and affirmative obligations. Options market makers are required to provide constant pricing and liquidity, during all market conditions, in order to assure that investors have the ability to trade efficiently. In exchange for these obligations, market makers are granted certain privileges. These privileges allow these participants to focus on the business of assuming risk and managing that risk. In order to do so, they must have reasonable assurances of fair competition, access to order flow and the fair opportunity to realize a profit.

As introducing broker/dealer firms take more of the opposite side of their customers' trades, the detrimental risks to general market efficiency are two-fold. First, selective and even systematic internalization may lead to a reduction in the number of liquidity providers. The broker/dealers, without market-benefiting obligations, will avoid unprofitable trades and uncertain market conditions. The marketplace, having driven out the primary liquidity providers, would experience dramatic reductions in overall liquidity at those times when it is most needed. Second, to the extent the growing internalization trend leads to exchanges establishing or allowing crossing procedures that result in the erosion of meaningful order exposure and price discovery, there will be a fragmentation of price discovery in the marketplace: Approval of the PIP would accelerate these unfortunate consequences.

2. Penny Increments.

By allowing non-public quoting to take place in increments that are smaller than the standard nickel and dime increments that will be used on BOX for publicly disseminated quotes, BOX is damaging the credibility of its public quotes. Only qualifying BOX participants who desire to trade in non-standard penny increments will be allowed to do so without providing penny quotes to the Options Price Reporting Authority ("OPRA") for dissemination to the public. Thus, **the disseminated** OPRA **quote feed from BOX will generally not represent the highest bids and lowest offers available on BOX.** This will render the publicly disseminated BOX quote meaningless. The PIP will allow certain BOX participants to penny-jump the prevailing BOX public quote. This means that by improving the quote by a penny without even disseminating the improved price, a firm can jump ahead of orders in the BOX book and shut them out from participation. Penny jumping is an existing problem in the stock market today, but at least in the equity markets the penny-better quotes are disseminated to the world. Here, a firm will trade ahead of orders on the BOX book by establishing priority over the quote without having to disseminate an improved quote or taking on any obligations. The options markets will be hurt by a lack of price transparency and this certainly will degrade intermarket quote competition.

One thing that is certain is that if the Commission approves the PIP, the other exchanges will be forced to respond with competitive initiatives of their own in this race to the bottom. If fact, the International Securities Exchange ("ISE"), eager to win that race and as the only existing all-electronic options exchange, has already filed to implement its own internalization program imaginatively called the "Price Improvement Mechanism" or PIM. The PIM will also allow internalized trades to take place in one-cent increments. Mimicking the PIP will be more difficult for the floor based options exchanges because a three-second exposure to a trading crowd in an

[6] Fragmentation in the options market would be compounded compared to the stock market because no one exchange dominates the option market pricing as is the case on a major segment of the stock arena.

open outcry auction may not be practicable. This will drive the floor based exchanges to seek other competitive alternatives.

The CBOE will likely respond to the PIP by changing the minimum increments for bids and offers on CBOE to one cent?[7] This will undoubtedly prompt other options exchanges to move to penny quoting (even BOX). Aside from the significant issues that the stock market is dealing with as a result of penny quoting, it remains to be seen if the options industry will have sufficient capacity to handle the ***massive*** message traffic that will result from penny quoting. When the industry converted to decimals several years ago, the options markets converted to nickel and dime increments for a reason (a penny pilot for options was not requested). We will now be forced to test the soundness of that decision. Perhaps OPRA will be able to handle the incredible message traffic attendant with constant streaming quotes in thousands of options series from numerous sources, but vendors that sell the OPRA feed may be pushed beyond their capacity limits so that instead of disseminating all quotes, the public will only see quotes that are selectively throttled.

This response by CBOE is not a cavalier one. After analyzing the PIP and forecasting its probable effects on our trading volume, we believe that moving to penny increments may become the only way to remain competitive with the proposed internalization machine. If BOX were so keen on trading in pennies, why didn't it propose to regularly quote and trade in penny increments? We believe it is because the BOX model is not predicated on competitive quoting, but rather on obtaining order flow via internalization at the expense of customers. We further believe that the issues attendant with quoting and trading in penny increments need to be studied before one-cent increments are allowed as proposed by BOX. Indeed, these issues need to be considered on a variety of fronts. First, the manner in which message traffic capacity planning is conducted by OPRA and the exchanges is still unresolved. CBOE and other exchanges have no Commission-approved method to plan for additional capacity needs that likely will result from the competitive initiatives that will be proposed in response to the PIP, which may include converting to penny and/or sub-penny quoting and trading. Second, trading issues that will come with penny and subpenny increments including "penny-jumping" and lack of depth in quotes should also be considered.

Other PIP and BOX Problems

CBOE has identified other significant concerns with the proposed PIP and BOX as stated below.

1. ***The Customer PIP Order (CPO).*** In its most recent amendment, BOX proposes to allow customer orders to participate in the PIP. To do so, the customer must designate the order as a CPO, enter a limit price for entry into BOX's book, and then enter the real limit price for PIP purposes. Based on the Commission's application of the limit order display rule to the options markets, it appears the BOX proposal will not adhere to limit order display requirements because the real limit price of a CPO will not be displayed to the public. Further, the CPO will only participate in a PIP if the CPO's "secondary" limit price is quoting at the NBBO at the time a PIP is commenced. This will almost never happen.

Since BOX provides no incentive for quoting large size, BOX market makers will be able to quote a small size market, well outside of the NBBO, and still participate in PIPs by

[7] **Pursuant to** CBOE Rule 6.42, **the** CBOE **may change its minimum quoting increment by filing a 19(b)(3)(A) effective-on-filing rule change with the Commission.**

automatically submitting penny increment PIP quotes at far better prices than the market makers' posted quotes. On the other hand, BOX customers will have to somehow stay on the NBBO to have a shot at PIP participation. Of course, even if the customer order were first at the NBBO price point, it would not get the Market Maker Prime's 20% guarantee. If BOX really wanted customers to participate during PIPs, they would allow customer orders on the same side of the market as the customer order being internalized in the PIP to trade against the liquidity provided by the PIP's penny increment quotes.

For example, a firm seeks to internalize a customer market order to buy 100 contracts. The national best offer is **3.80.** The firm initiates a PIP and creates a **3.79** improvement offer. Two seconds later three BOX market makers join the firm at **3.79,** each for 100 contracts (for a total of **400** contracts at **3.79).** Before the three-second period concludes, BOX receives an unrelated market order to buy 10 contracts. Pursuant to BOX rules, this concludes the PIP and the customer order for 100 contracts is executed at **3.79** but the unrelated customer market order is not allowed to trade at **3.79** despite the fact that **300** extra contracts were offered at **3.79** at the time the unrelated order was received by the BOX system (all improvement offers that don't trade with the pending customer order are cancelled). If approved, this proposed aspect of BOX would seem to violate the Commission's Firm Quote Rule (Rule 11Ac1-1). BOX should allow all customers to participate at superior PIP price points.[8]

The CPO also creates significant trade-through issues. For example, assume a CPO is disseminated through OPRA as an offer to sell 50 contracts at **3.80** (the secondary limit price). It is third in line at the **3.80** offer price point behind several other participants who established **3.80** offers before the CPO. The aggregate **3.80** quote size is for 150 contracts. The CPO also has a real limit price of **3.78** meaning the customer is willing to sell 50 contracts at **3.78.** When a marketable order to buy hits BOX (let's say it is for 100 contracts), it will trade at **3.80.** This will violate the limit price of the CPO which remains unexecuted (effectively trading through it) and it will give the buy order an inferior execution. CBOE fails to see how this is permissible.

2. PIP rewards those eager to internalize but not others. As previously noted, the PIP is geared toward attracting order flow from brokerage firms that internalize and market making firms that pay for order flow (in order to internalize). Interestingly, the PIP puts brokerage firms that do not internalize at a disadvantage. Why? Because aside from profiting from its own customer orders, an internalizing firm can at least argue that it provided its customer with one cent price improvement. A non-internalizing firm cannot, by definition, use the PIP. Therefore, those firms cannot get that one-cent price improvement for their customers. The system rewards firms that choose to utilize the inherent conflict of internalization, and it motivates non-internalizing firms to embrace this controversial practice. Moreover, the BOX proposal will drive other markets to adopt procedures that encourage this practice.

In terms of market makers' participation in the PIP, the chance to electronically.match a brokerage firm within three-seconds for a piece of a potentially profitable trade is the main benefit to trading on BOX. However, BOX provides no incentives for market makers to quote deep markets?[9] In fact, a market maker need not be quoting to participate in a PIP. So, some BOX "market makers" will likely not even provide quotes unless responding to a request for

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[8] Of course, that would not cure the other noted deficiencies of the PIP.

[9] Quotes provide not only a price, but also a contract size associated with the price. The larger the size, the more liquidity available at that price point.

quote (RFQ).[10] Others will quote a minimum-size market well outside of the NBBO. Lastly, some may quote aggressively in terms of price to attain Market Maker Prime status, but they need not display meaningful size in their quotes.

As previously mentioned, the PIP is designed to benefit market making firms with the biggest super-computers. The first market maker to turn the market and establish the NBBO gets to be Market Maker Prime (even if other market makers with identical autoquoting functionality match within milliseconds). So, the market maker with the fastest system wins. Because participation in the PIP is based on price/time priority, the first market maker to match the firm shuts out all other market makers. Although this sounds like a good deal for one of the BOX founders and owners, we are not sure how this will provide an incentive to other market making firms. We also fail to see how a technology race in this regard is beneficial to customers.

3. *NBBO and PIP.* BOX has failed to explain how the PIP will work in conjunction with the NBBO. It is clear that a PIP can only start at a penny better than the NBBO, but what happens if the NBBO moves to a price more favorable to the customer order while the PIP is in progress? For example, the NBBO is ***3.80*** and a PIP starts at ***3.79.*** Before the three-second period is over and the customer order is executed, another exchange disseminates a ***3.70*** offer. The Intermarket Options Linkage Plan ("Linkage Plan") dictates that BOX should either execute the customer order at ***3.70*** or route a linkage order to the exchange with the superior quote. BOX's silence on this issue appears to indicate that BOX intends to allow a trade-through of the better price on the away exchange thereby systematizing a pattern and practice of trading through better prices. Such systematization would clearly constitute a violation of the Linkage Plan.

4. Directed Orders. The most recent BOX amendment adds several new BOX order types, the most controversial of which is the directed order. This order type allows firms that accept payment for order flow to "direct" customer orders to the BOX market maker that paid for the customer orders so that the BOX market maker can internalize the orders via ***the*** PIP. Thus, the amendment actually expands upon who can internalize on BOX. Predictably, the result will be an increase not only in internalization, but also in payment for order flow.

Conclusion

The CBOE continues to have these and other serious concerns[11] about the BOX proposal. We believe the operation of the PIP is designed to permit virtually unimpeded internalization and would lead to a dangerous mutation of the options markets into a fragmented system of separate internalization mechanisms. Such a structure would serve the interests of professionals to the detriment of customers and would undermine the integrity of the options markets. We urge the Commission to disapprove the PIP aspect of the BOX filing. We stand ready to discuss these concerns further with the Commission and its staff.

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[10] Interestingly and curiously, BOX proposes a 15 second RFQ response time- much longer than the 3 seconds allowed to match an internalizer.

[11] CBOE previously conveyed concerns with this proposal in a letter dated February 14,2003, and we also expressed concerns with the related BOX "governance" filing in a letter dated August 26,2003.