



December 31, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, DC 20549-0609

Via Electronic Mail

Re: File No. SR-CBOE-2004-71; Preferencing

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") appreciates the opportunity to comment on the Chicago Board Options Exchange's ("CBOE") proposal to allow order flow providers to designate or "prefer" certain market makers to execute against their orders. The filing raises serious questions regarding specialist entitlements and the basis on which they are awarded. The CBOE proposal provides a specialist entitlement to certain market makers based upon their relationship with order flow providers rather than the obligations they have to the marketplace or the competitiveness of their quotes. We believe that this will have a negative impact on quote competition in favor of payment-for-order flow arrangements and affiliated practices such as internalization. Additionally, the proposal lacks the protections the Commission has required of similar practices, such as facilitation guarantees and directed order programs. Accordingly, we urge the Commission to institute proceedings to disapprove this proposal.

Overview of Proposal

The CBOE has multiple specialists, or Designated Primary Market Makers ("DPMs"), in options classes traded on its Hybrid system. There is one floor-based DPM and there can be multiple remote DPMs, known as e-DPMs. Collectively, these DPMs are termed the "DPM Complex," and CBOE rules provide the DPM Complex with priority to share a specified allocation of an order (the "specialist allocation"). Currently, the floor-based DPM receives half of the specialist allocation and the e-DPMs share the other half pro-rata. Presumably, the higher allocation to the floor-based DPMs reflects the fact that these DPMs have more obligations than e-DPMs.

The proposal would allow an order flow provider to designate a "preferred" DPM or e-DPM on an order. Assuming that the DPM Complex is quoting at the NBBO and that the preferred DPM or e-DPM is quoting at the best price, the preferred DPM or e-DPM would be allocated two-thirds of the specialist allocation as follows:

- If an order is preferenced to the floor-based DPM, it receives two-thirds of the specialist allocation and any other e-DPMs at the same price share the remaining one-third of the specialist allocation pro-rata. This is similar to the current

allocation rule, with a higher percentage going to the floor-based DPM because it was preferred by the order-flow provider.

- If the order is preferred to an e-DPM and the DPM is also quoting at the same price, the preferred e-DPM receives two-thirds of the specialist allocation, the DPM gets the remaining one-third of the specialist allocation, and any other e-DPMs receive nothing. Thus, an e-DPM will receive a significantly higher percentage of the specialist allocation than the DPM and other e-DPMs solely for the reason that it was preferred by the firm that entered the order. Moreover, the other e-DPMs will lose participation in the specialist allocation completely, even though they have the status of an e-DPM and are quoting at the best price.

Basis for Specialist Entitlements

The proposal would provide greater allocation entitlements to a DPM or e-DPM based solely on its status as the preferred market maker, which is inconsistent with stated Commission policy. Moreover, it would move the CBOE away from traditional exchange auction market principles towards a dealer-based market model. To prevent options exchanges from becoming dealer-based trading systems, the Commission has carefully reviewed all proposals by an exchange to provide "specialist guarantees" with a critical eye. As discussed in the Options Concept Release,¹ any order flow an exchange allocates to a specialist removes that order flow from the auction market, which can discourage price competition. Thus, the Commission has approved specialist guarantees only if they properly reward market making firms for the obligations they provide to the market, and not simply due to a firm's designation as a specialist.

As we have stated previously,² the Commission has struck the right balance between the rewards that a specialist receives for its obligations to the marketplace and the concerns that arise if specialists lock-up too much order flow based on their status in the market. While we believe that specialists deserve slight preferences over other professional market participants in any exchange algorithms that allocate incoming order flow, the degree to which an exchange preferences specialists should depend on the specific obligations specialists have on that particular exchange. Specialist guarantees should not be structured as ways for firms to attract or internalize order flow.

The CBOE's current entitlement percentages for the DPM Complex are consistent with similar entitlements across the options markets. The Commission has previously approved e-DPMs to share in the specialist allocation in a manner that recognizes the relative obligations of e-DPMs as compared to the floor-based DPMs. The current proposal departs from this principle to give higher entitlements to DPMs and e-DPMs based not upon their obligations to the market place, but to those market makers that have relationships with order-flow providers.

While the CBOE's filing explains how the proposed allocation rules would work, there is virtually no discussion of why the Commission should abandon its longstanding policy with respect to specialist entitlements in favor of an entitlement based on a non-competitive "preferred" status designated by the broker handling an order. In this respect, the release only contains the following statements in support of the proposal:

¹ Securities Exchange Act Release No. 49175 (February 3, 2004), 69 F.R. 3124.

² Letter to Jonathan G. Katz from Michael J. Simon, dated April 8, 2004.

- *By requiring DPMs to quote on the NBBO in order to receive a Preferred DPM participation entitlement, the [CBOE] believes that the proposed rule will significantly enhance quote competition and will result in greater liquidity for customers.*

We do not believe that the proposal will enhance quote competition, and there is no support provided for this statement. Existing rules require that market participants quote at the NBBO before they receive an allocation. Moreover, providing an enhanced allocation to an e-DPM based on its preferred status, while excluding all other e-DPMs quoting at the same price, will actually discourage competitive quoting by denying rewards when quoting at the NBBO.

- *By providing e-DPMs with a greater participation right in cases where orders are designated to them as a Preferred DPM, the CBOE believes the proposal creates incentives for e-DPMs to competitively quote and to attempt to attract order-flow to the CBOE. This benefits the Exchange and its customers by adding liquidity to the CBOE's markets.*

We agree that the proposal creates incentives for e-DPMs to enter into arrangements to bring order-flow to the CBOE, benefiting the CBOE. However, this incentive is not based on competitive quoting, but rather on a relationship between the market maker and the order flow provider. Thus, the proposal is a burden on quote competition because it rewards market makers based on relationships rather than the quality of their quotes. Additionally, we believe this burden on quote competition will have a negative effect on the liquidity available to non-preferenced orders, and therefore a negative effect on customers.

- *By rewarding DPMs and e-DPMs for making deep and tight markets and by enhancing their ability to compete for order flow, the Exchange believes the proposed rule change would: (i) promote just and equitable principles of trade; (ii) serve to remove impediments to and perfect the mechanism of a free and open market and a national market system; and (iii) help ensure that the Exchange can attract well capitalized firms as specialists which in turn serves to protect investors and the public interest.*

We do not understand this statement: The CBOE implies that it will be able to attract well capitalized firms by providing them a better opportunity to receive payment for their order flow and/or internalize their order flow. We fail to see how this serves to protect investors and the public interest. We believe this proposal is contrary to a free and open market and a national market system in that it perpetuates the routing of order flow not to the most competitive market, but to the market where the broker has a relationship with a market maker. We have previously commented that the Commission should take steps to ban all forms of payment-for-order flow for this reason.³

The CBOE provides no basis for its assertions that this proposal will enhance quote competition. It has not provided sufficient analysis for the Commission to find that the burden on quote competition that will result from granting market makers allocation guarantees based upon their status as a designated preferred market maker is

³ See Letter from Michael J. Simon, *supra* note 2.

reasonable or justified under the Exchange Act. Moreover, we do not believe the CBOE has provided any reason why the Commission should reconsider its historical approach to allowing specialist entitlements based upon marketplace obligations, while rejecting, or placing severe limitations on, other non-competitive, status-based entitlements.⁴

Existing Restrictions on Internalization and Preferencing

In facilitation and directed order programs, the options exchanges have complied with Commission staff requests to provide certain protections not included in the CBOE preferencing proposal. When facilitating a customer order, a firm seeks to provide liquidity to larger orders of at least 50 contract. Recognizing that additional liquidity may be needed for larger orders, the Commission has approved these programs only if an exchange's facilitation rules require the exposure of the order prior to execution to provide an opportunity for price improvement and for other market participants to participate in the order. Importantly, the Commission has permitted this only for orders of 50 or more contracts.

There is no distinction between a broker "facilitating" an order and a broker directing an order to a particular market maker for execution, as no broker will preference an order unless there is some economic incentive to do so, *i.e.*, the broker is either affiliated with the market maker or is receiving payment in return for directing the order to the market maker.⁵ Under the CBOE's proposal, not only is the preferred DPM not adding liquidity to the market, but the proposal would permit the preferred DPM to execute the order without any exposure to the market at all, for price improvement or otherwise. Moreover, it would be available for orders of *any* size.

The reason the Commission generally has not permitted an exchange to implement any facilitation or preferencing program for orders of less than 50 contracts is because members are not providing supplemental liquidity for smaller orders. This eliminates any justification for removing even a portion of an order from an auction. The one exception to this policy has been for the Boston Options Exchange's ("BOX") program permitting order entry firms to direct orders, including small orders of less than 50 contract, to specified market makers.

BOX's directed order program contains substantial protections for customers that are not present in the CBOE's preferencing proposal: a BOX directed market maker must either: (1) enter an order into the price improvement mechanism, where it *guarantees* the order price improvement over the NBBO, exposes the order for further price improvement, and is only provides the preferred market maker with a percentage of the order if the market maker is competitive with other market participants after the order is exposed; or (2) release the order into the market where the directed

⁴ We recognize that the CBOE is not proposing to remove additional order flow from the auction in order to "reward" the preferred DPM. Rather, it is reallocating the specialist allocation among DPMs when a member preferences one DPM. However, the Commission previously has not allowed *any* order flow to be removed from the auction simply due to the status of the member capturing the order flow. In this case, not only is the CBOE rewarding a DPM with order flow due solely to its status as a preferred DPM, but it is doing so at the expense of other DPMs quoting at the NBBO.

⁵ The Commission long has discussed payment for order flow, specialist guarantees and internalization together as related topic. See the Options Concept Release, *supra* note 1, at Section III.C.

market maker must yield priority to all other interest at the best price.⁶ The ISE has filed a proposal to adopt a similar directed orders program.⁷

The BOX's directed orders program and the ISE's pending directed orders program are extremely limited. Once orders are entered into the exchange's auction market, the limited guarantees apply only after the auction market has an opportunity to provide the orders price improvement and potentially take the entire order away from the directed market maker. This is especially critical for small orders where price improvement may be available. In contrast, the CBOE preferencing proposal will allow firms to direct orders of all sizes to DPMs without providing price improvement or even the opportunity for other market participants to provide price improvement, and will create a true locked-in guarantee with no risk of losing the order to the auction market.

We urge the Commission to consider carefully the implications of allowing order-flow providers to determine which market participants, quoting at the same price, may execute against their orders. The CBOE proposal limits preferencing to DPMs and e-DPMs, but there is little substantive difference between the CBOE e-DPMs and remote market makers on the other options exchanges. This is particularly true as markets adopt relaxed quotation requirements, allowing competing market makers and specialists to post nominal quotes with \$5 spreads.⁸ Indeed, the only significant obligations the CBOE initially imposed on e-DPMs was the requirement to quote continuously in their assigned options. Unlike floor-based DPMs, e-DPMs never have had any obligations to open the market or to protect customer orders when there is a better market away. Allowing \$5 spread effectively eliminates any substantive market making requirements for e-DPMs.⁹

Exacerbating the problems with the CBOE's proposal is the possibility of coordinated actions between an DPM and an order entry firm. There are no protections against an order flow provider notifying a DPM of an incoming preferred order, the DPM changing its quotation to match the NBBO for the split second necessary to capture the preferred order, and then fading back to a \$5 spread. While exchanges generally have "informational barrier" protections against this form of coordinated activity within a market maker's own firm,¹⁰ there is no protection against this form of abuse in preferred orders.

When we previously discussed with the Commission staff possible preferencing programs in our market, the staff stated that it would not consider enhanced allocations based on non-competitive status. However, that is exactly what the CBOE is proposing. We see no reason for the Commission to change its view and to accept status-based

⁶ The BOX rules also specify that a directed market maker must accept orders from all participants. Accordingly, the market maker has no way of knowing whether the order has been routed to it by an affiliate or another broker-dealer with which it has a payment relationship. There is no such requirement in the CBOE proposal.

⁷ File No. SR-ISE-2004-16.

⁸ See File Nos. SR-CBOE-2004-20 (Release No. 34-49791 (June 2, 2004)) and SR-ISE-2003-22 (Release No. 34-50015 (July 14, 2004)).

⁹ Like the CBOE, the ISE has adopted a \$5 spread requirement for both our Primary Market Makers ("PMMs," our specialist-equivalents) and Competitive Market Makers ("CMMs"). However, we do not permit our CMMs to share in the PMM's allocation of an order. If the Commission were to approve this filing, competitive pressures would require us to reconsider this.

¹⁰ See, e.g., CBOE Rule 8.93(x) and ISE Rule 810.

allocation algorithms unless the CBOE can provide a more compelling case for such a change. The current filing presents no such case.

Conclusion

Approval of this non-competitive status-based guarantee would be a significant departure from the Commission's policy on allocation entitlements and facilitation rules. It would have a significant negative impact on price competition, as the other options exchanges will be forced to explore similar arrangements that allow order-flow providers to direct the execution of their orders to market makers with which they have relationships. Moreover, in contrast to the options exchanges' facilitation rules and the BOX's limited directed orders program, the proposal provides a guarantee to a market maker without requiring that it provide price improvement, nor assuring that there is an opportunity for other market participants to provide price improvement. The Commission should not approve this proposal.

Sincerely,

Michael J. Simon,
General Counsel and Secretary

cc: Annette Nazareth
Robert Colby
Elizabeth King
John Roeser