January 19, 2004

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

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

Dear Mr. Katz:

The Boston Options Exchange Regulation ("BOXR"), a wholly-owned subsidiary of the Boston Stock Exchange ("BSE"), appreciates the opportunity to comment on the Chicago Board Options Exchange's ("CBOE") proposal to allow order flow providers to designate or "preference" certain market makers to execute against their orders. The CBOE proposal provides a significant entitlement to certain market makers based upon their relationship with order flow providers without correspondingly enhancing their obligations to the market or the competitiveness of their quotes. We believe that this will significantly discourage price competition in the market and hinder other market makers from competing with the preferenced market maker. Accordingly, we urge the Commission to institute proceedings to disapprove this proposal.

Summary of the Proposal[1]

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 "participation entitlement"). Currently, the floor-based DPM receives half of the participation entitlement 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

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[1] See Letter to Jonathan G. Katz from Michael J. Simon, dated December 31, 2004,

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or e-DPM is quoting at the best price,[2] the preferred DPM or e-DPM would be allocated two-thirds of the participation entitlement as follows:

- If an order is preferenced to the floor-based DPM, it receives two-thirds of the participation entitlement and any other e-DPMs at the same price share the remaining one-third of the participation entitlement pro-rata. This is similar to the current allocation rule, with a higher percentage going to the floor-based DPM because it was preferenced by the order-flow provider.

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

Something for Nothing

While BOXR does not per se oppose the idea of "preferencing" to market makers (indeed we agree that the institution of competing specialists/market makers is a major improvement in the overall market structure of CBOE), we agree with the Commission's concerns about any rule dealing with the handling of internalized/captive order flow that may reduce order flow to the competitive market place and the negative effects this may have on overall long-term market quality. The Commission has previously stated that it "is concerned that proposals by options exchanges that guarantee a significant portion of orders to any market participant could erode the incentive to display aggressively priced quotes."[3] While CBOE is not proposing to remove additional order flow from the entire market auction in order to "reward" the preferenced DPM, the exchange is, however, reallocating the specialist entitlement among competing DPMs when a member preferences one DPM.. The Commission must weigh whether the CBOE proposal would reduce the ability of other market participants to trade with an order *to the degree that it would reduce price competition.* This would be consistent with the analysis the Commission has applied to specialist guarantees.

To take into account this legitimate concern, BOXR believes that any specialist-like enhanced trade allocation privilege must be compensated for by the market maker in the form of improved market quality for ALL options investors. In other words, anyone who is going to "take out something" from the market (in this case an up to 50% participation entitlement) must be obliged to "give back something" of at least equal value to the marketplace. Since there is little, if any, overall improvement in market quality by the preferenced DPM (he does not have to do anything

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[2] Since the CBOE does not automatically filter customer orders entering the exchange from trading through the NBBO in a manner similar to Section 16(b) of Chapter V of the BOX Rules, we assume that the CBOE can demonstrate to the Commission that it has adequate surveillance in place to monitor compliance with this requirement of the proposed rule.

[3] See, Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) at 2789 See, e.g., Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778 (August 9, 2000).

more than he is already obliged to do), this CBOE preferencing proposal falls significantly short of this test.

In return for the current minimal obligations--quoting ten by ten markets with bid/offer spreads of now up to $5, the CBOE's e-DPMs would enjoy a very significant privilege to interact with captive order flow. While a precise definition of market quality remains elusive, most industry observers would agree that price and depth are two integral factors. In the CBOE proposal, there is no incentive for the e-DPM to improve the prevailing market in either price or size. By simply going along with the other market makers the e-DPM retains its special participation entitlement. Furthermore, in a marketplace where the posted size for bids and offers for many high volume classes is frequently several hundred contracts at all six options markets, it is difficult to see how an additional ten contracts will measurably improve overall market quality. Therefore, BOXR believes CBOE should require significantly higher obligations on the part of e-DPMs, especially for already liquid classes, before permitting an e-DPM to enjoy this special participation entitlement.

BOXR also believes that the proposed rules should specify that a DPM or e-DPM must accept preferenced orders from all members, not just those with which it has an order flow arrangement. As a result the DPM would have no way of knowing in advance whether the preferenced orders it will receive have been routed to it by an affiliate, another broker-dealer with which it has a payment relationship, or any other member. In this way the DPM would not be tempted to discriminate among customer orders when it chooses to give the NBBO.

Specialist Guarantees

The CBOE proposal would provide greater trade allocation entitlements to a DPM or e-DPM based solely on its designation by a broker as the preferred market maker without correspondingly enhancing its obligations to the market or the competitiveness of its quotes, which is inconsistent with Commission policy. "Specialist guarantees are intended to attract and retain well-capitalized firms that are responsible under exchange rules for assuring fair and orderly markets and fulfilling other responsibilities that enhance the exchange. The Commission has closely scrutinized exchange rule proposals to adopt or amend a specialist guarantee where the percentage of specialist participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange."[4] Therefore, the Commission has approved specialist guarantees only when they properly reward market making firms for their heightened obligations and enhancements to market quality, and not simply due to a firm's designation.

BOXR believes that this proposal is in contravention of CBOE's own statements to the Commission about its specialist guarantees made in response to the Options Concept Release- "The current specialist guarantee rules on CBOE significantly enhance competition by rewarding DPMs for providing liquidity and other services, while at the same time providing sufficient incentive to other market makers to assure their continued presence as sources of additional competition."[5] In this case, not only is the CBOE rewarding one DPM with additional entitlements, without enhancing their obligations to provide liquidity and other services, it is doing so at the expense of other competing e-DPMs who are also quoting at the NBBO. We do

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[4] Securities Exchange Act Release No. 49175 (February 3, 2004), 69 FR 3124.

[5] See Letter to Jonathan G. Katz from William J. Brodsky, dated April 16, 2004, Exhibit A p.3.

not understand what has changed so dramatically on the CBOE to justify this proposal to change specialist guarantees.

Effect on Competition and Market Quality

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. The existing rules already require market participants quote at the NBBO before they receive a trade allocation. This proposal adds nothing to the incentive to compete. Also, by having the NBBO quoting obligation limited to only when an order is preferenced to the e-DPM, the e-DPM is much less likely to quote on the less liquid or risky (e.g. in the money) series since there is very little customer order flow in those series. As a result, the e-DPM will simply quote on the most liquid series where his ten contract quote contribution is arguably the least useful in terms of improving overall market depth. Most of the time there is already ample liquidity on these series to attract and handle customer order flow.

In addition, because the CBOE does not require in this proposal that the e-DPM quote for a larger size than the current ten by ten obligation, the e-DPM could reliably take his 20%-50%[6] entitlement for most of his preferenced customer orders without any extra effort. This is because his ten contract quote will "max out" against an order of 50 contracts (20% of 50 equals ten); and it is widely known that almost all customer order flow is for fewer than 50 contracts.

The CBOE believes the proposal creates incentives for e-DPMs to competitively quote and to attempt to attract order-flow to the CBOE, benefiting the exchange and its customers by adding liquidity to the CBOE's markets. BOXR is concerned that the CBOE proposal could significantly discourage price competition on that market by "locking up" a large portion of each order and hindering other e-DPMs from competing with the preferred DPM. In fact, providing an additional entitlement to a preferred DPM, while excluding all other e-DPMs quoting at the same price, will actually discourage competitive quoting by denying rewards when quoting at the NBBO. BOXR believes that, over the long-term, the decrease in intramarket competition would widen spreads and diminish the quality of prices available to investors as well as have a negative effect on the liquidity available to non-preferenced orders. In addition, if the Commission approves this CBOE proposal, other exchanges would have to propose similar guarantees to remain competitive, thereby permanently undermining intermarket competition as well.

Exchange Sponsored Payment for Order Flow

We note that CBOE has an exchange sponsored payment for order flow program where CBOE applies a marketing fee of $0.22 on DPMs, e-DPMs and market-makers for *every* equity options contract they enter into on CBOE, other than market-maker-to-market-maker transactions.[7] All funds generated by the marketing fee are collected by CBOE and disbursed by CBOE according to the instructions of the DPM. We believe CBOE should address how this preferred DPM proposal would work in relation to the CBOE administered payment for order flow program. For instance, will preferenced trades be subject to the marketing fee? Will the CBOE payment for

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[6] 50% is the highest entitlement if there is only the DPM Complex quoting at the NBBO and 2/3 of 30% or 20% is the least if there are more than two DPMs. quoting the NBBO

[7] See Release No. 34-50736; File No. SR-CBOE-2004-68 (November 24, 2004)

order flow program be used to pay order flow providers for orders they send to preferred DPMs pursuant to this CBOE proposal? Is an e-DPM paying a marketing fee on all his equity options trading activity and also paying the order flow provider who is preferencing him? We are concerned that e-DPMs that do not have significant order flow arrangements would be subsidizing payments to order flow providers who preference other e-DPMs. In addition, we believe that this exchange sponsored payment for order flow program taken in combination with the CBOE proposal, in which the other non-preferred e-DPMs will completely lose allocation because of the participation entitlement, would force all e-DPMs to make payments for order flow arrangements or else lose their order flow completely to other e-DPMs. Market competition would be based on payments not the best quoted prices.

CONCLUSION

The CBOE proposal provides a significant entitlement to DPMs and e-DPMs based upon their relationship with order flow providers without correspondingly enhancing their obligations to the market or the competitiveness of their quotes. BOXR believes the CBOE proposal should provide for significantly higher obligations on the part of DPMs and e-DPMs, especially for already liquid classes. Any enhanced trade allocation privilege must be compensated for by the market maker in the form of improved market quality for all options investors. In this case, not only is the CBOE rewarding one DPM with additional entitlements, without enhancing their obligations to provide liquidity and competitive prices , but it is doing so at the expense of other competing e-DPMs. Over the long-term, the decrease in competition would widen spreads and diminish the quality of prices available to investors as well as have a negative effect on liquidity. The Commission should not approve this proposal.

If there are any questions or comments regarding the issues raised herein, please do not hesitate to contact me.

Sincerely,

Kenneth R. Leibler
Chairman
Boston Options Exchange Regulation

cc: Annette Nazareth
Robert Colby
Elizabeth King
John Roeser