



3

PHILIP D. DEFEO
CHAIRMAN
CHIEF EXECUTIVE OFFICER

VIA FACSIMILE AND FEDERAL EXPRESS

May 21, 2003

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

Re: File No. SR-CBOE-2002-05; Securities Exchange Act Release No. 47674

Dear Mr. Katz:

The Pacific Exchange, Inc. ("PCX" or "Exchange") appreciates the opportunity to comment on the Chicago Board Options Exchange, Inc.'s ("CBOE") proposal to adopt new rules for the implementation of a new options trading platform called the CBOE Hybrid System (the "System").¹ The PCX has concerns with that aspect of the CBOE rule proposal ("Proposal") that would permit the dissemination of "locked" quotes involving multiple CBOE market makers.² For reasons set forth below, the PCX believes that this part of the Proposal is inconsistent with certain provisions of the Options Intermarket Linkage Plan ("Linkage Plan") and would have deleterious effects on intermarket competition and the opportunity for investors to obtain best execution. Therefore, the PCX urges the Securities and Exchange Commission ("Commission") to delay effecting the proposed rule changes, until it has the benefit of further review and discussion on these issues.

The CBOE is proposing to adopt Rule 6.45A(d), which outlines the methodology used to disseminate quote information in the event that CBOE market makers' quotes become locked. In such circumstances, a so-called "counting period" will begin, during which time market makers, whose quotes are locked, may fade from the locked market price. The maximum duration of the counting period is initially set at ten seconds.

¹ See Securities Exchange Act Release No. 47676 (April 14, 2003), 68 FR 19865 (April 22, 2003) ("Proposal").

² See proposed CBOE Rule 6.45A(d) ("Quotes Interacting with Quotes").

Mr. Jonathan G. Katz

Page 2

May 21, 2003

During the counting period, market makers will be obligated to execute customer and broker-dealer orders eligible for automatic execution (pursuant to proposed CBOE Rule 6.13), and will also be obligated for one contract in open outcry to other market makers. In any instance, the CBOE is firm for its disseminated size, as required under Rule 8.51 (Finn Quote Rule). If at the end of the counting period the quotes remain locked, the locked quotes would automatically execute against each other in accordance with the allocation algorithm. The CBOE also notes that the System will not disseminate an internally crossed market. If a market maker submits an incoming quote that would cross an existing quote, the System would alter the incoming quote such that it locks the existing quote, at which point the locked quotes will be treated in accordance with the procedures described above.

The PCX believes that the requirements of the Linkage Plan on locked and crossed markets conflict with the CBOE's proposed methodology in processing quote information by multiple market makers where such quotes become locked. Section 7(a)(i)(C) of the Linkage Plan currently provides:

“(C) Locked and Crossed Markets. The Participants agree that the dissemination of “locked” or “crossed” markets shall be avoided. The Participants agree to approve and submit to the SEC for its consideration uniform rules providing that: (1) if an Eligible Market Maker should lock or cross a market, that Eligible Market Maker will unlock, uncross, or direct a Principal Order through the Linkage to trade against the bid or offer that was locked or crossed; and (2) if a member other than an Eligible Market Maker should lock or cross a market, that member will unlock or uncross the market.”

The PCX is concerned that CBOE's proposal will exacerbate the occurrence of locked and non-disclosed crossed markets to the detriment of public investors. The Proposal is vague and would appear to permit continuous locked markets and internally crossed markets due to overlapping counting periods. This occurrence decreases the likelihood of active price competition by CBOE market makers. The delay imposed by the counting period also will have a significant negative effect on other marketplaces. Because of CBOE's latency to post true markets, competing marketplaces will be unlikely to trade during a locked CBOE market. During this counting period, while CBOE is attempting to ascertain what its real market is, all competing marketplaces will be significantly discouraged from trading. Therefore, CBOE's difficulty in determining its own market should not impede or effectively freeze trading in away markets.

Mr. Jonathan G. Katz
Page 3
May 21, 2003

In addition, because the System will not disseminate an internally crossed market, market maker quotes that better the price of the then-disseminated CBOE quotation will not be displayed and, therefore, any inbound marketable orders eligible for automatic execution would not be executed at the more favorable price. For example, assume that Market Maker A quotes 1.00 – 1.20, 10 x 10 (which is the CBOE's disseminated quote) and Market Maker B submits a quote of 1.25 – 1.40, 1000 x 1000. Because Market Maker B's quote would invert Market Maker A's disseminated quote, the System would change Market Maker B's quote to 1.20 – 1.40 and the disseminated quote would be locked at 1.20 – 1.20, 1000 x 10. During the locked market (counting period), an inbound market or marketable limit order to sell would be either fully or partially executed against the displayed bid of 1.20, even though there was sizeable trading interest willing to pay 1.25. Furthermore, the lowering of Market Maker B's bid to 1.20 could adversely effect any customer sell orders residing in the electronic book at 1.25 by potentially causing a delay or missed opportunity to trade at 1.25. The CBOE rules make no mention of what will happen to the balance of Market Maker B's decremented bid after the completion of the counting period. The question is, will it remain represented as a 1.20 bid or will it be restored to a 1.25 bid and then be entered into the n-second pool to match against any interest at the next price. Therefore, we are concerned that this process is not conducive to satisfying market participants' best execution and due diligence obligations.

Because the CBOE Proposal would reduce price transparency and place an inappropriate burden on competition, the Exchange respectfully requests the Commission to delay approval of the proposed rule change until the Commission has the benefit of further review of our concerns.

* * *

We appreciate the Commission's consideration of our comments. If the Commission or its Staff has any questions, please feel free to contact me at (415) 835-4870.

Sincerely,



Philip D. DeFeo
Chairman and Chief Executive Officer

PDD/JW/JB/PB:cy

cc: Annette Nazareth, Director, Division of Market Regulation