July 14, 2000

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

Re: File No. SR-CBOE-00-27

Dear Mr. Katz:

The International Securities Exchange LLC urges the Commission to abrogate the above-referenced proposed rule change (the "Proposal") in which the Chicago Board Options Exchange ("CBOE") seeks to establish an exchange-sponsored payment-for-order-flow program. We believe the Proposal is improperly filed as an "effective-on-filing" rule change pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934, as amended ("Exchange Act"). Moreover, we believe that there are strong policy reasons not to permit this filing to take effect without providing interested persons an opportunity to comment on the Proposal.

This letter focuses primarily on procedural issues and does not discuss the merits of an exchange adopting a payment-for-order-flow program. We are hopeful that the Commission will abrogate the filing, thus instituting a proceeding in which commentators would have an opportunity to address the merits of this controversial practice, rather than focus on procedural improprieties. If the Commission does not abrogate the filing in the near future, we intend to make an additional submission discussing the substantive aspects of the Proposal before the expiration of the 60-day abrogation period.

The Payment-for-Order-Flow Proposal

The CBOE proposes to establish a "marketing fee" of $.40 per options contract traded on the CBOE, excluding only trades involving two market makers. The CBOE will give the funds generated by this fee to its designated primary market makers ("DPMs") "to attract orders in the classes of options traded at [the DPM's] station." This "could include" having the DPM pay broker-dealers to send their orders to the CBOE. The DPMs will have complete discretion on how to spend these funds:

> The specific terms governing the orders that qualify for payment and the amount of any payment to be made will be determined by the DPMs in whatever manner they believe is most likely to be effective in attracting order flow to the [CBOE] in options traded at the DPM's assigned stations.

The CBOE has filed the Proposal as "establishing or changing a due, fee or other charge, thereby qualifying for effectiveness on filing pursuant to Section 19(b)(3)(A)(ii) of the [Exchange] Act and subparagraph (e) of Rule 19b-4 thereunder."

The Proposal is Not Properly Filed as an "Effective-On-Filing" Rule Change

Section 19(b)(3)(A)(ii) of the Exchange Act provides that a rule filing may take effect on filing if the exchange designates the proposal as "establishing or changing a due, fee, or other charge imposed by the self-regulatory organization." To the extent the Proposal simply adds a "marketing fee" of $.40 a contract traded, the proposal, on its face, would fit within the legal requirements of Section 19(b)(3)(A)(ii). However, the Proposal does much more.

Rather than simply imposing a fee, the Proposal establishes a program by which the CBOE delegates to its DPMs the authority to pay for order flow on behalf of the exchange. Indeed the CBOE goes to great lengths in its filing to discuss the payment-for-order-flow program, specifying that DPMs alone will have discretion on all payment decisions. Effectively, this provides a system in which all members in a trading crowd are "taxed" by an exchange to pay order-entry firms for their order flow. The CBOE takes the proceeds of the fee, hands the money over to its DPMs, and then allows the DPMs to make collective payment decisions. We are not aware of any other fee program of a self-regulatory organization ("SRO") in which the SRO hands the proceeds of a fee to a member and then tells the member that the money is his or hers to spend as they see fit. This aspect of the Proposal goes well beyond any concept of a "fee" and certainly is not the appropriate subject of an effective-on-filing submission.

The procedural aspects of this filing also raise critical antitrust issues. The CBOE seeks regulatory "blessing" of collective action among supposed competitors on its trading floor. The effect of the Proposal would be that the market makers – supposed competitors – collectively put money into a "pot," and designate the DPM, a competitor, as their representative to bargain with order flow providers to send their orders to the CBOE for a payment. This provides for competitors jointly agreeing on the price they pay for orders, which certainly would be inappropriate collusion among competitors absent some form of antitrust immunity. We assume that it is for this reason that the CBOE details its payment program in the filing, implicitly seeking the Commission's blessing of this activity.[1]

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[1] A Commission determination that an exchange's action is consistent with the competitive standards of the Exchange Act may provide implied immunity from antitrust liability for actions by

We believe it is inappropriate for the CBOE to attempt to use the effective-on-filing rule change mechanism of Section 19(b)(3)(A)(ii) in an attempt to achieve antitrust "cover" for this form of collective action by its market makers. Section 19(b)(3)(A)(ii) is limited to fees themselves, and if the CBOE seeks to impose a marketing fee under this section, the Commission should require the CBOE to limit its filing solely to the proposed fee. Specifically, the Commission should require the CBOE to submit a new proposal that simply imposes the $.40 marketing fee, without addressing in any way the payment-for-order-flow program. The collective action by the supposed competitors on the CBOE floor would then be subject to full review under the antitrust laws without any argument that the Exchange Act has provided a shield of immunity. [2]

There are Strong Policy Reasons Why the Commission Should Not Permit the Proposal to Become Effective on Filing

Apart from the legal argument that there is no basis for filing the Proposal under Section 19(b)(3)(A)(ii) of the Exchange Act, there are strong policy reasons why the Commission should abrogate the filing. Abrogation would not "disapprove" the filing. The Exchange Act provides that such action simply would "require that the proposed rule change be refiled in accordance with the provisions of paragraph (1)" of Section 19(b). This would provide for notice and an opportunity for the public to comment on the Proposal before the Commission takes action on the filing.

We need not discuss the long and controversial history of payment for order flow in this letter. Suffice it to say that Chairman Levitt has expressed caution regarding the creep of payment for order flow into the options market. [3] In addition, Annette Nazareth, the Director of the Division of Market Regulation, has stated that "[w]e have concerns about these proposals, and we would look very carefully at the impact on the options markets before we permitted these

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that SRO that otherwise almost certainly would be prohibited. *Gordon v. New York Stock Exchange, Inc.,* 422 U.S. 659 (1975).

[2] We emphasize that there only is an argument that antitrust immunity would flow from the filing of a substantive rule change for immediate effectiveness under Section 19(b)(3)(A) of the Exchange Act. At least one court has explicitly stated that any proposed SRO action must be "scrutinized and reviewed" by a regulatory agency under that agency's governing law before there can be any antitrust immunity. *American Agricultural Movement v. Board of Trade*, 977 F.2d 1147 (7th Cir. 1992). There is no explicit Commission analysis of the competitive implications of a proposal filed under Section 19(b)(3)(A)(ii). We believe that the only way to ensure that antitrust immunity is available is for the Commission to issue an order approving a proposed rule change filed under Section 19(b)(1) explicitly explaining why any burden on competition imposed by the Proposal is appropriate under the Exchange Act.

[3] "Best Execution: Promise of Integrity, Guardian of Competition," Chairman Levitt's address at the Securities Industry Association Annual Meeting, November 4, 1999.

practices to occur."[4] Permitting a Proposal to take effect on filing, without an opportunity for public comment, is hardly a careful look at the practice.

Allowing the Proposal to become effective on filing cannot be justified by viewing this program as simply another manifestation of existing payment-for-order-flow practices. Rather, the Proposal takes payment for order flow to a new level. To date, payment for order flow has been limited to specific market makers or specialists making individual decisions to pay broker-dealers for their order flow. Governing SROs neither sanctioned these practices nor involved themselves in the mechanics of the payment process, although exchanges may provide data to its members to help the member determine to whom payments are owed.

In contrast, the CBOE proposes to establish the first SRO-sanctioned and operated payment-for-order-flow program. The serious policy issues the Proposal raises include:

- Vagueness: The Proposal does not specify how a DPM must use the pool of money the fee would generate. It does not even require that DPMs spend all the money collected. The complete discretion given to DPMs to "attract order flow" arguably could permit a DPM to use the money to increase its own net capital to finance its market making activities. At a bare minimum, a filing sanctioning an exchange-mandated payment-for-order flow program should describe the program.

- Discrimination. The Proposal gives DPMs absolute discretion on all payment issues, with no input by other market makers or the CBOE, let alone notice to the public through a subsequent filing with the Commission. We question the propriety of an exchange establishing – really mandating – a system by which one class of members (DPMs) has delegated authority from the exchange to make decisions on how to pay another class of members (order flow providers). This gives DPMs the unfettered ability to discriminate among CBOE members. We fail to see how this is consistent with the Exchange Act.

- Anti-Competitive Implications: Under the "rule of law" (that is, under the CBOE's rules, which are as binding as the Exchange Act on the CBOE's members), all market makers in a crowd effectively would be required to pay a competitor – the DPM – $.40 per contract traded. Failure to pay the DPM this fee would be a violation of the CBOE's rules and would subject the member to discipline. Effectively, this lets DPMs "tax" their competitors and use the proceeds of the tax for their own benefit.

- Conflicts of Interest: The Commission long has questioned whether receiving payment for order flow is consistent with a broker-dealer's best execution

[4] "Trying to Get a Grip on Equity Options," New York *Times*, October 26, 1999. Ms. Nazareth comments were directed at the practices of paying for order flow and order entry firms directing order flow to affiliated specialists.

responsibilities. Under our self-regulatory system, it is the primary responsibility of an exchange to police its members' best execution practices. When an exchange-sponsored payment-for-order flow system influences a broker-dealer's order routing decisions, it necessarily will raise questions regarding the objectivity of the exchange's best execution surveillance and disciplinary programs.

- Transparency: An exchange has the obligation to make available to the investing public its bids and offers. Payment for order flow complicates this process by establishing a "hidden" component of the price of a security. This becomes more of a problem when an exchange specifically establishes a payment-for-order-flow program, yet makes no attempt to include the amount of the payments in its published markets.

There can be a spirited debate over whether the Proposal is appropriate policy and beneficial to the investing public. However, there is no real question that it is wrong to permit the CBOE to institute this program without giving investors, other market participants and the public an opportunity to comment. A decision by the Commission not to abrogate the CBOE's filing only can be read as the Commission having determined that all aspects of the Proposal are consistent with the Exchange Act. With respect to an issue as controversial as payment for order flow, we believe it is far superior to have the Commission resolve these matters in a reasoned order, and not through inaction.

<u>Permitting this Proposal to be Effective on Filing is Inconsistent With Precedent</u>

In 1998 the CBOE proposed a fee structure very similar – but much less controversial – than the current Proposal. Specifically, the CBOE proposed to impose a "surcharge" on market makers to be used to reimburse "stationary floor brokers" ("SFB") for commission income they would lose if they lowered their commission rates.[5] The filing provided detailed procedures for establishing the surcharge, including a requirement that the market makers in a crowd vote on a recommended surcharge for an options class, with the CBOE's Floor Procedure Committee ("FPC") making the ultimate determination as to a surcharge. The CBOE submitted that filing as a "regular way" filing under Section 19(b)(1), providing notice and an opportunity for comment prior to approval. After the Commission approved the concept of the surcharge, the CBOE was required to file an effective-on-filing fee change with the Commission pursuant to Section 19(b)(3)(A) each time it implemented or changed a specific surcharge.[6]

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[5] File No. SR-CBOE-98-35, approved in Release No. 34-41121 (February 26, 1999).

[6] The surcharge initially applied only to multiply-traded options. The CBOE subsequently proposed to extend this program to solely-listed options. File No. SR-CBOE-98-35, Release No. 34-41732 (August 11, 1999). This filing also was filed "regular way," and not for immediate effectiveness. We are not aware of the Commission ever having issued an order approving this filing.

Contrast that procedural history concerning a limited brokerage rebate program with the proposed treatment of the first exchange-administered payment-for-order-flow program: The CBOE is filing only one rule change to authorize its program, with that rule change purportedly effective on filing under Section 19(b)(3)(A); there is no opportunity to address the merits of the Proposal prior to it becoming effective; and there is no filing – or notice at all – when a DPM authorizes a specific payment. We fail to understand the consistency in a policy that provided substantial opportunity for prior comment on a relatively-limited rebate program for commissions, but no opportunity for prior comment on perhaps the most significant competitive issue now facing the options industry.[7]

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We again urge the Commission to abrogate the CBOE's filing and to require the Proposal to be published for comment prior to the Commission taking any further action on it. We believe that the Proposal raises serious public policy and investor protection concerns. There is no basis in law or public policy to permit the Proposal to take effect on filing.

Yours very truly,

Michael J. Simon
Senior Vice President and General Counsel

cc: Annette Nazareth
Robert L.D. Colby
Belinda Blaine
Elizabeth King
Nancy Sanow
Joseph Lombard

Chairman Levitt
Commissioner Johnson
Commissioner Hunt
Commissioner Carey
Commissioner Unger

John D. Worland, Jr.

[7] Even the limited proposal to rebate SFB commissions generated negative comment. Specifically, the United States Department of Justice objected to that proposal, raising concerns that, among other things, the CBOE inappropriately was sanctioning a payment-for-order-flow program.