January 23, 2002

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

Re: File No. SR-CBOE-99-45, Amendment No. 2

Dear Mr. Katz:

The International Securities Exchange LLC ("ISE") appreciates the opportunity to comment on the above-referenced proposal ("Proposal") of the Chicago Board Options Exchange, Inc. ("CBOE"). The CBOE proposes to adopt criteria for its Floor Officials to use in excluding the quotations of other exchanges from its calculation of a national best bid and offer ("NBBO"). The effect of the Proposal would be to permit the CBOE to automatically execute customer orders in its Retail Automatic Execution System ("RAES") at prices inferior to the excluded quotations.

The Commission invites general comments on the Proposal and also requests comment on "the potential implications of this proposal on the implementation and operation of the Linkage Plan."[1] We believe that: the Proposal is overly broad; certain aspects of the proposal are inconsistent with the Linkage Plan; and the Proposal generally would harm investors. Thus, we believe that the Proposal is not consistent with the requirements of the Securities Exchange Act of 1934 ("Exchange Act") and we urge the Commission to institute proceedings to disapprove the filing.[2]

I. The Proposal Raises Fundamental Questions of Investor Protection

When the CBOE excludes an exchange's quotation from its NBBO, a customer order may be executed in RAES at a price inferior to the away exchange's quotation without any opportunity for the customer to receive the better price. This raises significant investor protection concerns and is directly contrary to the principle of "best execution":

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[1] The "Linkage Plan" refers to the plan the Commission approved in Securities Exchange Act Release No. 43086 (July 28, 2000), 65 *FR* 48023 (August 4, 2000).

[2] The focus of our comments is on the potential exclusion of the ISE's quotes from the CBOE's NBBO. We do not have sufficient expertise in the operation of the other options exchanges to discuss the specific impact of the Proposal on their markets.

> In accepting orders and routing them to a market center for execution, brokers act as agents for their customers and owe them a duty of best execution. The duty is derived from common law agency principles and fiduciary obligations. It is incorporated both in self-regulatory organization rules and, through judicial and Commission decisions, in the antifraud provisions of the federal securities laws. The duty requires a broker to seek the most favorable terms reasonably available under the circumstances for a customer's transaction.[3]

The CBOE's Proposal runs directly contrary to the Commission's efforts to promote best execution in the market.

It appears that the CBOE is attempting to justify the Proposal by relying on certain idiosyncrasies of the market for exchange-traded options, including the unique way in which the "Firm Quote Rule" (Rule 11Ac1-1 under the Exchange Act) applies to this market. Until April 2001 that rule did not apply at all to options.[4] When the Commission did extend the rule to the options market, it applied the rule in a "bifurcated" manner: a disseminated quotation has to be firm for its stated size only for "customers"; an exchange can be firm for non-customers for a smaller size established by rule. In practice, all exchanges are firm for customers for greater size than for professionals, and exchanges may be firm for non-customers for only one contract.

It is this application of the Firm Quote Rule that gives rise to a number of the CBOE's specific proposals. For example, while holding a customer order, a Designated Primary Market Maker ("DPM") on the CBOE floor may see an ISE quotation that is superior to the CBOE quotation. When the DPM attempts to trade against that quotation, it generally would do so as a non-customer, thus receiving an execution only for the "non-customer" volume provided by the ISE.[5] The CBOE appears to be concerned that "hitting" the ISE's quotations may not sufficiently clear that quotation to allow the DPM to execute the customer order at the inferior price disseminated by the CBOE.

We are sympathetic with the CBOE's frustration in clearing away markets. Our Primary Market Makers ("PMMs") certainly share many of these frustrations. However, the CBOE Proposal ignores the fact that the ISE quotation a DPM seeks to disregard is firm for its stated size for any customer order that a broker-dealer sends directly to the ISE. Indeed, a firm ISE quotation *always* is available for the customer, for its full size. There is no basis for the Commission to give the CBOE and its market makers regulatory comfort that they can ignore these

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[3] Securities Exchange Act Release No. 42450 (February 23, 2000), 65 *FR* 10577 (February 28, 2000) at 10584.

[4] *See* Securities Exchange Act Release No. 43591 (November 17, 2000), 65 *FR* 75439 (December 1, 2001) (the "FQR Release").

[5] However, it is now possible for the DPM to access that quote as a "customer" through the "interim linkage." As discussed in more detail below, the availability of the interim linkage provides a compelling reason for the Commission to reject the Proposal.

quotations and still hold themselves out to order flow providers as having the best price available. As discussed below, there is another way for the CBOE to address its concerns – a way that fully complies with the Exchange Act.

II. Limited Aspects of the Proposal Are Appropriate

We believe that excluding quotations from an exchange's NBBO is appropriate in three of the instances proposed by the CBOE: when an exchange designates a quotation as "non-firm" through the Options Price Reporting Authority ("OPRA"); when an exchange specifically confirms to the CBOE that it is experiencing systems or other problems; and when there are widespread locked or crossed markets.[6] In these limited circumstances there is clear, objective evidence that an exchange's disseminated quotation is suspect and that a customer may not receive an execution at that quotation if the customer's order were routed directly to that exchange.

Excluding quotations from the NBBO in these three situations also would be consistent with the Linkage Plan. The Plan specifically exempts an exchange member from liability for "trading through" the quote of another market if the quote is non-firm or if there is a systems or equipment failure.[7] In addition, the Linkage Plan provides procedures requiring an exchange to unlock or uncross a market, thus indicating that the dissemination of a locked or crossed market may well be fleeting and likely will not be accessible for any length of time.[8]

Our only concern with this aspect of the Proposal is the possibility of abuse in the application of these provisions. Currently, if our quotations are not firm for more than a few securities, the CBOE will remove *all* ISE quotes from its NBBO. CBOE staff has explained to us that, due to technical limitations, it must remove the entire ISE market from its NBBO in these situations. However, the proposed rule would permit the CBOE to remove only unreliable quotations from its NBBO, not the entire ISE market place (unless the entire exchange was experiencing a problem). We request that the Commission specifically reinforce this limitation if it determines to approve this aspect of the Proposal.

III. The CBOE Proposes Inappropriately Broad Exclusions from its NBBO

The balance of the CBOE's proposals raises serious legal and policy questions. Specifically, the three exclusions from the NBBO based on so-called "documented firm quote issues" are contrary to the requirements of the Exchange Act and are inconsistent with the Linkage Plan. We believe that there is no justification under the Exchange Act for denying customers the opportunity to receive an execution at a superior price in these situations.

[6] Paragraphs I.(a), (b) and (c) of Proposed Rule 6.8, Interpretation .02, respectively.
[7] Sections 8(c)(iii)(A) and (C) of the Linkage Plan.
[8] Section 7(a)(i)(C) of the Linkage Plan.

A. Orders Unfilled, or Filled at an Inferior Price

The first two proposed "documented firm quote issues" would not apply to ISE quotations. Specifically, the CBOE proposes to exclude from its NBBO exchange quotations when "one or more" market or marketable limit orders that a DPM or other CBOE market maker sends to an exchange either: (i) are executed at a price inferior to the disseminated quote; or (ii) are not filled at all (or are only partially filled), and in either case the exchange does not change its quotation in conformity with its "trade or fade" rule. Neither of these situations could occur on the ISE. Our automated trading system will not execute an order at a price inferior to the displayed quotation, and our system automatically "fades" the ISE's best bid or offer if we cannot fully execute an order.

Although these two situations cannot occur on the ISE, we still believe that they are overly broad and are inconsistent with the Exchange Act and the Linkage Plan. If a member of any exchange fails to honor its quotation, or does not properly "fade" its quotation under the rules of the member's exchange, that member is violating the rules of the exchange and is subject to disciplinary action. We would expect that the CBOE staff would call such action to the attention of the offending exchange, and that exchange would take prompt regulatory action. However, there is no basis under the Exchange Act, or precedent in the history of a national market system, to permit a customer to suffer an inferior execution due to the failure of a member on another exchange to comply with that exchange's rules.[9]

Similarly, these provisions conflict with the Linkage Plan. As adopted, the Plan does not except from liability a CBOE member that "trades-through" a quotation on another exchange due to previous instances of an exchange member failing to honor or fade its quotation. If a CBOE member were to trade through in this instance, that member would be subject to trade-through liability under the Linkage Plan. This would require the CBOE member to provide price protection to any customer orders represented in the quotation(s) the CBOE member traded through. It would be inconsistent to permit a CBOE member to execute the order of its own customer at a price inferior to that available on another market while requiring that member to provide price protection to the customer(s) in other market(s) that the CBOE member traded through.

B. Reinstating a Quotation Within 30 Seconds

The CBOE's final "documented firm quote issue" not only would harm investors, but also would seriously harm the ISE and competition in the market. The CBOE effectively proposes to exclude our quote from its NBBO if we: partially fill a DPM's or CBOE market maker's order; thereafter fade our quote;

[9] As proposed, the CBOE could exclude an exchange from its NBBO in an options class for a full 30 minutes if there is even *one* perceived instance of an exchange filling an order at an inferior price or not fading its quotation in that class. Thus, sporadic or isolated rule violations could lead to an exchange being excluded from the CBOE NBBO for long periods of time.

but then redisplay our quote within 30 seconds.[10] As with the other "documented firm quote issues," the CBOE could exclude the ISE quotation from the CBOE's NBBO if "one or more floor officials observe" this activity. This aspect of the Proposal suffers from the same infirmities as the other two "documented firm quote issues" discussed above. In particular, there is no basis to deny a customer with a superior execution due solely to the possibility of a previous rule violation on another exchange. However, this aspect of the proposal also suffers from an even greater fault: it is *impossible* to apply.

The ISE operates an anonymous, auction-based, electronic competitive market maker system. We have a PMM and generally up to 10 Competitive Market Makers quoting a particular option. In addition, we have multiple Electronic Access Members ("EAM") who can enter both proprietary and customer orders on our electronic book. If a market maker trades with an incoming order from any non-customer, including a CBOE DPM or market maker, and the ISE market maker does not execute the order to the full size of the ISE's market maker's quotation available to customers, our system automatically will fade the remainder of the market maker's quotation. Based on the Commission's Firm Quote Rule, absent a change in the price of the underlying security, we prohibit the market maker from reinstating that quotation for 30 seconds.

During the 30 seconds that a market maker must remain "faded," our market in the option remains active. During this time: (i) a market maker other than the market maker that executed the original trade could quote at the price of the previous execution; (ii) an EAM could enter a limit order on the book at the price of the previous execution; and/or (iii) the price of the underlying security could change, and the market maker that executed the original trade could change its quotation to its previous price. All three of these actions are fully consistent with the ISE's rules and the Firm Quote Rule.[11]

It is impossible for anyone on the CBOE floor – including floor officials – to tell when a new ISE quote at the price of a previous execution is a permitted quote change or the result of an ISE market maker inappropriately requoting at that price. As an anonymous market, we disseminate through OPRA only the ISE best bid and offer ("ISE BBO"). Neither a floor official on the CBOE nor anyone else looking at the ISE BBO can determine whether a "refreshed" quotation originates from the same member or a different member. Indeed, while

[10] In interpreting the Firm Quote Rule, the Commission has stated that it "expects that, in the absence of a price movement in the underlying security, the [market maker] will not reinstate its original bid or offer for at least 30 seconds." (FQR Release at footnote 141.) The ISE has adopted this 30-second requirement as a regulatory policy. *See* Regulatory Information Circular Number 2001-13.

[11] The Firm Quote Rule applies to the "responsible broker or dealer" disseminating a quotation. It does not apply to the exchange as a whole, and there is no prohibition on exchange members quoting at a price if another member fades from that price. Indeed, such a restriction could significantly impede price competition and harm investors by denying them improved prices.

ISE members viewing proprietary ISE data can see their own quotations and orders, even they cannot tell who else may be disseminating a quotation.[12]

The CBOE is proposing a rule that it cannot apply. The inevitable effect will be that CBOE floor officials will "guess" that ISE market makers are reentering quotations within 30 seconds, and without a factual basis will exclude ISE quotations from the CBOE NBBO. This will deny customers the opportunity to achieve the best execution of their orders. As discussed immediately below, if the Commission were to approve this Proposal, order entry firms could conclude that the Commission has determined that the CBOE's actions are consistent with the requirements of the Exchange Act. This would provide a broker with a false sense of comfort that it is complying with its best execution obligations when sending orders to the CBOE in these circumstances, and, worse yet, it would deny customers an opportunity for an execution at a better price.[13]

C. The Proposal Will Harm Investors and Market Competition

The CBOE has adopted a "best execution assurance program" to help the CBOE members "satisfy their best execution obligations when they direct orders to the CBOE for execution."[14] This program is similar to programs of the other exchanges, including the ISE, where exchanges provide members with daily "best execution" reports, indicating when customers received executions at prices inferior to away markets, with an explanation regarding such trades. The exchanges also use these best execution reports to compare the quality of executions on their exchanges to those on competing exchanges. The CBOE states that the operation of its best execution program begins as follows:

> The first step in processing [customer] orders to assure that executions take place at the best available price is to direct all orders received over the [Order Routing System] to RAES for execution in accordance with Exchange Rule 6.8. Interpretation and Policy .02 under that Rule provides that no orders may be executed on RAES at a price that is inferior to the national best bid and offer. . . .[15]

This is the very interpretation that the CBOE now proposes to amend to exclude the quotes of other exchanges based on guess-work by its floor officials.

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[12] When we view the quotations of the other markets we cannot identify the member of another exchange disseminating a quotation. Thus, we believe that this infirmity in the CBOE Proposal applies to all markets.
[13] As with the other two "documented firm quote issues" this aspect of the Proposal is inconsistent with the Linkage Plan. There is no exception from trade-through liability if a CBOE member trades through an ISE quotation that is "reposted" within 30 seconds. This is true whether it is the same member reposting its quote (either in violation of the 30-second standard or following a change in the price of the stock) or another member entering a new quote or order.
[14] *See* File No. SR-CBOE-00-32; Securities Exchange Act Release No. 43113, 65 *FR* 49038 (August 10, 2000).
[15] *Id*.

If the Commission approves the Proposal, the CBOE would not consider it to be a "trade through" if there is an execution at a price inferior to an excluded quotation, and would not identify and explain these trades in its best execution report. These "sanitized" reports would not even give brokers and customers notice that another market was offering a better price, rendering the CBOE's best execution program meaningless. Excluding these quotations also would render meaningless any CBOE "best execution" statistics, thus harming competition. There is no basis under the Exchange Act to permit the CBOE to impose this harm on the investing public or burden on competition.

D. The CBOE Can Achieve its Objectives in a Way that is Consistent with the Exchange Act

The CBOE ignores the fact that an alternative exists permitting it to achieve its objectives in a way that fully complies with the Exchange Act: use of the intermarket linkage. This linkage – both in its permanent and interim configurations – eliminates any need for this rule. The permanent linkage will permit CBOE market makers to access superior quotations of the other market both when they hold a customer order and when they seek to "clear" those quotations as principle. As discussed above, the Linkage Plan contains very specific provisions governing when an exchange's quotation is accessible and when a CBOE DPM or market maker can ignore such quotations (such as when a quotation is non-firm). The linkage will provide DPMs and market makers full access to all exchange quotes and will eliminate the "documented firm quote issues" that the CBOE is attempting to address in its Proposal.

We recognize that the CBOE has sought a delay in the implementation of the linkage from the third quarter of 2002 until 2003. We have agreed to accept the CBOE's proposed linkage delay so that the timing of the linkage does not provide any exchange with a competitive advantage. However, this delay does not justify the CBOE's Proposal. This is particularly true since the interim linkage currently operating provides CBOE DPMs and market makers with much the same protection against the concerns underlying the Proposal.

Under rules approved by the Commission,[16] CBOE DPMs can reach the quotations of the other exchanges – including the auto-execution systems of those exchanges – when they hold customer orders. The few times the auto-execution systems may not be available (such as when quotations are not firm or when markets are locked and crossed) are covered by the non-objectionable aspects of the CBOE's Proposal. In all other cases – including all the situations described as "documented firm quote issues" – the CBOE DPM has efficient access to the quotations of the other markets on behalf of a customer. There is

[16] *See* Securities Exchange Act Release No. 43904 (January 30, 2001); 66 *FR* 9112 (February 6, 2001) approving the ISE and CBOE interim linkage rules.

absolutely no basis to permit the CBOE DPM to deny their customers an execution at the superior price in these cases.[17]

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For the reasons discussed, we believe that the Proposal is contrary to the Exchange Act, will harm investors, and will impede competition in the options industry. We urge the Commission to institute proceedings to determine whether to disapprove the Proposal. If you have any questions on our comments, or if we can be of any additional help in this matter, please do not hesitate to contact us.

Yours very truly,

Michael J. Simon
Senior Vice President and Secretary

cc: Annette Nazareth
Robert Colby
Elizabeth King
Deborah Lassman Flynn

[17] The interim linkage is voluntary and is not currently available for all options. However, any two exchanges can add an option upon mutual agreement, and we are actively working with the CBOE and the other exchanges to include additional options in this linkage.