

May 13, 2003

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

Re: File No. SR-CBOE-2002-05

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") is pleased to offer its comments with respect to the above-referenced rule filing (the "Proposal") of the Chicago Board Options Exchange ("CBOE") in which it proposes to implement the CBOE Hybrid System.¹ We believe that the description of the Proposal is not adequate to support a finding that it is consistent with the Securities Exchange Act of 1934 ("Act"). In addition, we believe that the Proposal grants inappropriate discretion to the CBOE's Floor Procedures Committees ("FPCs") and inappropriately discriminates against market makers on other exchanges.

Inadequate Description of the Proposal

The text of the proposed rule change does not adequately explain how multiple electronic quotes, orders on the electronic limit order book, the automatic execution feature, oral bids and offers, and limit orders represented in the physical trading crowd will interact. Similarly, the description of the Proposal and the "Basis and Purpose Section" in the filing does not provide any examples that would allow us, much less the public, to understand how orders are handled under the various possible scenarios that are created as a result of the fragmented processes and rules. As a result, we do not believe it is possible to analyze the Proposal to determine whether the Hybrid System is designed in a manner that is consistent with the Act.

This uncertainty as to how the various pieces fit together in the Hybrid System is especially problematic when coupled with (i) the requirement that broker-dealer orders and/or competing market maker orders must be represented by brokers in the trading crowd, and (ii) the size restrictions the CBOE places on incoming orders that are eligible for automatic execution. Taken together, this raises best execution concerns not only for the orders represented in the trading crowd, but also for the incoming electronic orders and orders on the electronic limit order book that may receive automatic executions at inferior prices. These same requirements, which reduce the availability of automatic execution against the electronic quotes of market makers, also raise concerns regarding whether market maker quotes will be honored as required by Rule 11Ac1-1 under the Act (the "Firm Quote Rule").

¹ Exchange Act Release No. 47676 (April 14, 2003) (the "Hybrid Release").

Specifically, we question why an FPC would establish a size limit for orders eligible for automatic execution under proposed Rule 6.13 when the size of market maker quotes is displayed and firm for certain incoming orders. This rule will result in public customer orders that are less than the disseminated quote size being routed to CBOE's alternate order handling systems – PAR or BART – for manual handling instead of receiving automatic executions up to the size of the disseminated quote. Since the Firm Quote Rule requires CBOE's members to fill an incoming public customer order up to the size of the disseminated quote, we do not understand the purpose of setting a size-based eligibility requirement.²

In addition, the CBOE needs to provide further discussion regarding the operation of its market during the “N-second” period contained in proposed Rule 6.45A(c). This aspect of the Proposal raises best execution issues. For example, if a marketable public customer order is received during the N-second period, it appears that it will receive an automatic execution against orders in the limit order book during the N-seconds period.³ If the incoming order trades against orders in the limit order book and the best price moves, is the interest in the N-seconds group automatically canceled? What if a participant in an N-seconds group is representing a public customer order?⁴ The discussion of this issue in the Proposal is inadequate to understand whether the introduction of the N-seconds period for market participants seeking to execute against orders on the book raises best execution issues.⁵

Inappropriate Discretion to Floor Procedures Committees

The Proposal gives the FPCs discretion to make various determinations as to how the Hybrid System will operate. Some of the rules allow the FPCs to make determinations on a class-by-class basis, and all of the rules state that the decisions of the FPC will be “announced to the membership via Regulatory Circular.” The proposed

² The size-based eligibility requirement in Rule 6.13 raises an additional issue under the Firm Quote Rule. While the Firm Quote Rule permits market makers to establish a lesser firm quote size for non-customers than for public customers, it does not allow market makers to establish a different size for only competing market makers. There is no discussion in the filing about establishing different firm quote sizes for customer and non-customer orders. However, Rule 6.13(b)(i)(B) permits an FPC to determine on a class basis a lower eligibility size for automatic executions for competing market makers than for public customers and non-market maker broker-dealers. Because it is unclear to us how the CBOE interprets its obligations under the Firm Quote Rule with respect to its disseminated quotes given the existence of an eligibility size, it also is unclear whether this provision is intended to create a different firm quote size for competing market makers in violation of the Firm Quote Rule.

³ See Hybrid Release at note 15. The rule text itself does not address this issue.

⁴ The term “market participant” is defined in Rule 6.45A(a)(i) as an in-crowd market maker, DPM, or in-crowd floor broker. Thus, it appears that all orders handled manually (e.g., those not eligible for automatic execution) will be subject to the N-seconds period before being executable against orders in the book. Since orders for the account of broker-dealers are eligible for automatic execution under Rule 6.13, it appears that the N-seconds period does not provide customer order priority for orders represented by floor brokers.

⁵ It is also unclear in the Proposal whether market participants can enter orders to electronically trade against market maker quotes, as the N-seconds period is limited to situations where market participants “submit orders electronically to trade with orders in the electronic book.” Proposed Rule 6.45A(c). There is no parallel rule or discussion regarding market participants entering orders to electronically trade against market maker quotes.

rules do not contain any guidelines to be applied by the FPC when making these determinations.⁶ Moreover, the CBOE does not explain why it is appropriate to apply the rules differently on a class basis or on a crowd basis. Nor does the proposal place any limits on how often changes can be made. Finally, combinations of various standards applied under the different rules might produce an overall result that is inconsistent with the Act.⁷

We believe that these types of determinations are central to whether the Hybrid System in practice will operate in a manner that is consistent with the Act. In particular, the Commission has closely scrutinized the application of exchanges' allocation algorithms to assure that they are designed to promote quote competition and that specialists are not guaranteed large portions of orders based solely upon their status. In contrast, the Proposal will allow an FPC to change the allocation algorithm in many different ways, with no discussion of the effects of such changes.⁸ For example, the ability to adjust the weighting between the components of the algorithm and to decide between alternative DPM entitlement formulas might be used to protect the DPM or maximize its participation based upon the level of competition it faces. Such a broad range of allocation possibilities cannot be equally fair and equally provide the best incentives for competition. The CBOE provides no justification as to why different standards should be applied within its marketplace.

We do not believe the wide discretion the FPCs are given to change the operation of the system and the requirements of the rules is consistent with the Act. Furthermore, any such changes should be filed with the Commission as proposed rule changes under Section 19 of the Act.⁹

⁶ For example, with respect to the proposed allocation algorithm, note 9 of the Hybrid Release states that the FPC would adjust the algorithm's weighting "if it believed such modifications would further enhance market participants' incentives to quote competitively or reduce disincentives to quote competitively . . ." However, no standard is included in the text of Rule 6.13.

⁷ For example, under Rule 6.13, the FPC will (i) establish on a class basis the maximum size of orders entitled to receive automatic execution, (ii) determine on a class basis whether to allow competing market maker orders to be eligible for automatic execution, (iii) establish the maximum order size eligibility for competing market maker orders eligible for automatic execution at a level lower than the maximum order size eligibility available to other orders, and (iv) determine how orders not eligible for automatic execution will be routed. Under Rule 7.4, the FPC will determine on a class basis (i) the types of orders in addition to public customer orders that are eligible for entry into the electronic book, and (ii) the manner and form in which orders and quotes that are routed for entry into the electronic book must be submitted.

⁸ Under Rule 6.45A, the FPC will determine: (i) the weighting of the components of the allocation algorithm for incoming electronic orders, (ii) which DPM entitlement formula is used with respect to allocation of incoming electronic orders, (iii) the length of the "N-second group," (iv) the weighting of the allocation algorithm components for executions involving an "N-second group," and (v) whether to apply a maximum quote size to be used for each "N-second group" market participant in the "Component B" calculation.

⁹ The Division of Market Regulation recently sent a letter to the self-regulatory organizations ("SROs") reminding them that a "stated policy, practice or interpretation" of an SRO is generally deemed to be a proposed rule change and therefore subject to the notice-and-comment period under Rule 19b-4. See, e.g., Letter from Annette L. Nazareth, SEC, to Michael J. Simon, dated March 27, 2003.

Inappropriate Discrimination Against Competing Market Makers

The Proposal treats professional orders (orders of broker-dealers and competing market makers) differently from public customer orders. The Proposal also allows an FPC to distinguish between broker-dealer orders and competing market maker orders on a class basis, and to decide whether one or both categories of orders may be permitted on the book and/or be eligible for automatic execution.¹⁰

The Proposal provides that when competing market maker orders are not eligible for automatic execution they must be routed to a floor broker in the firm's booth. Upon receipt, they are printed and handled by the broker manually, rather than sent to BART, which is available for the routing of other broker-dealer orders and allows a broker to manage orders electronically.¹¹ As a result, the Proposal *requires* that orders for the account of a competing market maker be handled in the most inefficient and possibly most expensive (when including floor brokerage charges) of all alternatives otherwise available on the CBOE. Moreover, the Proposal changes the point at which firm quote obligations attached to orders represented by floor brokers to the time they are presented to the crowd,¹² so that there is greater potential for the quote to have changed from the time the order was received at the CBOE to the time it is walked into the crowd. Thus, the manual processing requirement has the effect of denying competing market makers the same firm-quote protections as other orders in options classes that are traded on the Hybrid System.

While the Commission historically has permitted limited discrimination against professional orders, it has rejected proposals that treat orders of competing dealers differently from those of other broker-dealers. The Act places the burden on the exchanges to show that any such rules are not anti-competitive and do not place an unnecessary burden on competition. Yet the Proposal contains no discussion of this issue. The Commission should not approve the Proposal unless the rules are amended to provide equal access to the Hybrid System to all broker-dealer orders, or the CBOE provides sufficient justification under the Act for the disparate treatment of competing market maker orders.

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¹⁰ Proposed Rule 6.13(b)(i)(B) (broker-dealer orders are given access to the automatic execution feature of the Hybrid System, but orders for competing market makers are not unless so determined by the FPC); Proposed Rule 7.4(a) (the FPC can determine whether to allow any professional orders on the electronic limit order book, or to allow only those of non-market maker broker-dealers).

¹¹ See Hybrid Release at note 6 and accompanying text. The Hybrid Release also states in the purpose section of the filing that the FPC may change this requirement, but the release does not specify what that change might be, the reason for such change, nor whether a change may be made on a class-by-class basis or only market-wide. The requirement is only vaguely reflected in proposed Rule 6.13(b)(i)(B).

¹² Proposed Interpretation .10 to Rule 8.15.

For the reasons discussed above, we request that the Commission not approve the Proposal until: (1) the CBOE amends the Proposal so that it is clear how all orders and quotes will interact in the Hybrid System and commentators are given an opportunity to submit additional comments; (2) the CBOE amends the rules to remove the discretion of the FPC to change the operation of the Hybrid System without filing a proposed rule change under section 19 of the Act; and (3) the CBOE amends the rules so that all broker-dealer orders are treated equally in the Hybrid System, or the CBOE provides sufficient justification under the Act for treating such orders differently.

If you have any questions on our comments, or if we can be of any other assistance to the Commission on this matter, please do not hesitate to call us.

Yours truly,

Michael J. Simon
Senior Vice President and Secretary

cc: Annette Nazareth
Elizabeth King
Deborah Lassman Flynn