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<u>VIA FEDERAL EXPRESS</u>

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

Re: <u>Proposed Rule Changes by the American Stock Exchange and the Philadelphia Stock Exchange Relating to the Prohibition Against Off-Floor Members Functioning as Market Makers, File Nos. SR-AMEX-01-3 and PHLX-01-05.</u>

Dear Mr. Katz:

Interactive Brokers LLC ("IB")[1] respectfully submits these comments on the proposed rule changes submitted by the American Stock Exchange ("Amex") and the Philadelphia Stock Exchange ("PHLX") imposing new burdens on members and new limitations on public customer

[1] Interactive Brokers LLC ("IB") is a registered broker-dealer and a member in good standing of all U.S. option exchanges. IB is a member of the Interactive Brokers Group, a global organization that provides brokerage services and conducts proprietary trading and market making on more than 30 exchanges worldwide.

use of limit orders. Both exchanges have proposed virtually identical rules intended to prohibit members and their public customers from engaging in trading that the exchanges consider "market making" from off-floor. The rules are similar to a rule already in place on the International Securities Exchange that the Commission approved last year with the *caveat* that it would revisit the issue depending on the state of ongoing competition in the options markets.[2]

In the interests of fostering increased liquidity and quote competition, the Commission should revisit its policy of allowing exchanges to ban off-floor market participants from making markets. More importantly however, even if the Commission accepts the notion that floor-based exchanges may properly ban off-floor market making, the realm of prohibited activities under the proposed PHLX and Amex rules is much broader than simply "market making" by regularly posting simultaneous bids and offers for the same security. The proposed rules prohibit other, very common, trading practices that have nothing whatsoever to do with making two-sided markets. At a time when the Commission repeatedly has encouraged the use of limit orders by public customers so that they may compete on a level-playing field with exchange professionals, the proposed rules would dramatically undermine customers' ability to do so. The vague, subjective and overbroad standards for what constitutes prohibited "market making" will have a dual chilling effect – as both public customers and the brokerage firms that provide them access to exchange systems will fear enforcement actions arising from trading that the exchange deems

[2] When the Commission approved the similar prohibition on the ISE last year, it stated that "***given the ISE's fully automated market,***" the prohibition might be necessary to strike an appropriate balance between PMMs and CMMs, who carry certain affirmative obligations in their option classes, and EAMs and public customers, who have equal electronic access to the ISE but have no such affirmative obligations. This rationale does not apply in the floor-based environment of the Amex and PHLX, where specialists and market makers enjoy many forms of advantage (proximity, better market information, reduced transaction costs, favorable margin treatment, etc.) over order entry firms and public customers. In any event, the Commission made clear in its order that its approval of the ISE rule was not intended to set a precedent and was without prejudice to further reconsideration of the issue.

to be "market making" under its open-ended standards. Likewise, the subjective standards in the proposed rules clearly are designed to allow market makers and exchanges to enforce these rules against member firms whose customers tend to trade profitably with market makers, while treating so-called "dumb order flow" provided by other member firms far more leniently.

With the rapid increase in the use of technology in the national securities markets, and with the growth of multiple listing, our options markets should be moving toward a more flat, open and competitive market structure, characterized by increased ease of access to exchange systems, lower spreads and trading costs, and greater liquidity. Unfortunately, because of an unending series of anti-competitive trading restrictions being imposed by the exchanges, the opposite is happening. The most significant development in the options markets over the past year has not been multiple listing or linkage or anything else. It has been the exchanges' increasing use their self-regulatory powers not to improve their markets, but to protect the monopoly positions of exchange specialists and market makers in the face of perceived competition. We urge the Commission to stop placing its imprimatur on these efforts, and to abrogate these proposed rules or work with the exchanges to amend them. We discuss these issues in detail, below.

I. The Commission Must Stem the Tide of Anti-Competitive Rules that Are Being Imposed by the Option Exchanges as a Response to Electronic Trading and Multiple Listing.

The restrictions imposed by the new Amex and PHLX rules represent the latest attempt by the option exchanges to hinder the ability of public customers to trade competitively on their markets and to discourage broker-dealers from providing direct, electronic access to those markets. As the Commission must be aware by now, the exchanges have responded to the advent of widespread multiple listing of options, and the increasing popularity of electronic trading, not by embracing these positive developments but by undermining them through passage of restrictive trading rules. In the past year or so alone, the exchanges have, among other things:

- passed rules turning off their automatic execution systems whenever prices are crossed or locked across exchanges (thus allowing market makers to fix their prices and preventing customers from taking advantage of differently-priced markets);
- passed rules turning off their automatic execution systems where the bid or offer for a series of options generated by the autoquote system becomes crossed or locked with the best bid or offer for that series as established by a booked order;
- passed rules or issued regulatory circulars requiring public customers to express all of their potential trading interest in a single order rather than using multiple orders to "work" a trade (thus putting customers at a disadvantage to market makers, who do not have to display their real size at a particular price but only have to show a price for the firm quote minimum size);
- passed rules preventing public customers from using computers to generate and transmit option orders (again, putting customers at a disadvantage to market makers who can freely use automated valuation and trading systems);
- proposed rules or issued regulatory circulars restricting public customers from canceling orders submitted to the exchange (thus allowing market makers to capture and lean on customer orders).

The justification employed by the exchanges in passing these rules – and the justification cited by Amex and PHLX in connection with the rules addressed herein – is the same: that the exchanges' "business models" depend on having a class of favored specialists and market makers whose profits must be protected by competition from the outside because these market makers and specialists provide liquidity. In other words: to encourage market makers to provide liquidity we must discourage public customers from doing so. The other justification offered by the exchanges for the impediments they have increasingly imposed on public customers is that such impediments are necessary because public customers have trading priority. Thus, what the exchanges have given with the left hand must be taken away ten-fold with the right hand.

The Commission at some point must draw a line and discourage or prevent the exchanges from using these rationalizations to further close their markets from competition and from technology. Public securities markets should be free and open and provide a level playing field for all participants. The fact that they have given customers trading priority should not give the exchanges *carte blanche* to pass more and more rules that stifle competition, decrease liquidity and perpetuate wider spreads. Yet this seems to be the end result. Rather than implementing ever more trading restrictions to ensure that incoming order flow is limited, slow and uninformed, the exchanges should abolish the customer priority and compete with the public on even terms. If they choose not to do this, they should not be able to invoke customer priority as an excuse for passing anti-competitive trading rules.

Under Section 106 of the National Securities Markets Improvement Act, in considering proposed rules, the self-regulatory organizations and the Commission must consider whether the rules will promote efficiency and competition. *See* H.R. Rep. No. 104-622 (June 17, 1996). If a proposed rule would restrict efficiency and competition, it can only be approved on a specific finding, supported by a sufficient evidentiary record, that the negative competitive impact of the proposed rule is necessary to protect the public interest and is the least restrictive means available to protect that interest. Time and again, however, in the slew of rules they have proposed over the last year the exchanges have provided no analysis of the competitive impact of new trading restrictions being imposed, let alone any evidentiary basis to find that each of the exchanges' actions have been the least restrictive means available to accomplish the goal of maintaining orderly and liquid option markets. Instead, the exchanges merely repeat their empty mantra that in order to protect our option markets we must further insulate market makers from the natural forces of competition. The exchanges have almost completely dropped the veil of being legitimate "regulatory organizations" and have become mere Chambers of Commerce seeking to protect the perks of their constituents. Sooner or later this must stop, and we urge the Commission to begin drawing a line somewhere.

II. The Proposed Rules Are Overbroad.

The operative provisions of both the Amex and PHLX rules are as follows:

> "[M]embers, acting as either principal or agent, may not permit the entry of orders into the electronic order routing system if the orders are limit orders for the account or accounts of the same or related beneficial owners and the limit orders are entered in such a manner that the member of the beneficial owner(s) effectively is operating as a market maker by holding itself out as willing to buy and sell such securities on a regular or continuous basis. In determining whether a member or beneficial owner effectively is operating as a market maker, the Exchange will consider, among other things, the simultaneous or near-simultaneous entry of limit orders to buy and sell the same security; the multiple acquisition and liquidation of positions in the security during the same day; and the entry of multiple limit orders at different prices in the same security." See Exch. Act. Rel. No. 43938 (Feb. 15, 2001).

While the proposed Amex and PHLX rules purport to prevent off-floor market making by members and public customers, the subjective and broad wording of the rules provides little guidance to firms or customers about what is and is not prohibited, and would restrict many trading techniques that are unobjectionable. Lack of any clear objective criteria will make the rules difficult to enforce by members, will make such members subject to arbitrary and discriminatory enforcement by exchanges, and will discourage customers from using limit orders and discourage member firms from providing electronic access to exchange systems.

The rules do not define off-floor market making but rather list three criteria that firms and the exchanges may consider in determining whether a customer is "holding itself out as willing to buy and sell securities on a regular basis:"

1) simultaneous or near-simultaneous entry of limit orders to buy and sell the same security;

2) multiple acquisition and liquidation of positions in the security during the same day; and
3) entry of multiple limit orders at different prices in the same security.

None of the terms in these criteria are defined with specificity and there is no guidance as to what constitutes "near-simultaneous" entry of limit orders to buy and sell, or what constitutes "multiple" buys and sells. As we have pointed out in connection with prior exchange rules, because online brokerage firms such as Interactive Brokers do not speak to their customers on the phone or have personal involvement in the investment decisions and strategies of their customers, the only way online brokers can enforce these types of rules is by using automated surveillance mechanisms. Automated surveillance mechanisms require precise, objective standards, however. Adjectives such as "near-simultaneous" and "multiple" are useless.

Worse, two of the three trading patterns that would be used by the exchanges as evidence of prohibited activity have nothing to do with "market making" and are so broadly defined as to encompass much of the daily activity of any active options trader. The second of the three specified criteria -- "multiple acquisition and liquidation of positions in the security during the same day" -- essentially bans day trading of options or options arbitraging, neither of which has anything to do with making two-sided markets. Active option traders may amass and unwind positions repeatedly throughout the day in order to take advantage of market movements in the underlying securities, price discrepancies between option exchanges listing the same products, or other investment opportunities. However distasteful this trading is to the exchanges, this activity makes the options markets more efficient and improves the price discovery function.

The third of the three criteria specified in the rule -- "entry of multiple limit orders at different prices in the same security" -- also encompasses activity far more broad than making two-sided markets. Active or even infrequent option traders may use multiple limit prices for the same option to dollar-cost average or "scale" into or out of a position, <u>on one side of the market</u>. Without a requirement that the activity be on both sides of the market at the same time, the use of multiple limit orders at different prices has no bearing on whether a trader is engaged in market making. Again, the overbroad criteria in the rule will put an unfair regulatory cloud over market activity that is far afield from the policy objectives of the proposed rules.

The expansive definition of what constitutes market making for purposes of the Amex and PHLX rules is also at odds with prior Commission statements on the acceptable scope of off-floor market making prohibitions on floor-based exchanges. In 1996, the Commission approved a CBOE rule disallowing hand-held brokerage terminals to be used on the CBOE floor to perform a market making function. *See* Exch. Act. Rel. No. 34-38054 (Dec. 16, 1996). Under the CBOE rule approved by the Commission, users of hand-held terminals had to execute an Application Agreement, which stated: "Orders that will be deemed to 'perform a market making function' are those that create a pattern of offering in the aggregate either to make two-sided markets or simultaneously to represent opposite sides of the market in any class of options." *Id.*

The CBOE prohibition that was approved by the Commission was thus far more limited than the proposed Amex and PHLX restrictions, and required a pattern of making two-sided markets or simultaneously bidding and offering for the same security. The CBOE restriction did not limit day trading, arbitraging, dollar-cost averaging, or any of the other market activity that would be questionable under the PHLX and Amex rules. Moreover, in its approval order the Commission specifically emphasized that it expected the CBOE to enforce the market making restriction "in accordance with [the] traditional definition as defined under the Act." The Commission noted:

> "The definition of market making should not capture parties who enter orders on one side of the market; nor would it capture parties who enter two-sided limit

> orders on occasion. A party would not be deemed to be engaging in market making unless it regularly or continuously holds itself out as willing to buy <u>and</u> sell the security." *Id.*

The definition of market making in the PHLX and Amex rules would clearly capture parties whose trading does not meet the traditional definition of market making.

III. The Proposed Rules Will Have a Chilling Effect and Will Discourage Public Customers from Adding Liquidity By Placing Limit Orders.

The overreaching definition of market making in the Amex and PHLX rules is made worse because these rules place the burden of enforcement on member firms. Every member firm that services active traders or provides direct access to exchange facilities will be at peril that the exchange will consider the actions of one or more of its customers to constitute prohibited off-floor market making, for which the exchange will hold the member firm liable. Likewise, the open-ended standards in the proposed rules will allow market makers and exchanges to enforce the rule against member firms whose customers trade profitably, while treating the "dumb order flow" preferred by specialists more kindly. All of this will have a chilling effect, as member firms either decline to provide services to active option traders or impose burdensome restrictions on their trading. Of course, this is precisely the exchanges' goal.

The new rules are thus directly contrary to the Commission's policy of trying to encourage investors to become liquidity providers and price "makers" by using limit orders to trade. Former Chairman Levitt noted in several speeches last year that one of the fundamental goals of the Commission in improving the structure of the nation's options markets is to encourage investors to use limit orders to increase liquidity and spur price competition:

> "Limit orders have been a powerful agent of transparency in our markets today. They serve a critical market function – increasing information and improving the price-setting mechanism. This past March, I asked the Commission staff to

> prepare a report on the display of limit orders. Released yesterday, the Report confirms that limit orders have become building blocks of transparency in our markets, and proven stimulants of price competition in the options markets as well as the equity markets." Speech of Arthur Levitt at Annual Options Industry Conference (May 5, 2000).[3]

Likewise, in its Concept Release on Market Fragmentation, the Commission noted the importance of providing public customers with access to post limit orders on public markets – both to improve quote competition on such markets and to allow those customers who are willing to add liquidity to profit from doing so:

> "Investors need not, however, always be price-takers and accept whatever prices the other side of the market is offering at the moment. They can participate in price competition by submitting limit orders to obtain better prices than the market is offering. These non-marketable limit orders can be priced between the quotes, at the quotes, or outside the quotes. A between-the-quotes limit order improves the market for a security by offering immediate liquidity at a price that reduces the quoted spread. An at-the-quote limit order improves the market by adding more size at the best displayed price. For investors, the primary benefit of participating in price competition and submitting a non-marketable limit order is the opportunity to earn, rather than pay, the effective spread." 65 Fed. Reg. 10577 at 10581 (Feb. 23, 2000).

By defining "market making" far more broadly than the traditional understanding of the term, and by imposing on member firms the burden of enforcing the wide-ranging prohibitions in the new rules, the Amex and PHLX will discourage aggressive use of limit orders by public customers, undermining liquidity and price competition on these exchanges.

[3] *See also* Opening Statement of Chairman Levitt at Commission Open Meeting on Market Structure (July 25, 2000)("We must remember what's at stake: a robust price discovery mechanism that encourages market makers to quote aggressively and customers to place limit orders.").

Conclusion

The Commission should consider carefully the continuing corrosive effects of the ever more restrictive trading rules being enacted on the nation's options exchanges. The exchanges have responded to multiple listing and technological change by circling the wagons and becoming more closed to competition from outside and more difficult for public customers to access. The Commission and the industry must find a way to reverse this trend.

Sincerely,

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