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VIA HAND DELIVERY

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

Re: Proposed Rule Change Relating to Non-Automatic Handling of RAES Orders, File No. 99-61

Dear Mr. Katz:

Interactive Brokers, on behalf of itself and its parent company, The Timber Hill Group[1], respectfully submits these comments on the proposed rule change submitted by the Chicago Board Options Exchange ("CBOE") that would allow CBOE to deny automatic execution of

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[1] The Timber Hill Group includes Timber Hill LLC, Interactive Brokers LLC and other affiliates which, through the use of proprietary communications technology, trade standardized derivative investment products on organized securities and futures exchanges worldwide. Timber Hill LLC is registered with the Commission as a broker-dealer and is a member in good standing of the Chicago Board Options Exchange, American Stock Exchange, National Association of Securities Dealers, Philadelphia Stock Exchange and Pacific Exchange. Interactive Brokers LLC, also a registered broker-dealer, engages exclusively in agency trading. It is a member in good standing of the Chicago Board Options Exchange, American Stock Exchange and Philadelphia Stock Exchange, where it offers execution of customer orders in all option classes.

public customer orders where the bid or offer for a series of options generated by CBOE's Autoquote system becomes crossed or locked with the best bid or offer for that series as established by a booked order.[2] Pending public comment, the Commission approved the proposed rule change on a pilot-program basis to expire February 21, 2000. However, as we show below, the pilot program undermines broker-dealer best execution order routing systems, and there are better, less disruptive solutions to the problem CBOE seeks to address.

We urge the Commission to disapprove the proposed rule change, or, at a minimum, to decline to renew its approval of the rule once the pilot program expires.[3]

I. <u>Approval of this Rule Would Penalize Customers of Broker-Dealers that Are Implementing Linked, Best Execution Order Routing Pursuant to SEC Guidelines.</u>

The best hope for an efficient, linked national options market is the continued development and deployment of broker-dealer technology that intelligently routes customer orders for best-price automatic execution among multiple, vigorously competing markets. These broker-dealer systems, however, rely on firm quotes and the constant availability of automated exchange systems like RAES.

Interactive Brokers expended a great deal of effort in developing a system based on the availability of firm quotes and automatic execution of customer orders. This is what customer

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[2] Interactive Brokers and the Timber Hill Group are also filing comments today regarding another CBOE rule, File No. 99-57, which would allow CBOE floor procedure committees to deny automatic execution of public customer orders, even where CBOE is at the national best bid or offer, simply because another market locks or crosses the CBOE. Our objection to that rule is based largely on the same grounds as our objection to the instant rule.

[3] If the Commission nonetheless determines to accept the rule, as a condition therefor the exchanges at least should be required to post in electronic form accessible to broker-dealer order routing systems a notification that automatic execution is not available for a particular option series, so that broker-dealer routing systems can continue to function. Such notification should be electronically accessible at least three seconds prior to such option series being removed from the automatic execution system.

protection is all about and this should be the paramount guiding force. We have built technology that enables our customers on the Internet to interact, in real time, with the four options exchanges' automated execution systems. We have promised our customers fast, automatic execution of their orders at the best price. Yet when the exchanges' automatic execution systems are suspended -- as happens more and more often as more and more exemptions are adopted -- our customers' orders are taken off line (to a printer or broker) and our customers lose electronic control of those orders (i.e., their orders can no longer be modified or canceled online).

Firm quotes, best prices, and automated executions are the right concepts. Adopting rules that subvert them would be an enormous step backwards and would cause our customers and the investing public irreparable harm by denying them, now, the truly competitive options market they were so long denied because of the exchanges' failure to offer multiple listing.

The Commission has stated that "***as a general rule, automatic execution systems should remain operational at all times***,"[4] yet as noted the growing number of exceptions to automatic execution on the options exchanges -- most recently exemplified in the CBOE rule discussed herein and another rule allowing RAES to be turned off where the NBBO becomes crossed or locked – disadvantage firms like Interactive Brokers who use advanced order routing technology to send customer options orders to the best market expecting automatic executions.

As the Commission has recognized, the exchanges must create a market framework that preserves competition and provides customers with the benefits of advancing technology. We discuss below what the essential elements of such a framework might be. In the meantime, the

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[4] See Exchange Act Release 34-38792, 64 S.E.C. Docket 2158 (June 30, 1997)(permanently approving automatic execution system of the Philadelphia Stock Exchange)(emphasis added).

Commission should be wary of exchange rules such as this and others that interfere with best execution and provide no incentive for market makers to improve their systems.

II. The Pilot Rule Should Be Disapproved.

Deployment of the Automated Book Priority ("ABP") system, under which incoming RAES orders will trade directly against matching booked orders rather than being rejected for manual handling, will substantially enhance the efficiency of RAES and is a significant step in further automating options trading and facilitating best execution of customer orders. See Exchange Act Release 34-41995, 64 Fed. Reg. 56547 (Oct. 20, 1999)(urging rapid implementation of the new system and noting that "investors should benefit from more efficient executions of both RAES and booked orders"). However, the new pilot program rule compromises the benefit of the ABP system by kicking orders out for manual handling whenever an especially attractive price becomes executable on the book, as indicated by the price of the booked order crossing or locking the prices generated by the Autoquote system. As with other kickout rules, broker-dealers will be given no warning when they transmit RAES-eligible electronic orders that such orders will not, in fact, be executed on RAES. Once a customer order has been routed to an exchange that has actually turned off automatic execution, that order is sent to the floor and cannot be canceled and retransmitted to a different exchange.

A. Rather than Suspend *All* Automatic Execution, When an Autoquote Price Touches the Price of a Booked Order, that Booked Order Should Simply Be Automatically Executed.

CBOE's rationale for the rule is that where a booked order is crossed or locked with prices generated by the Autoquote system, the booked order will be manually executed by the crowd, and market makers may delay in updating their price quotes while they remove the executed book order. During this delay in updating their prices, CBOE argues that market makers unfairly will be exposed to the risk of having to execute new incoming RAES orders at the old price.

There is a less disruptive solution to the problem the pilot program seeks to address than suspending all automatic execution. When an Autoquote price touches the price of a booked order, the system should automatically execute the booked order against a market maker. This would eliminate the possibility of a booked order being locked or crossed with the Autoquote prices, the booked order would get executed automatically, and correct market prices automatically would be posted after the execution. Since Autoquote identifies prices at which a market maker should be prepared to trade, this solution would be fair to everyone.[5] A potentially easier although less ideal solution would be merely to remove the customer order from the book at the time it is touched or crossed by the Autoquote price. In that case, the booked customer order would be executed manually. Lastly, and in case of booked customer orders exceeding RAES limit sizes, the Autoquote price could be forced to remain a tick away from the customer order.

In any case, we think it would be more appropriate for the CBOE to devote a few days of programming work to fixing the problem addressed by the pilot program than to continue to suspend automatic execution for all public customer orders in perpetuity.

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[5] This is the approach taken by the Nasdaq market in its new proposal to enhance the national market system for Nasdaq stocks and to implement its new Order Collector Facility. See Exchange Act Release 34-42166, 1999 Westlaw 1080624 (Nov. 22, 1999). Under that proposal, whenever a Nasdaq market maker posts a quote that would lock or cross the national Nasdaq market, that quote would be treated as a marketable limit order and would be executed in time priority against the market maker displaying the best bid or offer. Id. As Nasdaq has recognized, increased automatic execution of orders is a better solution to issues arising from fast-moving markets than creating more exceptions to automatic execution.

B. <u>The Pilot Program Removes the Incentive for Market Makers to Update Prices Promptly</u>.

Failing the above, to the extent market makers actually face risk of RAES executions at inaccurate prices because they have failed timely to update their prices after a manual execution of a booked order, CBOE has not provided any support for the proposition that customers should pay the price for that failure rather than the market makers themselves. Public customers and the broker dealers that attempt to route their orders for best execution need firm, reliable quotes upon which to trade. To that end, Designated Primary Market Makers on the CBOE have an affirmative obligation to "assure that disseminated market quotations are accurate" and to maintain adequate systems and staff to that end. See CBOE Rule 8.80(c). The new pilot rule removes the incentive for market makers to take whatever steps are necessary to ensure that prices are updated immediately after a booked order is executed.[6]

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In sum, the pilot program rule allowing automatic execution of customer orders to be suspended when a booked order locks or crosses Autoquote prices should be disapproved. If the Commission nonetheless determines to allow the pilot program to continue, as a condition therefor the exchanges at least should be required to post in electronic form, accessible to broker-dealer routing systems, a notification that automatic execution is not available for a particular option series– so that broker-dealer best execution routing systems can continue to function. Such notification should be electronically accessible at least three seconds prior to such option series being removed from the automatic execution system.

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[6] The pilot rule may encourage market makers to delay in updating their prices. If a booked order has been executed at a price more attractive than the price actually available on the exchange, for as long as that stale price remains posted customer order flow seeking that price will be attracted to the CBOE.

III. <u>Essential Elements of a Truly Competitive National Options Market</u>

The Commission is at a crucial point in rulemaking. The automatic execution rules discussed in our comment letters filed today, the pending rules of the International Securities Exchange, and the rules proposed by the options exchanges in the context of their linkage proposals, will all have a profound effect on what the electronic options market of the future will look like and whether true competition and increased customer access to the markets will be realized. The judgments made by the Commission in facing these issues in the options markets may also serve as a precedent for the stock market, where there is also a proliferation of increasingly electronic trading venues.

In dealing particularly with "linkage" issues, the Commission should regard with suspicion any exchange linkage plan that would foster *de facto* price fixing across exchanges and create what essentially would be a new regulated monopoly. Namely, one in which all exchanges would display some price with an artificially wide spread while providing a guarantee to fill orders by stepping up to the NBBO. The highly profitable order flow therefrom would be allocated based on direct or veiled payment for order flow, exchange membership categories, or other allocation schemes, rather than member willingness to attract order flow with better prices.

In the interest of a fair and efficient market, the Commission instead should encourage the continued formation of different, vigorously competing market centers, and make sure that the rules of such market centers do not prevent matching orders – whether from customers, market makers or other broker-dealers -- from trading against each other regardless of origin. These competing markets would be linked in two ways. First, pursuant to their duty of best execution, broker-dealers would route each customer order to the best market based on the price <u>displayed</u> at that market. Second, trade-throughs and crossed and locked markets would not persist because markets would be open to each others' quotes and would use electronic links to trade with each other to eliminate disparities in pricing.

We think that it would be inadvisable on a number of levels to place the primary responsibility for order routing with the exchanges. As noted, such a step would tend to create a functionally single market resistant to change, whereas different market centers operating in parallel would provide more competition and innovation. In addition, multiple broker-dealer routing systems will also provide far more routing capacity and redundancy than a monolithic exchange system, and will be less susceptible to system failures. Finally, there is a danger that through their linkage, existing exchanges could erect barriers to potential new participants.

As we show below, the competitive national options market of the future should be based on three essential elements that will create powerful incentives for increased liquidity, price competition, and best execution of customer orders:

1. **Orders Must Be Routed to Exchanges that Display the Best Price;**
2. ***Within* Each Market Center, Price/Time Priority Must Be Maintained; and**
3. **All Quotes or Guarantees to Trade Must Be Posted as Firm, Executable Orders Accessible to All Market Participants.**

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A. Orders Must Be Routed to Exchanges that Display the Best Price.

Broker-dealers should use best execution systems to route customer orders to the best posted market, and an exchange should not be permitted to step-up to a better price if it was not posting that price when it received a customer order. Some options exchanges support a model under which -- regardless of the posted price on the exchange -- customer orders will be guaranteed to trade at the NBBO because the exchange will have an opportunity to "step-up" to NBBO after it receives a customer order. These exchanges argue that by stepping-up their quotes to guarantee the NBBO once they have an order in hand, they are providing price improvement and guaranteeing best execution. In fact, what they are guaranteeing is that no market center will have any incentive to narrow the spread because that will not increase its market share as against other market centers (since those market centers will be pre-committed to match the same price). Other exchanges or new entrants will have no incentive to compete with their more established competitors by posting more aggressive prices, since the established exchanges will have a Commission-sanctioned right simply to step-up and match their price. Broker-dealers will be free to send their order flow to the exchange or market maker that is able to offer the wealthiest incentives, since "best execution" at NBBO is guaranteed.

This is a frightening scenario: If exchanges can post uncompetitive markets but simply guarantee to step up to NBBO ***after*** receiving orders, market share will not be determined by price competition but by direct or indirect payment for order flow. Ultimately, the result will be fewer competitors and wider markets and the benefits of multiple listing will disappear.[7]

There is a far better model for competition, however, and it is very simple. Rather than accepting payment for order flow or other troublesome incentives, broker-dealers should abide by their duty of best execution and route orders to the market showing the best price. As recently noted by Chairman Levitt, "systems for broker-dealers recently have emerged that include sophisticated algorithms for automatically routing investor orders in a security to the best market."[8] Broker-dealers should use these systems or, less ideally, manually route each order to the market displaying the best price. This will provide a powerful incentive for an exchange to

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[7] This is why guarantees among exchanges to trade at a single national price would constitute a violation of the antitrust laws absent Commission approval immunizing them from liability. See e.g., Falls City Industries, Inc. v. Vanco Beverage, Inc., 460 U.S. 428, 441 (1983) (citing FTC v. A.E. Staley MFG Co., 324 U.S. 746 (1945) (setting prices according to a single scheme by its nature precludes independent pricing in response to normal competitive forces and is therefore illegal)).

[8] Hearing Before the Senate Subcomm. on Securities, Comm. on Banking, Housing, And Urban Affairs Concerning Market Structure Issues Currently Facing the Commission (Oct. 27, 1999)(statement of Chairman Arthur Levitt).

narrow the spread and be at the best price before a broker-dealer makes its routing decision (so that the exchange gets the order). If an exchange is not at the best price but a broker-dealer nonetheless sends it an order (e.g, because of error or because the broker-dealer does not have systems sufficient to route each order to the best market), that exchange should be required immediately and automatically to send the order to the away market displaying the best price. The exchange thus would have no opportunity to step-up and benefit from execution of an order if it did not post the best price before that order was received.

B. ***Within*** Each Market Center, Price/Time Priority Must Be Maintained.

Closely related to the foregoing, orders should be allocated to market makers within each exchange on a strict time/priority basis. The first member to post a better price should be rewarded with an execution. This should ensure intra-exchange price competition and result in narrowing the NBBO, which other exchanges will also have to display to compete for order flow in accordance with our point above. Exchange rules for preferential allocation of trades on grounds other than best price (e.g., because of special membership status) reduce any incentive market makers have to post narrower markets and have no place in the options markets of the future.[9]

If the Commission nonetheless determines that it is appropriate for exchanges to provide specialists or designated primary market makers with a guaranteed reward, other than lower exchange transaction fees, for making markets, such specialists or designated primary market makers may be given a fixed percentage of all orders. In order to retain the critical incentive for

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[9] Technological advances have made quote attribution possible. The majority of exchange market makers now maintain what was once the exception, real-time theoretical values, on handheld computers. When connected to exchange systems, these real-time quotes provide the basis for quote attribution and thus, enhanced competition. RAES allocation based on quoting rather than entitlement would assure the best possible markets. Moreover, such competitive intra-market quoting will speed the retirement of the exchanges' current consensual autoquote systems, which are by definition anticompetitive.

other members to post better prices, however, this percentage should be low, and in no event should it be 100% of small orders.[10]

C. All Quotes or Guarantees to Trade Must Be Posted as Firm, Automatically Executable Orders Accessible to All Market Participants**.**

With the advent of electronic exchanges, rules governing the trading process are translated into computer programs. Trading rules become crystal clear, no longer subject to interpretation and difficult to change. In a computer program, firm markets or guarantees to trade at the NBBO are functionally equivalent to orders with a stated size. In the interests of efficiency and transparency, such guarantees therefore should be displayed as firm, automatically executable orders.

Electronic order books should be accessible to customers and broker-dealers alike. Barring broker-dealers from accessing electronic order books on a proprietary basis reduces liquidity and competition and harms the price discovery process. First, if broker-dealers are excluded from entering orders that could better posted markets, public customers are denied the potential for true price improvement and narrower markets. Second, the exclusion of broker-dealers from accessing market centers enables participating market makers to tilt their quote away from the direction of public demand and take advantage of relative price insensitivity on the part of the public. Lastly, if broker-dealers may not access market centers that have drawn away liquidity, they may have difficulty hedging or liquidating positions. As a result they may withdraw from the business, further reducing liquidity.

In short, markets are most efficient and liquid when all quotes are firm, posted publicly, and openly accessible to everyone on an equal basis. Allowing a hodgepodge of exceptions to this principle to persist into the future is not consistent with the Commission's vision for the national options market.

[10] C.f. Proposed ISE Rules.

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The three essential elements discussed above, operating together, will result in a marketplace that will have all the practical advantages of a centralized order book without any of its limitations. It will ensure vigorous price competition along with all the benefits of parallel processing.

Conclusion

Broker-dealer best execution systems that route orders to exchange automatic execution systems are the best way to ensure -- today -- that exchanges compete and that customers get the best price across markets. Public customers should be able to rely on the ability to execute trades automatically at firm posted prices. And in the context both of specific rules like the rules discussed herein, and the exchange linkage plans that will be presented shortly, we urge the Commission to focus on protecting the interests of the customer. The Commission should resist any rule or plan that reduces competition, places the interests of exchanges or their constituents above the interest of customers, or seeks to deny customers the dramatic benefits of rapidly advancing technology.

Sincerely,

Thomas Peterffy, Chairman

David M. Battan
Vice President and General Counsel

cc: Hon. Arthur Levitt
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