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April 10, 2000

VIA HAND DELIVERY

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

Re: Supplemental Comments of Interactive Brokers and the Timber Hill Group Regarding Option Market Linkage Plans, File No. 4-429

Dear Mr. Katz:

This letter is a brief supplement to the April 3, 2000 comments filed by Interactive Brokers LLC, on behalf of itself and its parent company, the Timber Hill Group, regarding the proposed linkage plans recently submitted by the options exchanges. Since we filed our original comments, there have been several developments that confirm a number of the points raised in our comment letter and which merit the Commission's attention.

1. The CBOE Payment for Order Flow Plan

In our initial comments, we noted that the central foundation of the linkage plan filed by the CBOE and the Amex and joined by the ISE is that exchanges would have the right to step up and match more competitive prices posted by other exchanges in order to fill incoming customer orders. We further noted that hand in hand with step-up and match rules come internalization or payment for order flow arrangements, whereby broker-dealers route orders to affiliates or to market makers who share with those broker-dealers some portion of the profits from executing their captive order flow, while at the same time guaranteeing "best" execution at the NBBO. We pointed out the danger in this scenario:

> "If exchanges can post uncompetitive markets and 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."

See Comment of Interactive Brokers and the Timber Hill Group on Option Market Linkage (Apr. 3, 2000) ("IB Comment Letter") at 5.

In this regard, Attachment 1 hereto is a copy of an article published in the Wall Street Journal just days after comments on option market linkage were due to the Commission. *See* "CBOE Trader Group Unveils Plan to Install System for Buying Orders from Retail Brokers," *Wall Street Journal* (Apr. 6, 2000). The article describes a major new payment for order flow initiative at the CBOE:

> "A contingent of traders at the [CBOE] is trying to implement a floorwide plan to buy orders from retail brokerage firms. The payment for order flow plan would be the first such plan at a U.S. options exchange, financed by special fees charged to certain exchange members. 'Brokerage firms might get 50 cents a contract or a dime,' a CBOE member familiar with the plan said. 'Preferred firms would get it; other firms won't. It will probably be based on the percentage of business you do with us.'"

Id. The article goes on to note:

> "The CBOE association intends to concentrate on attracting retail options orders that can almost always be filled at the bid or offer, which enables dealers to pocket the spread – the difference between the two prices – the exchange member familiar with the plan said."

Id.

The new CBOE payment for order flow plan confirms what we noted in our comments: that if the exchanges immortalize step-up and match policies in a Commission-sanctioned linkage plan, payment for order flow plans like this one will determine how orders get routed, not price competition. The "NBBO" that customers will be guaranteed will be artificially wide, and the hidden cost borne thereunder by customers will finance the payments being made to their brokers. This runs contrary to fundamental principles of customer protection, transparency and competition, and should not be tolerated by the Commission.

2. **The New York Stock Exchange Panel Report on the Intermarket Trading System**

In our comments on the proposed linkage plans we also argued that rather than relying so heavily on an intermarket linkage under which exchanges would bear the primary responsibility for routing customer orders (either in price/time priority or after an opportunity to step up and match), that instead broker-dealers – pursuant to their best execution responsibilities-- should route customer orders to the market displaying the best price. As we said in our initial comments:

> "[A] monolithic inter-exchange linkage through which all or substantially all customer orders would be routed . . . would present all the problems of any regulated monopoly. The system would have a single failure point and would be susceptible to delays and outages. The system would be inflexible and resistant to change. With existing exchanges presumably merging or disappearing altogether there would be little incentive for the operator of the linkage to be responsive to the demands of members or customers because there would be nowhere else to trade. And once entrenched, it would be very difficult for new and innovative trading venues to be established to compete with the exchange or exchanges that control the linkage system.
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> For these reasons, the Commission should continue to encourage the formation of different, vigorously competing market centers that would be linked, first, by broker-dealers routing orders to the best posted markets, and second by links that allow members of different exchanges to trade with each other. Multiple broker-dealer routing systems will provide higher capacity and redundancy than a single, centralized linkage system, and will provide the same customer protection benefits as a central limit order book, without its limitations."

IB Comment Letter at 18-19.

Shortly after these comments were filed, a report by a committee of the outside directors of the New York Stock Exchange regarding the Intermarket Trading System ("ITS") for stocks ("NYSE Committee Report") was made public. *See* "NYSE Panel Calls for Elimination of System Linking U.S. Markets," Wall Street Journal (Apr. 7, 2000) (Attachment 2 hereto). The NYSE Committee Report affirms many of the points we raised in our comment letter. The Report points out that the ITS – which, like the proposed option plans, requires unanimous consent of all participants for any changes to the linkage – has become outmoded and ungovernable and is not serving the purpose for which it was intended. The NYSE Committee Report proposes to replace the ITS and place the onus on broker-dealers to route each individual order to the best market:

> "[Developments in communications technology have eliminated the need for an intermarket order-routing system such as ITS … Given these advances, we believe that broker-dealers now have the ability to fulfill their fiduciary obligations to deliver best executions on an order-by-order basis without the need for intermarket order-routing linkages."

Id.

We strongly agree with this view. Broker-dealer best execution systems that route orders based on best posted prices, and not based on direct or hidden incentives, are the best way to ensure that exchanges compete vigorously and that customers get the best price across markets. Electronic, inter-exchange linkages should be primarily for trading between members of various exchanges, and to act as a back up for customer orders that are misrouted to an exchange not posting the best price.

s/ Thomas Peterffy

Thomas Peterffy
Chairman

s/ David M. Battan

David M. Battan
Vice President and General Counsel

cc: Hon. Arthur Levitt
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