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VIA REGULAR MAIL

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

> **Re:** **Accelerated Approval of Amendments No. 1 and 2 Relating to**
> **Changes to the Chicago Board Options Exchange Rule Governing**
> **the Retail Automatic Execution System, File No. SR-CBOE-00-47**

Dear Mr. Katz:

Interactive Brokers LLC ("IB")[1] respectfully submits these comments on the

Commission's approval of a rule change submitted by the Chicago Board Options Exchange

("CBOE" or "the Exchange") relating to its Retail Automatic Execution System ("RAES")

system. We comment only on one aspect of CBOE's revised rule – the restriction preventing a

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[1] Interactive Brokers LLC is a registered broker-dealer and a member in good standing of all U.S.
option exchanges.

public customer from submitting more than one order on the same side of the market in the same option class within any 15-second period.

The 15-second restriction is intended to protect market makers from having to automatically execute multiple, rapid orders from a single customer that in aggregate would exceed the RAES size commitment, without such market makers having a chance to update their quotes between executions. While there are better solutions to this problem than the 15-second restriction, for purposes of this comment letter we have no quarrel with the rule in and of itself. Indeed, the 15-second rule was approved by the Commission based on the Commission's prior approval of a 15-second rule on the Pacific Exchange ("PCX") and on the International Securities Exchange ("ISE").

The problem with the CBOE 15-second rule is that, unlike the PCX or ISE rules, the CBOE rule does not contain an explicit safe-harbor for orders entered *more* than 15 seconds apart. While the Commission and most observers might be tempted to think that this safe harbor is implicit in the rule (*i.e.*, if a customer is not allowed to place orders for the same option class less than 15 seconds apart, one would assume that a customer *is* allowed to place orders for the same option class more than 15 seconds apart), the CBOE has stated that this is not the case. Instead, the CBOE intends to rely on certain language in a CBOE regulatory circular

(RG 00-27), issued in January 2000 but never submitted to or approved by the Commission, to prevent customers from sending multiple orders on the same side of the market in an option class to the Exchange's order routing system even if such orders are more than 15-seconds apart.[2] In fact, CBOE officials have told representatives from member firms that customers submitting orders on the same side of the market in the same option class several minutes or even several

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[2] *See* correspondence attached hereto as Exhibits A, B and C.

hours apart unwittingly could be in violation of Regulatory Circular RG 00-27 if a CBOE Market Maker complains.

To put it simply, by intentionally withholding Regulatory Circular RG 00-27 from Commission review, the CBOE is trying to accomplish in an unapproved regulatory circular what it could not have accomplished had it followed the proper Exchange Act rulemaking procedures. It is the Commission's policy that "unbundling" rules or other rules restricting the speed or manner in which customers may access exchange order routing systems or automatic execution systems must be specific and limited and must contain clear standards identifying what customers can and cannot do. The Commission's actions with respect to the PCX rule are instructive on this point. Under the original PCX proposal, it would have been a violation for a customer to unbundle a "single investment decision" into multiple orders to be transmitted to the PCX Auto-Ex system no matter how far apart in time those orders were. *See* Rel No. 34-43049, 65 Fed. Reg. 45810 (July 25, 2000). Orders submitted within 15 seconds would have been deemed to constitute a single investment decision, but there was no corresponding safe harbor for orders submitted more than 15 seconds apart. Thus, even if a customer waited 30 seconds or 30 minutes to transmit a second order to the PCX for the same option class, under the original PCX rule proposal the customer could have been subject to a claim that the subsequent order violated the unbundling restriction. *Id.*

The Commission found this to be unacceptable. At the Commission's urging, the PCX amended its proposed rule to include a specific time standard for how quickly a customer can submit orders on the same side of the market in the same option class. *See* Rel. No. 34-43971, 66 Fed. Reg. 11344 (Feb. 23, 2001). Under the amended PCX rule, multiple orders on the same side of the market in the same option class within 15 seconds are subject to the unbundling restriction. On the other hand, if multiple orders on the same side of the market in the same

option class are transmitted by the customer more than 15 seconds apart, such orders are deemed

to constitute separate investment decisions and cannot be said to violate the PCX unbundling

rule. *Id.*

The clear-cut 15-second safe-harbor provision was not an optional element of the PCX

rule. Citing a number of public comments on the issue, the Commission noted explicitly that the

safe harbor was a <u>requirement for approval</u>:

> **"The Commission believes that this safe-harbor rule for multiple orders entered after the fifteen second time period is necessary to provide Users of Auto-Ex with guidance and comfort that their entry of orders after fifteen seconds will not be presumed a single investment decision."** *Id.* at 11348.

See also Rel No. 44017, 66 Fed. Reg. at 13820-21 ("The Commission believes that fifteen

seconds is a sufficient time period to allow market makers to change their quotations following

an execution, while at the same time not unduly long as to place a burden on investors seeking to

execute transactions on the Exchange.") (approving ISE 15-second restriction).

The CBOE is trying to circumvent this Commission policy by using a proper 19b-4 rule

filing to impose a 15-second time restriction on placing orders on the same side of the market in

the same option class (seeming to be consistent with the PCX and ISE rules), but then relying on

its **unapproved** Regulatory Circular RG 00-27 to restrict customers from placing orders on the

same side in the same class however far apart in time those orders are, with no safe harbor. By

intentionally declining to submit RG 00-27 for public comment and Commission approval, the

CBOE is trying to enforce on public customers a trading restriction far broader than that which

the Commission was willing to accept from PCX and ISE.

The CBOE attempts to justify its actions by claiming that its 15-second rule is a "speed

bump" or pacing rule that is entirely separate and distinct from RG 00-27, which deals with

customer unbundling of orders (and therefore presumably is allowed to be vague, subjective and

unlimited in scope). This distinction is unsupportable. First, whether these restrictions are called

"speed bumps" or unbundling rules or whatever, they serve the exact same public policy purpose -- to slow down order flow into automatic execution systems -- and require the same balancing of the interests of market makers (not to have to honor orders in excess of their firm quote minimums) versus public customers (to have free and open access to the exchange).

More importantly, the PCX rule **is** framed as an unbundling rule (prohibiting investors from splitting "single investment decisions" into multiple auto-ex orders), just like CBOE Regulatory Circular RG 00-27. Yet the Commission still insisted on a safe-harbor in the PCX rule for any orders more than 15 seconds apart. This is because short of hiring clairvoyants as registered representatives, it is virtually impossible (and probably meaningless) for a member firm to try to divine whether two customer orders are "separate" or are part of a single investment decision. Likewise, for the increasing portion of option customers who wish to control their own trading electronically without a human broker, it is impossible to tell whether the transmission of multiple small orders represents the "permissible" goal of attaining a better price by working an order or the "impermissible" goal of satisfying auto-ex size restrictions. Indeed, the problem is that these two motives are inextricably joined in the electronic trading context. Addressing the problem of rapid transmission of auto-ex orders by focusing on the subjective intent of each individual option customer is therefore unworkable from the outset. The Commission realizes this, and that objective standards (*e.g.*, fifteen seconds) both prevent member firms from having to read their customers' minds and give customers clear guidance as to what they can and cannot do.

The CBOE's actions leave the Commission in the following situation: While the Commission expressly has disallowed the PCX from extending its unbundling prohibition to orders more than 15 seconds apart, CBOE claims that its unbundling restriction (in RG 00-27) extends to orders minutes or hours apart. **By purposefully withholding RG 00-27 and the customer unbundling rule stated therein from Commission scrutiny, and by failing to**

follow the dictates of Exchange Act Rule 19b-4, the CBOE is attempting to impose a restriction on public customer trading far broader than PCX (or ISE) were able to impose in rules that were passed by those exchanges using the proper Exchange Act rulemaking procedures. If the Commission allows this situation to persist, it will have penalized PCX and ISE for complying with Rule 19(b) of the Exchange Act and it will be rewarding the CBOE for ignoring it. The option exchanges will quickly learn this lesson, and the Commission's rule review powers will be gravely undermined at a crucial time in the development of the option markets.

We urge the Commission to take care not to cede any authority over self-regulatory organizations that are increasingly tempted to use their SRO powers not to create fairer markets but to protect the "business models" of their member constituents in the face of heightened competition and technological change. We urge the Commission to take appropriate action to force the CBOE to comply with the Exchange Act or withdraw those portions of Regulatory Circular RG 00-27 that are inconsistent with the Commission's stated policy requiring customer unbundling rules to be limited in scope and duration and contain clear safe harbor provisions.

Sincerely,

David M. Battan
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cc: Annette L. Nazareth, Esq.
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