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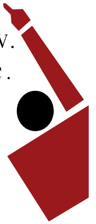

David M. Battan
Vice President and General Counsel

August 15, 2000

VIA FEDERAL EXPRESS AND E-MAIL

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

Re: Proposed Rule Change by the Pacific Exchange Relating to Its Automatic Execution System, File No. SR-PCX-00-05

Dear Mr. Katz:

Interactive Brokers LLC ("IB")[1] respectfully submits these comments on the proposed rule change submitted by the Pacific Exchange ("PCX") imposing new limitations on public customer access to its automatic execution ("Auto-Ex") system. The most significant aspect of the proposed rule is that the exchange has asked the Commission to place its imprimatur upon a requirement that public customers using the exchange must express all of their potential

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

investment interest in a single order transmitted to the exchange. In other words, customers must lay all their cards on the table and reveal their intentions to the market before they even begin trading. This is in contrast to the established practice of "working an order" to try to achieve the best aggregate price.

The exchange is trying to address the potential problem that arises when multiple Auto-Ex eligible orders are transmitted to the exchange in rapid succession, potentially depriving market makers of the ability to update their prices after an automatic execution and before subsequent executions. While the exchange has a legitimate need to protect the integrity and operation of its Auto-Ex systems, the method it has chosen in this instance will not solve the problem and yet imposes restrictions on customer trading that are inconsistent with Commission policy and the fundamental nature of a free and open market.

As we show below, the proposed rule should be disapproved or changed very substantially. The essential concept behind the rule -- that customers cannot "unbundle" a single investment decision into multiple orders -- is unfair and unworkable and does not address the real issue of concern to the exchange. Moreover, the manner in which the exchange proposes to implement the new "customer unbundling" restriction is flawed and will lead to uneven enforcement of the rule. Rather than addressing the issues raised by rapid Auto-Ex orders by focusing on the subjective intent of individual customers (and placing member firms at peril in trying to divine that intent and enforce the rule), the exchange if it must should implement a specific, across-the-board time delay of a small number of seconds that would be programmed into the Auto-Ex system and would prevent subsequent executions from any firm or customer during the specified period after a prior execution. This would offer a more comprehensive solution to the potential problems faced by market makers from rapid order flow, would be objective and would apply evenly across all trades, and would be more consistent with

approaches approved by the Commission in the past. We discuss these issues in more detail below.

1. **The Rule is Inconsistent with Prior Commission Precedent Regarding "Unbundling" and Would Unduly Restrict Public Customers' Trading Decisions.**

Current "unbundling" restrictions on the option exchanges -- including the existing PCX rule previously approved by the Commission -- prevent member firms from breaking a customer's order into multiple smaller parts for the purpose of evading the size limits for exchange auto-ex systems, and from soliciting their customers to do so. *See, e.g.,* PCX Rule 6.87(d)("Firms entering orders for execution on Auto-Ex may not divide them up in order to make their parts eligible for Auto-Ex.")(emphasis added). Current rules as written thus do not generally attempt to interfere with fundamental trading decisions of public investors, but rather seek to ensure that brokers do not divide unitary customer orders in such a way as to change their eligibility for automatic execution.

The Commission seems to have recognized that while it is permissible for an exchange to regulate how its member brokers handle a customer order once they have received it, it should not be permissible for an exchange to reach past its members and try to regulate the manner in which customers themselves formulate and express their investment decisions. As the Commission noted in approving the Philadelphia Stock Exchange's automatic execution system for stocks:

> "[B]ecause the exchange does not have any jurisdiction over non-members, the proposed ***prohibition against unbundling does not extend to any orders broken up by a non-member customer at his or her own discretion*** as long as the customer was not solicited to do so by the PHLX member firm for the aforementioned purpose." Exchange Act Release 34290; 57 S.E.C. Docket 67 (June 30, 1994)(emphasis added).

See also 56 S.E.C. Docket 22 (Feb. 8, 1994)("Unbundling occurs when a member organization or its agent splits a larger sized order into two or more small-sized orders.")(emphasis added).

The proposed PCX rule would prohibit customers from engaging in what the Commission has always seen as fundamental trading behavior -- that is, revealing one's potential investment interest to the market in the time and size of one's choosing. It is difficult to imagine any free market of any kind in which traders -- particularly those seeking to trade in large size -- cannot reveal their trading interest to the market gradually so as not to tip their hands and thus receive a less favorable aggregate price.

The requirement that public customers must expose all of their potential investment interest at once in a single order is thus contrary to established Commission policy and puts option customers at a disadvantage. The Commission has recognized repeatedly that an important function of an efficient trading venue is to allow market professionals and customers alike **not** to have to display all of their trading interest at once, so as to provide for better-priced executions. In this regard, the Commission has approved a "reserve size functionality" in the proposed new Nasdaq SOES system that "would allow a market maker or its customer to display publicly part of the full size of its order or interest with the remainder of its order or interest held in undisplayed reserve." *See* Exch. Act. Rel. No. 42344 (Jan. 14, 2000)(granting accelerated approval to proposed rule changes by the NASD to modify the SOES and Selectnet services). Likewise, in its recent actions in response to market fragmentation concerns, the Commission has noted:

> "Many market centers offer significant opportunities for execution of orders at prices better than the consolidated BBO. These price improvement opportunities are attributable to undisplayed trading interest that may take many forms. Large investors, for example, often are not willing to display their full trading interest to the general market and therefore seek other ways to interact with other trading interest." Proposed Rules on Disclosure of Order Routing and Execution Practices, Exch. Act. Rel. No. 43084 (July 28, 2000).

The proposed rule thus is contrary to oft-stated Commission market structure policies.

It does not answer that the rule only prevents customers from using multiple orders to express a single investment decision "for the purpose of meeting the order size requirements for

Auto-Ex." *See* proposed Rule 6.87(d)(2). 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 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 and, as explained below, will lead to uneven and discriminatory enforcement of the rule.

2. The Rule Does Not Address Successive Auto-Ex Orders of *Different Customers* and Therefore Does Not Solve the Problem.

The proposed rule is intended to prevent market makers from having to accept rapid, successive automatic executions without having a chance to change their quotes, yet the rule only addresses successive Auto-Ex orders from the same customer, and does nothing to address the same problem arising from rapid, successive orders from *different* customers, which will be much more common as the volume of electronic options trading continues to surge. Thus, while the rule is subjective and unduly restrictive on the one hand, on the other hand it is under-inclusive and will not protect market makers from, for example, an automatic execution of a Schwab order, followed three seconds later by an automatic execution at the same price for a Fidelity order. For the same reason, the rule will be easy for any sophisticated customer to evade, by simply opening two or more accounts with different member firms and sending multiple small orders through those different firms.

These problems further illustrate that the approach of focusing on each customer's subjective intent and attempting to force each customer to express all their trading interest in a single order is problematic. As we describe in more detail below, if the exchange wishes to

implement a time delay after an automatic execution such that a market maker will have time to adjust its quotes before a subsequent execution, that time delay should apply objectively, across the entire market, it should be programmed into the Auto-Ex system, and it should prevent execution of any customer's order for the prescribed time period.

3. The Proposed Rule Invites Uneven Enforcement

Rather than providing an objective standard for handling rapid orders from all customers, the subjective standard in the new PCX unbundling rule– combined with the almost unlimited discretion given to exchange floor officials to enforce the rule, will allow market makers and floor officials, *ex-post facto,* selectively to cancel (or price-adjust) trades that are unprofitable while accepting trades that are profitable. Likewise, there will be a strong temptation to enforce the rule against member firms with sophisticated customers and member firms who provide relatively less order flow to the exchange, while treating so-called "dumb order flow" provided by larger member firms far more leniently.[2]

A. The 15-Second Standard is a One-Way "Presumption" that Provides No Safe Harbor for Customers and No Certainty to Member Order Entry Firms

The proposed rule makes it a disciplinary violation for a customer to place and a member firm to transmit multiple orders that arise from a single "investment decision." The proposed rule includes a "one-way ratchet" in which all orders from the same customer in the same option class within 15 seconds are "presumed" to constitute a single investment decision, yet there is no

[2] As the Commission noted in its 1996 enforcement report regarding NASD's oversight of Nasdaq, when exchange membership organizations use their self-regulatory authority to enact trading rules, there is an inherent conflict of interest and an inherent temptation to slant those rules against the public customers trading on the exchange. *See generally* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (Aug. 8, 1996)(noting uneven and discriminatory enforcement of SOES rules and that "Nasdaq market makers in certain instances unduly influenced the NASD's regulatory process in their favor").

corresponding safe harbor for orders transmitted more than 15 seconds apart.[3] *See* proposed Rule 6.87(d)(2). Worse, because floor officials are vested with unfettered discretion to enforce the new rule (by canceling and price adjusting trades) without having to utilize the exchange's ordinary surveillance and enforcement mechanisms, member firms and their customers are exposed to harsh sanctions based on unknown and unknowable standards. Thus, the floor officials overseeing the IBM post might cancel or adjust any trades from the same customer within 45 seconds while the floor officials overseeing the Cisco post may decide to cancel or adjust any trades from a single customer within 2 minutes. All of these "standards" will be unofficial and unknown to member firms, and it will be impossible for member firms, the exchange or the Commission to verify that they are being enforced in a consistent fashion.

Indeed, however hard floor officials try, it will be impossible for them to enforce the proposed rule in a fair and even-handed way, because market makers will only have an economic incentive to complain about "unbundled" trades that went against them, not trades from which they have profited. Likewise, market makers may be hesitant to raise questions about trades from powerful member firms that provide significant order flow to the exchange. Thus, Customer A who submits two trades within 45 seconds on Monday may have the second trade canceled or price-adjusted after-the-fact for "unbundling" because the second trade went against the market maker, while Customer B on Tuesday may submit two trades within 20 seconds that are left undisturbed because the second trade favored the market maker. Meanwhile, Customer C from a firm providing substantial order flow need likely never worry about having trades canceled, no matter how close together in time they are.

[3] Moreover, the 15-second presumption applies even if a market maker has changed its price after the first execution. In these situations, there is no justification not to accept a subsequent order.

B. The Rule Bypasses Ordinary Exchange Surveillance and Enforcement Mechanisms and Vests Floor Officials With Too Much Discretion to Cancel or Price-Adjust Trades.

The certainty of executed and reported trades is a central foundation for any fair and stable securities market. While exchange rules allow cancellation or price adjustment of trades in certain limited circumstances such as an incorrectly reported or aberrant price, the proposed PCX rule will make cancellation and price adjustment of trades an everyday facet of ordinary rule enforcement. *See* proposed new subsection (g) to Rule 6.77, Commentary .01. The proposed rule invites floor officials to shoot first and ask questions later by canceling and price adjusting trades if they suspect that a customer or member firm has engaged in any of the list of prohibited practices specified by the rule. Yet the proposed rule provides no procedural protections for customers and is silent on the issue of what remedies may be sought by customers whose trades are canceled or price-adjusted in error.

It is inappropriate for the exchange to vest floor officials with the responsibility to enforce the proposed rule because – unlike ordinary trading crowd disputes between professionals who are right there on the scene – the unbundling and other prohibitions in the proposed rule relate to the intent and actions of customers, who are far away and whose identities and motives necessarily are beyond the knowledge of floor officials. With respect to the unbundling prohibition, the first problem is that floor officials ordinarily will not even know whether two or more orders from the same member firm are from the same or different customers. More to the point, it is not at all clear how floor officials could possibly determine whether multiple orders represented a "single investment decision" and, if so, whether that decision was split into multiple orders "for the purpose of meeting the order size requirements of Auto-Ex eligibility." Floor officials are not in a position to request documents, investigate trading patterns, interview the customer or member firm personnel, or take any of the other basic

investigative steps that would be needed to determine the rationale behind a given series of trades.[4]

There is no justification for bypassing the exchange's ordinary market surveillance and enforcement mechanisms – and the related procedural protections – and allowing floor officials to enforce a rule that governs the behavior of unknown public customers who may be 100 or 1000 miles from the exchange floor. Ordinary exchange surveillance and enforcement mechanisms provide at least some limited protection to member firms and customers. The proposed PCX rule eliminates this protection and allows the exchange to bring the full brunt of its self-regulatory power to bear against firms and customers without affording them any real process.

The rule even vests floor officials with the power to cancel or price-adjust trades in cases of suspected market manipulation, which is one of the "prohibited practices" listed in the rule. *See* proposed Rule 6.87(d)(4). While the exchange certainly has a legitimate concern in ensuring that the Auto-Ex system is not used by customers to manipulate markets, manipulation is the quintessential example of an offense that must be proved by careful investigation and exploration of the intent of the trader. For example, one form of potential market manipulation of concern to the option exchanges is known as "small-lot baiting" and involves the situation where a customer places an order on an exchange for the purpose of affecting the execution price of a separate order from that customer on that exchange or another exchange (for example by taking advantage of firm-quote minimums or step-up guarantees). Exchange and member firm

[4] Even if multiple orders from the same customer are received by the exchange within 15 seconds, the proposed rule only says that there is a "presumption" that such orders were improperly unbundled. Is this presumption rebuttable by the member firm or the customer? Will floor officials always cancel or price adjust the second trade in such circumstances? If so, then calling the 15-second period a "presumption" is a misnomer. If not, then, again, the rule surely will not be applied evenly across winning and losing trades and across large and small firms.

surveillance programs thus look for situations where a customer may place a small order on one side of the market concurrently or nearly concurrently with a larger order on the other side of the market.

The problem is that while this trading pattern is indicative of potential manipulation, it is by no means conclusive. Active option traders may trade on both sides of the market for many reasons, the majority of which are unexceptionable. For example, a trader may wish to take advantage of an arbitrage opportunity in which CBOE is offering an option at a lower price than PCX is bidding, so a trader may send a 1-lot order to PCX to make sure that it's automatic execution systems are operating before consummating the opening leg of the trade (this would not be necessary if the exchanges would alert market participants as to the operational status of their auto-ex systems). Or a trader may initially enter a small order on one side of the market (for example, initiating a short position) and then enter a much larger order on the other side of the market if the market moves and the trader then wishes to be long.

Without a careful examination of the customer's trading patterns, the relevant prices across all markets when the trades were entered, an interview of the customer and/or the member firm, and other customary investigative steps, it would be impossible to conclude with any reasonable certainty that a customer was engaging in what is a serious form of securities fraud. Yet the proposed rule allows two floor officials to reach this conclusion at their sole discretion without even the most basic facts at their disposal.

After-the-fact cancellation and price adjustment of executed and reported trades is a serious sanction that undermines investors' most basic assumptions regarding the certainty of exchange trading. Where trades are unilaterally price-adjusted, customers lose the benefit of the firm posted price that drew them to place their orders with the exchange. In cases where trades are canceled, member firms and their customers may be informed of the cancellation anywhere

from ten or fifteen minutes up to an hour or more from the time when the customer thought its trade had been consummated. During this time period, customers are unwittingly exposed to full market risk. Customers who executed opening transactions find that they did not have the positions they thought they had. Customers who executed closing transactions find that they were either unknowingly long or short the market in the options series at issue. Both results are intolerable and, if permitted, can only lead to uncertain and chaotic markets.

The final problem flowing from the wide discretion granted to floor officials to alter or negate executed trades is that there will be no meaningful recourse for firms or customers whose trades are canceled or adjusted in error. Since floor official rulings necessarily will be based on little or no concrete evidence, meaningful appeals to the Option Floor Trading Committee and/or the exchange Board of Governors will be virtually impossible.[5]

4. <u>Other Solutions Must Be Sought to Address the Issues Raised by Rapid Transmission of Auto-Ex Orders</u>

IB agrees that the Exchange has a legitimate concern in trying to ensure that market makers do not face automatic executions at unfavorable prices because they were not able to update prices after a prior execution. The ultimate solution to this problem must come from systems that instantaneously, automatically update prices after each execution. While another, temporary solution may be appropriate until instantaneous update becomes a reality, that solution cannot take the form of a subjective "customer unbundling" rule that limits the way individual customers may formulate and place trades and creates an incentive for market makers to keep trades that are profitable and seek to nullify trades that

[5] As the Commission is aware, Interactive Brokers filed appeals with the boards of governors both of the Pacific Exchange and the Philadelphia Stock Exchange regarding improper cancellations and price adjustment of customer trades supposedly based on violations of existing exchange rules preventing member firms from unbundling trades. Even though it was clear beyond doubt that IB had not unbundled the subject trades, IB was forced to expend a tremendous amount of time and effort bringing appeals and it took months to reach a satisfactory resolution of the underlying issues.

are not. Any "time-delay" rule approved by the Commission to address these issues must be objective and firm, must apply equally to all firms and customers, and must be programmed into the Auto-Ex system itself rather than implemented by placing the burden on member firms to read the minds of their customers.

Although certain past policies regarding Nasdaq's SOES system have been the rightful subject of Commission criticism[6], the time-delay functionality implemented in the system to prevent multiple rapid executions against the same market maker seems to provide a better model for dealing with rapid order entry than an enhanced unbundling rule. In SOES, the system itself will not issue a subsequent automatic execution to the same Nasdaq market maker within 15 seconds of a prior execution (this time delay will be drastically reduced or eliminated in the new SOES system). Thus, unlike the proposed PCX rule, market makers are protected from multiple automatic executions whether they are from the same customer or different customers. Further, because the system automatically implements the delay regardless of the intent or identity of the customer, the operation of the system is objective and even-handed and spares member firms the burden of enforcing subjective standards against their customers. Finally, the system is more efficient because, if a market maker *does* change its price after a prior automatic execution, the system recognizes that fact and allows an immediate subsequent execution against the same market maker.

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[6] In 1988, NASD promulgated an interpretation to the SOES rules under which all orders within five minutes from accounts controlled by the same registered representative or customer were considered to constitute one investment decision and could not be separated for purposes of the SOES size limits. *See* NASD Notice 88-61. This "interpretation" does not seem to have been submitted to the Commission for review. Moreover, the automatic 15-second time delay programmed into the SOES system itself (see discussion above) seems to have been far more important in addressing rapid SOES order flow than this unbundling policy. In any event, in light of criticism of the policy and subsequent technological

Conclusion

The SOES system is just one example of an approach that would avoid many of the problems inherent in the proposed PCX rule. Whether the PCX adopts a similar solution or identifies a new one, the current proposed rule should be disapproved and Commission staff should work with the exchange to formulate a better policy. While exchanges have significant latitude in rulemaking, and of course need not even offer automatic execution of orders, the Commission should not approve rules that fundamentally restrict the way investors may trade and that are subjective, vague and subject to uneven or discriminatory application.

Sincerely,

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developments, NASD has withdrawn Notice 88-61 and the "single investment decision" policy. *See* Exch. Act. Rel. No. 41015 (Feb. 9, 1999).