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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 Chicago Board Options Exchange
Relating to the Prohibition Against Electronically Generated and
Communicated Orders, File No. SR-CBOE-00-57***

Dear Mr. Katz:

Interactive Brokers LLC (“IB”)¹ respectfully submits these comments on the proposed rule change submitted by the Chicago Board Options Exchange (“CBOE”) imposing yet another restriction on public customer access to its Retail Automatic Execution System (“RAES”) system. For the reasons outlined below, the rule should be disapproved.

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

Introduction: Over the objection of a number of commenters, including Interactive Brokers, the Commission has allowed the options exchanges over the past year to implement rules under which public customers are prohibited from sending to exchange order routing systems option orders that have been created and generated electronically without manual intervention. We have argued that these rules distort the exchange price discovery function, foster wider spreads, and impair liquidity by preventing public customers from using pricing programs that might generate faster and more competitive prices than those of the professional market makers that operate under the exclusive franchises granted them by the exchanges. We have also argued that these rules are contrary to settled Commission policy in that they interfere with market efficiency by placing artificial technological restraints on traders. Finally, we have argued that these rules are impossible for broker-dealers to enforce against their customers and are so ambiguous as to invite selective prosecution against exchange members whose customers are sophisticated and able to trade successfully against market makers.

Notwithstanding these problems with the existing rules, the CBOE now seeks to expand its rule. At the direct behest of one of its Designated Primary Market Makers, the CBOE has submitted a proposal to expand the reach of the prohibition against electronically generated and transmitted orders. Under the proposed rule, an order would be “deemed” electronically generated and communicated for purposes of the rule even if the order creation and transmission process involves human intervention – if such intervention can be described as “minimal”. No standards are provided to describe what the exchange will determine to be “enough” human intervention to enable an order to be transmitted to the exchange’s order routing system.

As we explain, the Commission should resist this first step by the CBOE in expanding the prohibition against electronically generated and transmitted orders (which surely will be followed by the other exchanges and then by a new round of further restrictions).

The Rule Will Be Impossible to Enforce: First, the rule will be impossible for member firms to enforce, because keystroke emulation and other simple techniques can be programmed easily by sophisticated customers to make an automated order look as though it was entered manually. These techniques will be impossible for member firms to detect and, even if a particular technique is discovered by a firm and prevented, customers will then simply “program around” the surveillance mechanism, and so on.

As the Commission has recognized, in this era of rapidly increasing online trading, customer orders are more often than not merely bits and bytes of data transmitted over large computer networks and automatically routed by member firms like IB to an appropriate forum for execution. In order to be successful, member firms must offer flexible interfaces to service disparate types of customers using different order entry systems. In this environment, it is difficult, if not impossible, to determine whether a stream of data coming across a network was generated by someone typing at a keyboard (presumably permitted under the rule), someone using a voice-recognition system to generate their orders (probably permitted under the rule, but who knows?), or someone using a keyboard emulator that generates random-length subsecond delays between “keystrokes” to make it look as though a human being is typing an order even though a computerized trading algorithm is calling the shots (prohibited).

The Rule is Vague and Ambiguous and Will Lead to Uneven and Discriminatory Enforcement. Closely related to the foregoing, the rule is hopelessly vague and indeterminate, and, since the burden of proof is placed on member firms to enforce the rule and show that orders are not being generated and transmitted electronically, disfavored member firms

(technologically advanced firms with a sophisticated customer base) will be subjected to uneven and discriminatory enforcement of the rule.

The rule requires that order placement involve more than “minimal” human intervention but does not specify what that might be. The reason that clear lines are not drawn in the rule is because, as the CBOE recognizes, it is impossible to draw clear lines once exchanges start to discriminate against certain orders because of how those orders are generated. Indeed, this is exactly why these types of rules are fundamentally inconsistent with a free and open market.

The unanswered and unanswerable question is as follows: How much “human intervention” is required before an order is slow enough and dumb enough that the exchange will force its market makers to honor their firm quotes and trade with the order? Even a “single keystroke” standard -- which would be much more definitive than the proposed rule is -- immediately raises questions. If the operator is using a single keystroke unthinkingly to release orders that have been generated by an automated valuation system, such orders presumably would run afoul of the proposed new rule. What would happen, however, if a computerized system generates “suggested” orders that a human trader can look at and decide to transmit or delete with a single keystroke. Since human judgment is being used, does this scenario pass muster? What if the trader uses a single keystroke to select from a slate of possible orders that are generated automatically by the trader's software ?

What if the trader is using a crude spreadsheet program to generate options valuations that are less accurate and sophisticated than those used by market makers, but the trader has rigged up his personal computer such that he can transmit these spreadsheet orders with a single keystroke? What if it requires five keystrokes? Ten keystrokes? How many keystrokes are enough and/or how poorly performing must the trader’s valuation model be before the exchange deems it “safe” for the trader to access RAES?

What if the trader has highly sophisticated valuation software and then reads the orders generated by the software from his or her computer screen into a voice recognition system, which then creates and transmits orders that are released with further spoken commands. Is this enough manual intervention? What if the customer instead programs his computer to dial the phone and then read the orders into a voice recognition system employed by the member firm to allow placement of telephone orders?

These crude examples do not even begin to approximate the problems of interpretation that will arise when the creativity of traders is combined with the multitude of systems, order entry methods and advancing technologies that are coming to the fore. They do illustrate, however, that trying to draw a line that says that customers are allowed to use this much technology but not this much is impossible, and will only lead to confusion and regulatory mischief that the Commission will then have to sort out.

The exchange claims to address this line-drawing problem by asserting that member firms can simply seek guidance from the exchange based on a given set of facts to determine if an outlined scenario is allowed under the rule. This is very problematic. These rules were proposed at the urging of certain market makers and they will be enforced at the urging of those market makers. It is clear that the answer to whether a particular way of creating and entering orders is “manual enough” will depend on which member is asking the question, how profitable its customers are perceived to be, how much order flow the member brings to the exchange, etc. Moreover, rather than having clear guidelines from the outset, these decisions will be made on an ex post facto “look-back” basis either through informal, unpublished agreements between exchange staff and member firms, or through actual or threatened enforcement actions. No member firm or customer will have clear guidelines to follow and since the stated purpose of the rule is to further the “business model” of the exchange (i.e., that its market makers continue to

enjoy profits commensurate with their protected regulatory franchises), there is every reason to think that the profitability of the customers engaged in the particular method of trading will be the primary determinant of whether that method is “manual enough”.

* * *

In closing, there seems to be no end to the steady stream of rule filings placing more and more restrictions on access to exchange automatic execution systems. Nor does there seem to be any meaningful stopping point to the rationale employed by the exchanges to justify these restrictions – that they are necessary to protect the exchanges’ “business models.” We urge the Commission to scrutinize these rules very carefully.

Sincerely,

David M. Battan
Vice President and General Counsel

cc: Annette L. Nazareth, Esq.
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