Before the
Securities and Exchange Commission
Washington, D.C.

IN THE MATTER OF:

File No. SR-CBOE-98-35
Proposed Rule Change by the Chicago Board Options Exchange, Inc.
Relating to Floor Brokerage Subsidies

Comments of the United States
Department of Justice

I. Introduction

On September 16, 1998, the Securities and Exchange Commission ("Commission") requested public comment on a proposed rule change by the Chicago Board Options Exchange, Inc. (the "CBOE") relating to floor brokerage subsidies. Under Section 3(f) of the Exchange Act the Commission must consider the impact on competition and efficiency of rules proposed by self regulatory organizations, like the CBOE. 15 U.S.C. §78c(f).

The United States Department of Justice ("Department") respectfully submits that the proposed rule change (the "Proposal") raises a number of competitive issues that were not adequately addressed by the CBOE. While the Department has not conducted an investigation of this matter, the Department believes that the Commission should not approve this Proposal until the CBOE has adequately explained why this rule will not adversely effect competition and provided a fuller explanation of how this rule will promote competition between exchanges.

II. The Proposal

The Proposal would allow CBOE "Resident Market Makers" in each class of options to act jointly in setting and imposing a uniform fee on each contract traded by any market maker in that options class. (Resident Market Makers are those market makers who do 80% of their business in that particular class of options.) The fee would apply to <u>all</u> trades in that option, by <u>any</u> market maker. Market maker votes would be weighed by market shares. The fee would be assessed on a per-contract basis and would be used to create a fund to pay subsidies to commission agents. The CBOE would collect the funds set by this joint assessment, and would use them to pay subsidies to certain commission-earning business units on the floor of the CBOE.

Specifically, Resident Market Makers would be able to vote to reduce the commission charge for the Order Book Official ("OBO") who keeps the public limit order book in the relevant class of options. The fees on the market makers would then fund the difference between the CBOE's standard OBO rate and the reduced OBO commission level. Any remaining funds from the market maker fees would be used to subsidize certain floor brokers who commit to doing most of their brokerage business in the relevant class of options (known as "Stationary Floor Brokers"). These subsidies would apply on a per unit basis for the business done by the selected floor brokers. All CBOE floor brokers are free to set their commissions as they see fit, and will remain free to do so even under the Proposal, but the Proposal anticipates that Stationary Floor Brokers who receive the subsidies will reduce their commissions to off-floor or retail brokers (who receive the original customer orders).

III. The Stated Rationale for the Proposal

The stated purpose of the Proposal is to enable the commission agents to lower their commissions to the general public to meet competition from options exchanges, such as the American Stock Exchange, which use specialists rather than market makers to provide liquidity. On the specialist exchanges, the specialist maintains a public limit order book. The specialist may charge a commission for orders crossed from the book. The specialist in each class of option sets the order book commission for that class of option. The specialist may also trade as a principal for his own account.

On the CBOE, the OBO keeps the limit order book as an employee of the CBOE. The OBO charges a commission for crossing orders from the book, but the OBO does not set the level of this commission. Instead, the CBOE sets a uniform OBO commission rate applicable to all OBO business on the CBOE floor. In addition, OBO's cannot trade as a principal.

The Proposal would give market makers the ability to subsidize the OBO function, allowing market makers to lower OBO's effective commission charges to off-floor or retail brokers. Specialists on the other exchanges can already (internally) subsidize their order book commission business with profits from trading. Thus, this Proposal would arguably allow CBOE market makers to place the OBO function on an equal competitive footing with the order book business of exchange specialists.

Insofar as the Proposal would allow the Resident Market Makers to subsidize floor brokers who qualify as Stationary Floor Brokers, the subsidy is apparently meant to overcome a disadvantage resulting from the inability of floor brokers to subsidize their commission business by trading as principals as specialists do. However, it is not clear from the CBOE's explanation of the Proposal why the CBOE compares floor brokers on the CBOE with specialists on the other exchanges. Floor brokers exist on all options exchanges and currently, as we understand it, they are not subsidized on any exchange. CBOE has not shown why subsidizing CBOE floor brokers, when others are not, will promote competition.

IV. Competitive Issues Raised by the Proposal

As a general matter, CBOE market makers are competitors in buying and selling options contracts with the public. Under the Proposal, the market makers would be collectively setting fee and payment obligations that could affect the prices paid by the public for their market maker services. The CBOE should not be permitted to adopt a rule allowing market makers to agree on matters that could affect prices the public pays for securities and/or securities transactions without a compelling justification.

The explanation and information provided by the CBOE in support of its Proposal are inadequate. Under the Proposal, CBOE market makers would pay the subsidies to the OBO and floor brokers from trading revenues earned from the difference in bid and ask quotations. The Proposal, therefore, may increase pressure on market makers to increase their spreads in order to finance the subsidies. Wider spreads would result in consumers buying and selling options at prices inferior to those at which they could purchase options absent the Proposal. While any adverse effect on securities prices might be offset by reduced commission payments if floor brokers pass through their subsidies, a rule that would allow competitors to create a subsidy that may increase one consumer cost in order to reduce another needs more justification than the CBOE has provided. At the very least, the CBOE should indicate why the Proposal will not adversely affect spreads and/or net consumer cost.

The risk for an adverse effect from the Proposal would appear to be greatest for small retail market orders that are executed automatically without intervention by the OBO or a floor broker. These customers are most likely to see their transaction costs increase, inasmuch as they may not receive any benefit from lower floor broker commissions. The Proposal may also give market makers the ability to affect the relative costs of limit and market orders by giving market makers the power to allocate the subsidy between the OBO and floor brokers. If market makers acting under the Proposal were to discourage limit orders, limit order discipline on market maker spreads may be reduced and spreads may widen.

In addition, there is no guarantee that the Proposal will reduce consumer commission costs. Floor brokers are under no obligation to reduce their commission rates. Moreover, if they do reduce their commission rates to off-floor brokers, an off-floor broker may not reduce charges to his or her customers and the customers would not benefit from the Proposal. Further, the off-floor broker would have an incentive to route orders to the CBOE because the commissions he or she pays to the CBOE floor brokers or OBO's may be less than that charged by competing exchanges. The result of the Proposal, then, would be the creation of a form of "payment for order flow." Customers may be harmed if off-floor brokers route their orders to CBOE because of the payments when they would receive a better execution if routed elsewhere.

The voting mechanism by which market makers would establish the fee also raises competitive issues. By weighing each Resident Market Maker's vote by market share, the Proposal creates an opportunity for market makers with substantial order flow to set fees that competing market makers on the CBOE must also pay. The fees assessed could raise disproportionately the total costs of smaller rivals, thereby disadvantaging them.

Finally, the CBOE's objectives may well be achievable through less anticompetitive means. At a minimum, the CBOE should be required to show that other non-collaborative methods could not achieve the same ends.

Respectfully submitted,

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