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VIA HAND DELIVERY

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 Establishing Cancellation Fees for Orders Routed through its Automated Order Routing System, File No. SR-CBOE-2001-40

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 a $1.00 cancellation fee for orders routed through the Exchange's Automated Order Routing System ("ORS"). As outlined below, because the CBOE has provided no meaningful analysis of the need for, or the amount of, the proposed cancellation fee, the proposed rule should be abrogated.

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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.

The Exchange should be required to re-file its rule with a careful analysis of the administrative costs actually incurred by the Exchange in processing cancellation requests and a justification of the amount of the proposed fee. The Exchange should also set forth how it will use the funds collected pursuant to the cancellation fee program, and should provide information sufficient for the Commission to ensure that the fees will be applied to all members on an equal and non-discriminatory basis.

I. Cancellation Fees Make it Harder for Customers to Respond to Market Changes, therefore Increasing Effective Spreads.

While the Commission has approved modest fees to be imposed by exchanges to defray the administrative cost of handling order cancellations, we urge the Commission to proceed very carefully in this area. The precedents being established now will affect the competitive landscape in the options market for years to come, and if the CBOE cancellation fee proposal is approved in its current form, other exchanges will quickly adopt equal or greater fees, with little or no analysis or justification. Unlike other exchange-imposed fees like transaction or membership fees, cancellation fees uniquely affect the trading process itself, making it more costly and difficult for customers to respond to changes in market prices while they have an order pending at an Exchange. By imposing a cost on canceling and replacing/rerouting orders, cancellation fees tend to lock orders in at a particular price and size and on a particular exchange, exacerbating the problem of the "free option" – where market makers will trade against an order that is moving against the customer while declining to execute when the price moves in the customer's favor. The Commission calls this practice "adverse selection" and has looked for tools – such as the Commission's new execution quality disclosure rules -- to expose it to public scrutiny. Order cancellation fees, however, will make the problem worse and will make it easier for market makers to "lean on" customer limit orders.

Cancellation fees also make it less attractive for public investors to add liquidity to the markets. Customers who know they will pay a $1.00 penalty every time they cancel an order in response to a change in the markets will be less likely to enter limit orders, including limit orders between the quotes that would narrow the spread for other investors.

II. Cancellation Fees Undermine the Benefits of Multiple Listing and Impair Efforts to Offer Best Execution of Customer Orders.

Like other recent option exchange rule changes, imposing cancellation fees also seriously undermines the Commission's hard-fought effort to have option contracts listed on multiple exchanges, as customers and their brokers will now have to pay a penalty every time they cancel an order and reroute it to another exchange (either because a better price has been posted at another exchange or because the initial destination has failed timely to execute the customer's order). With the advent of multiple listing, there are more and more brokers like IB who have invested much time and money developing intelligent best execution order routing systems that route each customer order individually to the best posted market and then cancel and reroute these orders if a better price appears on another exchange or if the initial routing destination has failed to execute the order. Public policy should favor the increased deployment of these types of order routing systems, as they both ensure customer best execution of orders and help to ensure that market makers who post competitive prices actually receive some order flow. Exchange cancellation fees impose a prohibitive or nearly-prohibitive tax on these order-by-order routing systems and will drive brokers to give up on these efforts and simply internalize or sell their order flow to the highest bidder. Indeed, the Commission might rightfully suspect that this is a primary goal of the proponents of cancellation fees.

IB's commission structure illustrates this point. We currently charge $1.95 per contract to execute option orders via our order-by-order "Best Execution" routing system. Our system routes customer option orders to the best posted market and then constantly reevaluates the market and cancels and reroutes orders if a better price appears elsewhere or if an order has failed to receive a timely execution. Canceling and rerouting a small order even once under the CBOE rule will cost us most or all of our profit on that trade.

III. The Commission Should Require a Careful Cost-Recovery Analysis of Proposed Cancellation Fees.

Because of their fundamental impact on the trading process, if the Commission is willing to accept the imposition of order cancellation fees, the Commission should at least require exchanges to make a showing that the fees to be imposed are directly related to the actual costs to the Exchange in processing cancellation requests, and are not merely imposed to penalize customers and their brokers for canceling and replacing/rerouting their orders. In this case, the CBOE has made absolutely no attempt to justify the amount of the proposed $1.00 fee, and it seems grossly excessive. As noted above, on small orders (the majority of customer option orders) the cancellation fee is of the same order of magnitude as the Commission charged by low cost brokers for carrying the customer option account and executing and clearing trades. The $1.00 per order cancellation fee is also far in excess of the analogous fee that the Commission approved for Selectnet stock trades several years ago ($.25 per order).

The first step in any cost-recovery justification of a proposed cancellation fee would be a demonstration that there actually is some significant incremental cost to the exchange in processing cancellation requests. Exchange automated systems should be designed (or improved over time) so as to make canceling an order entirely automated, in which case the incremental "cancellation" cost per order would be fractions of penny. Failing this, if there ***is*** human intervention in the order cancellation process, the exchange should set forth an analysis of the costs involved when it proposes a to impose a cancellation fee. This at least would provide a fair basis for public comment and Commission analysis. Again, in this case the CBOE has provided no information upon which to judge the reasonableness of the proposed fee or whether it bears any relation to the supposed administrative costs associated with processing cancellation requests.

An exchange seeking to impose a cancellation fee should also make a showing that it will actually use the fees collected to enhance and improve its systems so that administrative costs related to order processing will be lowered in the future. Since cancellation fees will tend to increase effective spreads for option orders, it will not be in the interest of the exchange market making constituency to reduce cancellation costs (and therefore fees). In a proper rule proposal in support of a cancellation fee, an exchange should set forth how it will use the fees collected and how it will improve its systems in the future to reduce and eventually eliminate cancellation fees.

IV. Cancellation Fees Should Apply Equally to All Exchange Members

Another essential requirement for any exchange-imposed cancellation fee must be that it is applied equally to all exchange members. This means, first, that neither the Exchange nor any Designated Primary Market Maker (or the like on other exchanges) should have the power to waive the fee for certain members or to grant "rebates" or "discounts" of the fee. If the exchange or DPM has any mechanism to "tailor" the individual cancellation fee to be borne by particular members, there will be a strong temptation to discriminate against certain firms at the expense of other firms with larger or more profitable, less-sophisticated order flow. If cancellation fees are actually intended to defray the administrative cost of processing order cancellations – and not as a penalty – they should apply equally to everyone with no exceptions.

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Because the CBOE has provided no information to justify the imposition or the amount of the $1.00 cancellation fee it proposes to implement, the proposed rule should be abrogated. The Exchange should be required to re-file its rule with a careful analysis of the administrative costs incurred by the Exchange in processing cancellation requests and a justification of the amount of the proposed fee. The Exchange should also set forth how it will use the funds collected pursuant to the cancellation fee program, and should provide information sufficient for the Commission to ensure that the fees will be applied to all members on an equal and non-discriminatory basis.

Sincerely,

David M. Battan
Vice President and General Counsel

cc: Annette L. Nazareth, Esq.
Robert L.D. Colby, Esq.
Elizabeth King, Esq.
Nancy Sanow, Esq.