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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-6628

Re: Proposed Amendments to Rule 610 of Regulation NMS, File No. S7-09-10

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated ("CBOE") respectfully submits these comments on the Commission's proposed amendments to Rule 610 under the Securities Exchange Act of 1934 (the "Act"). The amendments would (1) establish a limit on the fees that an options exchange can charge to access the displayed best bid and offer for options listed on the exchange, and (2) prohibit an exchange from imposing "unfairly discriminatory" terms on non-members to access quotations. Proposed Amendments to Rule 610 of Regulation NMS, Release No. 34-61902, 75 Fed. Reg. 20738 (Apr. 14, 2010) ("Proposing Release").

CBOE is the largest U.S. options exchange and the leading creator of listed options products. As recognized in the Commission's Proposing Release, CBOE may also be the entity most seriously affected by the Commission's proposal to cap options exchange fees. CBOE supports the Commission's efforts to improve the national market system and ensure fairness and transparency for investors, but respectfully disagrees with the approach in the current fee cap proposal.

Introduction

With its proposed amendment to Section 610(c), the Commission would limit to $0.30 per contract the amount that options exchanges can charge in fees for execution of orders that access displayed quotations. There currently is no such regulatory limit on the "access" or "transaction" fees that may be charged by options exchanges, although all exchange fees are required to be filed with the Commission, which has the authority to abrogate them. More importantly, and as discussed below, exchange fees are constrained by what the Commission itself recognizes to be robust competition among the options exchanges.

The Proposing Release offers several, interrelated rationales for imposing these proposed price controls. In an effort to foster a "national market system" ("NMS") for securities, the Commission has imposed "intermarket" "linkage" requirements on securities exchanges which provide, among other things, that an exchange must "match the best quoted prices, cancel orders without an execution, or route orders to the trading centers quoting the best prices." Final Rule, Regulation NMS, Release No. 34-51808, 70 Fed. Reg. 37496, 37525 (Jun. 29, 2005). Options exchanges have, at the Commission's directive, adopted a similar "linkage" plan. Subject to limited exceptions, exchanges are thereby prohibited from "trading through" a better priced quotation displayed on another options exchange, although currently exchanges may give participants on that exchange an opportunity to "step up" to the "National Best Bid and Offer" ("NBBO") before the order is routed to another exchange. (This so-called "flash" functionality is the subject of a separate Commission rulemaking.)

Transaction fees that are imposed on the executions of trades are the most important source of revenue for options exchanges, as discussed further below. The amount of these fees and the circumstances in which they are imposed vary among exchanges, although the fees are publicly-known and available, are programmed into the order routing and execution management systems that route orders for execution to the various exchanges, and are always less than the penny increment that is the minimum difference in price for most options. It is this variation in transaction fee prices—something ordinarily considered a necessary and beneficial aspect of a competitive market—which underlies the proposed fee cap. The Proposing Release states that because access fees vary and are an added cost of a trade, the "all-in price for the trade" cannot "readily" be ascertained from the displayed quote. Proposing Release, 75 Fed. Reg. at 20755. Price controls for access fees would cause exchanges' quoted prices to "more closely reflect the total cost of a trade," making quotation information "more useful" and the cost of accessing quoted prices "more transparent." *Id.* The Release suggests that the rule would also "prohibit individual exchanges from raising their fees substantially in an attempt to take improper advantage of protection against trade throughs" with "exorbitant fees." *Id.* at 20743. Under the existing system, orders already may be routed to the exchange that displays the NBBO with the lowest transaction fees, which the Release recognizes to be a "significant incentive[]" to avoid high fees. *Id.* But, the Release suggests, some exchanges might charge high fees knowing that they "would be the last exchange to which orders would be routed, [but that] prices could not move to the next level until someone routed an order to take out the displayed price at such a high fee exchange." *Id.* Generally, the Release suggests, "the integrity of the price protection requirement under the Trade-Through Rules" (*id.*) would be furthered if a person submitting an order to one exchange were not subjected to a transaction fee at another exchange that is significantly different than the fee chargeable at the exchange initially receiving the order.

The principal reason for the specific amount of the proposed cap—$0.30 per options contract—appears to be that this was the amount of the cap imposed on equities in an earlier rulemaking. *See id.* at 20745.

In the comments that follow, CBOE respectfully submits that the proposed fee cap is unnecessary and unwarranted and would have significant adverse consequences for options exchanges and market participants.

1. The imposition of federal price controls is always a drastic measure, and CBOE respectfully submits that there is no need or justification for taking such a step with respect to options exchanges. The options markets are competitive by the Commission's own admission, and in the past the Commission has recognized that vibrant competition is a powerful reason to abstain from regulatory price intervention. Moreover, to the extent that rare circumstances arise that warrant direct price regulation by the Commission, the agency already has that opportunity

in the statutory requirement that options exchanges' fees be filed with the Commission and subject to abrogation by the agency within 60 days. The same is not true for all stock execution fees, since many stock trades occur on venues that are not registered with the Commission as securities exchanges.

2. The particular cap proposed by the Commission would extend far more broadly than the rationale offered to support it. The rationale given for the cap is to prevent some options exchanges from charging transaction fees for accessing exchanges' displayed quotations that are significantly higher than other exchanges'. When such variations in price occur, the Proposing Release suggests, the transparency and comparability of quotes in the NMS are impaired, and higher-priced exchanges might take advantage of the intermarket requirement that orders be routed to them when they offer the NBBO. These purported problems could only arise when an order is routed for execution on an exchange other than the exchange where the order was first placed. Yet, the proposed rule applies regardless of where the order was placed, and even applies to options that are only listed on a single options exchange. Similarly, the proposed rule would seemingly apply to a range of transactions, including FLEX option trades and complex order executions, that are not made against NMS displayed quotes.

3. The specific point at which the Commission has set the fee cap—$0.30 per contract—is insupportable. When the Commission adopted Regulation NMS, it made clear that it was adopting a fee that approximated the highest fees then being charged by trading centers for executions in the cash market. By contrast, the Proposing Release readily acknowledges that numerous options exchanges currently charge fees well in excess of $0.30. This change in approach by the Commission has not been explained, is improper, and would have serious adverse consequences because options exchanges, unlike stock exchanges, do not earn listing fees or substantial market data fees, have less ability to charge significant membership fees, and rely more heavily on transaction fees to recoup costs. In short, in a market where transaction fees are a far more important source of revenue and commercial vitality, the Commission inexplicably has abandoned an approach under which it set a cap at approximate current market rates, pursuing instead an aggressive, fee-cutting strategy.

For all of these reasons, and as explained below, CBOE respectfully submits that the Commission should not impose a cap of any kind on options exchange fees. Were the Commission to proceed with the cap contained in the proposal, it would sharply reduce the revenues available to CBOE and other options exchanges. That would undermine the exchanges' ability and incentive to innovate and introduce new products, which in turn would deter the introduction of popular new financial products and impede capital formation. There would be an adverse effect on competition with other markets that are not as heavily regulated or subject to a fee cap, such as futures markets (another derivatives-based market whose product can be used to hedge against risks on particular positions or strategies), the over-the-counter ("OTC") market, and overseas options markets. Finally, a substantial question about the Commission's authority to impose across-the-board price controls would be presented.[1]

I. Background: CBOE And Its Interest In This Rulemaking.

CBOE is the largest U.S. options exchange and the national leader in options product innovation. Unlike stock exchanges, CBOE does not generate substantial revenue from listing fees or market data fees. Rather, its operating revenues derive primarily from the number of contracts traded on the exchange and the amount it charges for those contracts. These "transaction fees" accounted for 73.8% of the exchange's total operating revenues in 2009.[2]

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[1] With respect to the Commission's proposed "anti-discrimination" provision, CBOE has no objection to it as stated, but respectfully requests that the Commission make clear that it will not be interpreted to prohibit volume discounts or preferred pricing, applied objectively, for certain types of customers (such as large retail brokerage firms). As evidenced by the exchange's move to a "for-profit" model, exchanges are not utilities and should be free to establish preferred pricing to certain classes of customers if they desire. CBOE believes that any restrictions on preferred pricing would also have an adverse economic impact on options exchanges and on efficiency, competition, and capital formation.

[2] *See* CBOE Holdings, Inc., Prospectus Filed Pursuant to Rule 424(b)(4), at 53 (Jun. 15, 2010). The Proposing Release defines "access fee" as "any fee, no matter what it is called, charged to any person for the execution of an incoming order against an options exchange's best bid and offer." Proposing Release, 75 Fed. Reg. at 20743 (emphases omitted). CBOE uses the term "transaction fee" in the same sense in this comment.

CBOE earns "transaction fees" through a "traditional" or "Broker Payment" model. Under this model, as described by the Commission, exchanges charge little to no fees for the execution of customer orders, but may charge fees to broker-dealers and certain other market participants who execute orders on the exchange. 75 Fed Reg. at 20743. In addition, "traditional" exchanges charge fees to market makers; these fees are pooled and made available to market makers to pay brokers in exchange for customer order flow. *See id.* at 20740-41. Finally, a "traditional" exchange (such as CBOE) may provide its market makers with opportunities to match the NBBO at another exchange before routing the order out to that exchange.

To some extent, CBOE's trading volume and the mix of market participants who trade on the exchange are determined by factors outside its control, such as price volatility in the underlying securities and national and international economic and political conditions. The primary factor over which CBOE may exercise some control is the level of transaction fees that it charges market participants as economic conditions change, based in part on its assessment of the incentives needed to attract order flow and liquidity.

As the Commission notes, CBOE's pricing model differs from the "Make or Take" model adopted more recently by some other exchanges. Under the "Make or Take" model, typically broker-dealers representing customer orders pay a "Take" fee to access displayed quotations on the exchange, and the exchange provides a portion of that "Take" fee as a rebate to market makers for providing liquidity. *See id.* at 20740-41. These two models represent different strategies for attracting order flow to the exchange—one by providing rebates to market makers as incentives to provide liquidity, the other by making it attractive for customers to submit orders to an exchange without paying "Take" fees on each transaction. Competitive pressures (such as the behavior of market makers and customers in response to pricing changes) determine the pricing model that each exchange will adopt, the types of contracts to which that pricing model will be applied, and the level of fees or rebates that will best attract order flow.

In addition to using transaction fees to provide incentives for various market participants to trade on the exchange, CBOE also relies upon the fees to recoup operating costs incurred as a result of its responsibilities as a self-regulatory organization ("SRO"), to recoup licensing costs incurred on options products that use third-party proprietary indexes as benchmarks (such as the S&P 500), and to generate returns on its investments for its own popular proprietary products.[3] Thus, the access fee cap proposed by the Commission would not only eliminate transaction fee revenues that CBOE depends upon, but would also provide a disincentive for CBOE to develop and market proprietary options products in the future, as discussed further below.

In sum, CBOE needs flexibility to adjust its fees in the face of shifting economic conditions, to compete with other exchanges for market share, and to maintain the health of its business. As shown in these comments, an arbitrary $0.30 cap on "access" or "transaction" fees would require significant changes in current industry practice, cost CBOE millions of dollars in revenue, and hamper its ability to compete with other options exchanges and futures exchanges.

II. There Is No Need Or Justification For Imposing Price Controls On Options Fees.

Government-imposed price controls are a rare and particularly intrusive form of regulatory action.[4] They conflict with the very concept of a market-based system, and with

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[3] A prominent example is the development of options contracts related to the CBOE Volatility Index ("VIX"), a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility. VIX options are increasingly popular with investors and volume continues to grow at an impressive rate.

[4] Direct federal oversight of pricing has been in disfavor among economists and regulators for more than a generation. "[T]he 'public utility' cost-based ratemaking approach," for example, "is resource-intensive, involves arbitrary judgments on appropriate costs, and creates distortive economic incentives." Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change, at § VII.D.3 (SEC Sept. 14, 2001). *See also* Stephen G. Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reforms*, 92 HARV. L. REV. 547, 565 (1979) ("insofar as one advocates price regulation . . . as a 'cure' for market failure, one must believe the market is working very badly before advocating regulation as a cure. Given the inability of regulation to reproduce the competitive market's price signals, only severe market failure would make the regulatory game worth the candle."); Richard B. Stewart, *Reconstitutive Law*, 46 MD. L. REV. 86, 88 (1986) ("the shift from federal price and entry controls in transportation, finance, and communications to reliance on competitive markets policed by antitrust law has created

[Footnote continued on next page]

Congress's and the Commission's expressed preference for relying on competition to determine prices in our national market system for securities.

As explained below, the Proposing Release has failed to marshal the evidence necessary to justify the extraordinary step of imposing price controls on the options markets. By the Commission's own acknowledgment, the options markets are competitive. There is no evidence that options exchange fees—all of which have been filed with the Commission for review—are improperly opportunistic or excessive. There is also no evidence that the reported opportunistic pricing by "outlier" trading platforms that prompted the Commission to impose price caps in the stock market exists in the options market. Moreover, significant differences exist between the options markets and equities markets that make it erroneous to assume that the cap imposed on equity fees in Regulation NMS—a rule that itself drew a dissent by two Commissioners—would be appropriate for the options markets. Rather, the cap would have significant adverse consequences.

A. The Commission Has Not Established The Existence Of Improper Opportunistic Pricing Or Market Failure In The Options Market.

It is the essence of a market-based economy that prices are determined by supply and demand and interactions in the marketplace, not by the government. Accordingly, when Congress charged the Commission with supervising the development of a "national market system" for securities, a premise of its action was that prices ordinarily would be determined by market forces. *See, e.g.*, H.R. Rep. No. 94-229, at 92 (1975) (Conf. Rep.) (stating Congress's intent that the "national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed").

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enormous benefits for consumers"); Richard J. Pierce, Jr., *Reconciling Chevron and Stare Decisis*, 85 GEO. L.J. 2225, 2232 (1997) ("Regulatory scholars have long recognized that command and control regulation is both ineffective and inefficient."); Herbert Hovenkamp, *Book Review: The Takings Clause and Improvident Regulatory Bargains*, 108 YALE L.J. 801, 827 (1999) (noting that "the many defects of cost-of-service ratemaking have been a standard if not completely uncontroversial part of the literature for well over three decades").

Consistent with this, Congress and the Commission have repeatedly stated their preference for competition, rather than regulatory intervention, to determine prices, products, and services in the securities markets. *See* S. Rep. No. 94-75, 94th Cong., 1st Sess. 8 (1975) ("The objective [in enacting the 1975 amendments to the Exchange Act] would be to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services."); Order Approving Proposed Rule Change Relating to NYSE Arca Data, Release No. 34-59039, 73 Fed. Reg. 74770, 74781 (Dec. 9, 2008) ("The Exchange Act and its legislative history strongly support the Commission's reliance on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system. Indeed, competition among multiple markets and market participants trading the same products is the hallmark of the national market system."); Regulation NMS, 70 Fed. Reg. at 37499 (observing that NMS regulation "has been remarkably successful in promoting market competition in [the] forms that are most important to investors and listed companies").

The Commission repeats that premise in the Proposing Release, stating: "[M]arket forces and the dynamics of competition should determine the level of exchange fees whenever possible." Proposing Release, 75 Fed. Reg. at 20742. And, the Release adds, "currently, the options exchanges are competitive." *Id.* at 20756.

That assessment is correct. There are more options exchanges now than ever before, with no single exchange commanding more than 35% of listed options market share, a very different picture than 10 or 20 years ago. Access to exchange quotes is also more efficient than ever. Orders are processed and executed electronically in milliseconds (also very different than 10 years ago) and markets are more open to new users than ever before.

The competition that exists among options exchanges exerts competitive pressure on the exchanges' transaction fees. Under the NMS plan for order protection in listed options ("Options Linkage Plan"), each participating options exchange is required "to establish, maintain, and enforce written policies and procedures as approved by the Commission that are reasonably designed to prevent Trade-Throughs" in each exchange's listed options contracts.[5] When more than one exchange is displaying the NBBO (which is overwhelmingly the case), brokers often assign lowest priority in their order routing tables to the exchange with the highest transaction fees. This means that if an exchange sets high fees, it risks losing business to exchanges with lower fees—the same competitive pressure used by our free markets every day to constrain price. Indeed, order routers' ability to effectively view all exchanges' displayed prices simultaneously and execute at the exchange that charges the lowest fees is *more* disciplining than the market forces that operate in many other industries. A customer in the market for a new microwave, for instance, cannot simultaneously know the price of every microwave in the market. And even if all those prices were known, transaction costs often would prevent the customer from buying at the lowest price—perhaps the cheapest microwave is on the other side of town, for example. In the options markets, by contrast, order routers can simultaneously view and execute orders at the exchange with the lowest transaction fees when more than one exchange has, or may match, the NBBO. Plus, broker-dealers, who have accepted responsibility for handling orders on behalf of customers, are monitoring displayed quotes. They are typically more sophisticated and better-informed market participants than customers in non-financial markets, and therefore are better able to make the types of decisions that will produce efficient markets and constrain prices.

A further competitive constraint on prices on the options exchanges is the competition among exchanges to attract customers and liquidity providers and increase order flow. Options exchanges compete in a "two-sided" market, that is, they provide a platform for market makers and customers to interact, and an exchange can only be successful by providing the proper

[5] Joint Industry Plan; Order Approving the National Market System Plan Relating to Options Order Protection and Locked/Crossed Markets Submitted by the Chicago Board Options Exchange, Incorporated, International Securities Exchange, LLC, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMS PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc., Release No. 34-60405, 74 Fed. Reg. 39362, 39364-65 (Aug. 6, 2009).

incentives for both types of market participants to trade on the exchange.[6] In "two-sided" markets, "pricing to one side of the market depends not only on the demand and costs that [one set of] consumers bring but also on how their participation affects participation on the other side and the profit that is extracted from that participation."[7] Therefore, the optimal price for exchange transaction fees will depend on the sensitivity of both market makers and customers to changes in price, and the effect that increased participation by one group will have on the attractiveness of the exchange for the other group.[8] For example, an exchange using "Make or Take" pricing might find it attractive to increase "Take" fees, so it can provide its market makers with higher rebates and attract more liquidity. But pushed too far, that strategy would put the exchange at a competitive disadvantage with customers who want to pay the lowest possible transaction fees—brokers who are routing customer orders would assign low routing priority to the exchange in favor of other exchanges that have lower "Take" fees or apply a "Broker Payment" model. Similarly, if "Broker Payment" exchanges overcharge market makers for order flow, liquidity would contract, as market makers posted on "Make or Take" exchanges.

Because options exchange transaction fees upset the sensitive balances of a two-sided market, regulating the fees is a much more nuanced—and potentially perilous—enterprise than regulating a "single-sided" market. Public utilities, for example, were typically local monopolists for whom the socially "optimal" price was based simply upon the cost of providing

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6 *See* Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. ECON. 645, 664-65 (Autumn 2006) ("A market is two-sided if the platform can affect the volume of transactions by charging more to one side of the market and reducing the price paid by the other side by an equal amount; in other words, the price structure matters, and platforms must design it so as to bring both sides on board.").

7 Marc Rysman, *The Economics of Two Sided Markets*, 23 J. OF ECON. PERSPECTIVES 125, 129 (Summer 2009).

8 *See* David S. Evans & Richard Schmalensee, *The Industrial Organization of Markets with Two-Sided Platforms*, 3 COMPETITION POL'Y INT'L 160 (Spring 2007) ("The optimal prices [in 'two-sided' markets] depend in a complex way on the price sensitivity of demand on both sides, the nature and intensity of the indirect network effects between the two sides, and the marginal costs that result from changing output of each side.").

a service and the demand for that service.[9] In two-sided markets, by contrast, "[e]ven if one were convinced . . . that current [transaction] fees are too high, unlike the public utility case, there is no guarantee that lowering them toward any particular target will improve welfare." Evans & Schmalensee, *supra* n.9, at 102. That is because the optimal transaction fee in a "two-sided" market is a function not merely of the costs incurred by the exchange in providing the trading platform, but also of the incentives that different fees will have on market participants' decision to choose a particular trading platform to execute orders.

Options exchanges have adopted different pricing models ("Make or Take" or "Broker Payment") based on their competitive assessment of the incentives that will best attract order flow and liquidity. If the prices charged to either side of the market under those models are altered by regulation, it will upset the model's achievement of its objective, *i.e.*, to attract liquidity and orders. The Commission's proposed fee cap would thus introduce inefficiencies into the options market by restricting the ability of exchanges to adjust their pricing models to provide optimal incentives for market makers and customers. By narrowing the choices at the exchanges' disposal, the proposal would hinder competition from achieving one of its signature benefits, *i.e.*, allowing the marketplace to determine which pricing model best serves consumer needs. As shown below, moreover, it is doubtful the public will receive a countervailing benefit in return.

In proposing the exceptional step of federal price controls, the Commission does not cite any actual evidence of market failure, but identifies the asserted ***possibility*** that exchanges will take advantage of the Trade-Through Rules and charge exorbitant fees for trades that are required to be routed to access the best displayed quote. *See* 75 Fed. Reg. at 20755. As expressed in Regulation NMS, the concern is that "[o]utlier markets might well try to take advantage of intermarket price protection by acting essentially as a toll booth between price

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[9] *See* David S. Evans & Richard Schmalensee, *The Economics of Interchange Fees and Their Regulation*, *in* INTERCHANGE FEES IN CREDIT AND DEBIT CARD INDUSTRIES 73, 94-95 (2005). Of course, as noted above (*supra* n.4), "even in these near-textbook cases, economic welfare in practice was not reliably improved by government ownership or price regulation." *Id.* at 95.

levels," *id.* at 37545, that is, "outlier" exchanges with few available shares at the best displayed price would charge exorbitant access fees, which brokers would be forced to access before seeking deeper liquidity at the next price level on another exchange. Mere speculation regarding theoretical potential abuse, however, without actual evidence of a market failure that enables exchanges to engage in improper opportunistic behavior, cannot justify government-imposed price controls. *See, e.g., Horsehead Resource Dev. Co. v. Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994) ("speculation is an inadequate replacement for the agency's duty to undertake an examination of the relevant data and reasoned analysis," and reliance on speculation is "arbitrary and capricious" under the APA); *Natural Res. Def. Council, Inc. v. EPA*, 859 F.2d 156, 210 (D.C. Cir. 1988) (where agency "offers no more than mere speculation to support its conclusion," it fails to provide "adequate grounds upon which to sustain [] agency[] action").

When the Commission adopted a similar fee cap for equities in Regulation NMS, it cited evidence of what it perceived to be anti-competitive pricing behavior. *See, e.g.*, 70 Fed. Reg. at 37545 (noting one exchange's purported practice of charging high fees selectively to competitors); *id.* at 37547 (citing evidence of locked and crossed markets in equities). No such evidence has been cited here. To the contrary, there is every indication that no such pricing strategies exist. The best bid and offer is deeper and changes frequently to reflect underlying stock prices as well as supply and demand, making options orders less likely to exhaust liquidity at the best quote and trade at the next price level. In addition, as the Commission notes, the options market is characterized by robust competition for order volume, which is fairly evenly distributed between the four largest entities that own exchanges: CBOE (29.58%), ISE (22.86%), NYSE Euronext (25.82% combined market share), and The NASDAQ OMX Group, Inc. (19.76% combined market share). Proposing Release, 75 Fed. Reg. at 20759. None of these four entities (which control over 98% of the market) could afford to charge opportunistic fees that resulted in being placed at the bottom of an order routing table and losing market share to competitors.

There also is no evidence that the smaller exchanges (BOX or BATS) engage in the improper opportunistic "toll booth" pricing behavior hypothesized in Regulation NMS and by some commentators. Speculation about dubious pricing strategies affecting less than 2% of options contracts cannot justify an across-the-board fee cap that, by the Commission's estimates, would cost the major exchanges tens of millions of dollars.

The supposition that, absent a fee cap, exchanges would engage in improper opportunistic pricing is not only lacking empirical support, it also fails as a theoretical matter, for at least two separate reasons.

First, the possibility that a competitor might engage in short-term opportunistic pricing does not warrant government intervention if, among other things, the pricing strategy does not constitute a viable business model. Opportunistic pricing strategies with no prospect of success do not merit government intervention. *Cf. Brooke Group v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 224 (1993) (liability under the Sherman Act based on predatory pricing strategy requires showing that market actor had a "reasonable prospect . . . of recouping its investment" by adopting strategy). In this case, there simply is no basis to believe an exchange would find it a successful business model to consciously charge the highest transaction fees for a small amount of liquidity to capture orders at the NBBO before they access greater liquidity at a less favorable price.

Second, the Commission has not shown that a strategy of charging high transaction fees would be so different from what occurs in other markets that extraordinary federal intervention is needed: Merchants in a free economy are always free to charge a high price in the hope that what they lose in volume they can make up through increased profit margin. The most notable difference in the securities markets appears to be that, as discussed above, customers have the ready ability to know which exchanges are charging above market rates, and avoid them for that reason. Transaction fees are transparent and readily available to the general public.

Claims made by commenters in prior rulemakings also fail to show the need for the intervention proposed here. The Commission cites in passing a letter from a commenter suggesting that "when an exchange is quoting alone at the NBBO, market participants cannot avoid the Taker fees imposed by such exchange, irrespective of how high such fees may be." Proposing Release, 75 Fed. Reg. at 20743 at n.70. The Commission does not explain, however, how this harms consumers. One purpose of rebates is to encourage market makers to quote aggressively (*see id.* at 20740); if the incentive to collect a rebate causes a market maker to adjust a quote by a penny, a consumer is better off paying the better quoted price plus the access fee than paying a quote a penny worse. An access fee cap, by placing an artificial limit on the maker rebate that "Make or Take" exchanges can offer consumers, could ultimately result in higher quotes and higher "all-in" prices.

Another commenter stated that, if one exchange provided high maker rebates, "other options exchanges would have to increase their fees and rebates in order to defend their market share." *Id.* This price battle, however, is a healthy sign of a competitive market, not a call for government intervention. Exchanges cannot simply raise "Take" fees indefinitely; at some point, market makers (and exchanges) would lose in order volume what they would gain in rebates on each individual contract. Indeed, the fact that CBOE boasts the *highest* market share of any options exchange (29.58%) demonstrates that many market makers are willing to forego maker rebates entirely—and indeed, pay for order flow—to have access to a "traditional" exchange's customer orders and trading platform. The optimal level of "Take" fees for each exchange and each type of contract should be determined in the first instance by the exchanges based on the behavior of actual market participants, not by a government regulator proposing a single, across-the-board rule.

Finally, the same commenter has suggested that "Make or Take fees have the potential to create incentives for participants to post liquidity and lock markets." *Id.* However, the Commission has put forward no evidence that pricing practices on options exchanges have led to "locked" markets in which a market maker would post liquidity on a "Make or Take" exchange in hopes of capturing a rebate rather than fill an existing order on a "traditional" exchange that would charge the market maker an access fee. *Cf.* 70 Fed. Reg. at 37547. In any event, locking a market is not necessarily evidence of a desire to game the Trade-Through Rules. Rather, it is a potential consequence of exchanges adopting different pricing models to attract liquidity: Sometimes, a market maker will prefer to post on one exchange rather than another, as explained above.

For all the foregoing reasons, the incomplete and erroneous analysis of the options markets in the Proposing Release is a wholly inadequate basis for the Commission to take the extreme step of placing federal price controls on options' exchanges principal source of revenue.

B. The Imposition of Fee Caps In Regulation NMS Does Not Justify Imposing A Cap On Options Exchange Fees, Particularly Because There Are Substantial Differences Between The Stock and Options Markets That Make A Fee Cap For Options Especially Inappropriate.

The Proposing Release suggests at points that imposing a fee cap on the options markets is the natural corollary to the 2005 decision to impose fee caps on equities exchanges in Regulation NMS. *See, e.g.*, Proposing Release, 75 Fed. Reg. at 20745 ("The Commission's proposal is based on its preliminary view that the $0.30 per-contract level is consistent with the maximum fee limit for NMS stocks under Rule 610(c)."); *id.* at 20750 (same). We respectfully submit that this is incorrect.

As an initial matter, the fee cap proposal under Regulation NMS was controversial, as the Commission acknowledged at the time: "Perhaps more than any other single issue, the proposed limitation on access fees splintered the commenters." 70 Fed. Reg. at 37502. Simply, federal price controls are extraordinary and should not be regarded as presumptively appropriate for the options markets merely because the Commission previously made the controversial decision to impose them on the equities markets.

Moreover, there are substantial differences between stock and options exchanges that make it especially inappropriate for the Commission to extend to options exchanges the $0.30 per 100 shares fee cap adopted for stocks:

1. Equities may be traded on venues that are not subject to Commission requirements for review of fees. By contrast, standardized options can only be traded on an exchange. This means that all applicable transaction fees for options are filed with the Commission, which reviews them and has the authority to abrogate them if they are improper. Put differently, if the options exchanges are charging excessive, opportunistic fees, the Commission would have had to allow fees to go into effect that are so unreasonable or discriminatory that they should have been abrogated. There is no evidence of that.

2. Options exchanges rely on transaction fee revenue to a much greater extent than stock exchanges. Unlike traditional equities exchanges, options exchanges do not generate listing fees. Also, because there is much greater demand for market data in stock markets, options exchanges

do not generate nearly the same amount of market data revenue as stock exchanges. According to its annual report, NYSE Euronext generated approximately $406 million in listing fees and $402 million in market data fees in 2009.[10] By contrast, CBOE in 2009 received no listing-related revenue and roughly $20.5 million in market data fees.[11] Accordingly, in proposing to cap transaction fees for the options exchanges, the Commission is targeting the exchanges' bottom line in a way that was not the case at all for Regulation NMS. The consequences of an improper price control will be far greater—for options exchanges, and ultimately for consumers.

3. Unlike stock exchanges, CBOE and other options exchanges expend considerable resources on research and development related to new product offerings. CBOE has an entire department of professionals dedicated to developing innovative, proprietary derivative products for market participants. An example is VIX options, which would never have been developed absent the ability to recoup costs and earn a reasonable return through transaction-based fees. Moreover, options exchanges incur large licensing costs for many products, such as SPX, an options product that uses the S&P 500 stock index as a benchmark. Stock exchanges incur such costs with far less frequency, if at all.

In short, options exchanges incur costs that equities exchanges do not, and lack revenue sources that the equities exchanges possess—meaning that a cap on options exchange fees will have a dramatically different impact than the cap imposed by Regulation NMS.

4. Unlike traditional stock exchanges, options exchanges compete directly with futures exchanges in the development and trading of new derivative products, which can be designed either as options vehicles or as futures vehicles. The proposed fee cap will not apply to futures products. Capping the fees that options exchanges can charge will place an artificial ceiling on the profitability of products developed for the options markets, thereby driving talented researchers and developers to the future markets or elsewhere, further depleting revenues for the

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10 *See* Form 10-K, NYSE Euronext – NYX, Selected Financial and Operating Data, at 42 (Mar. 1, 2010).

11 *See* CBOE Holdings, Inc., Prospectus Filed Pursuant to Rule 424(b)(4), at 63 (Jun. 15, 2010).

options exchanges and shrinking the funds available to develop new products. The proposed fee cap would thereby reduce competition that currently exists between options and futures exchanges, as well as between options and other markets, such as OTC markets.

C. A Fee Cap Would Not Put To Rest Objections To The Commission's Proposed Ban On "Flash" Trading.

Contrary to a suggestion made in the Proposing Release, capping options fees will not resolve the problems presented by the Commission's separate proposed rule to ban "flash" trading.

Flash functionality gives an exchange an opportunity to execute a trade at the NBBO when the NBBO is not displayed on that exchange—which in turn avoids an unexpected access fee from an "away exchange" for the exchange or the customer. Commenters on the Commission's proposed flash trading ban have identified the higher costs that would be incurred by customers as among the reasons flash trading should be allowed. In proposing its fee cap, the Commission asserted that if a cap is imposed this function of flash trading will be unnecessary, and the case for banning flash trading will be stronger. *See* Proposing Release, 75 Fed. Reg. at 20741 (observing that the "absence of a limit on [access] fees . . . was one reason commenters said that banning flash orders would be more detrimental to listed options customers than to cash equity customers").

The value of flash trading, however, extends well beyond avoiding the expense that customers or exchanges may incur by routing orders to other exchanges. (CBOE absorbs the costs associated with routes to and executions on away exchanges for its customers after a flash has not achieved step-up, but other exchanges may pass through those costs to customers.) Rather, flash trading provides a competitive opportunity for exchanges to match prices posted by competing exchanges and to provide customers and brokers with a *choice* of where to execute their orders. Lowering options access fees to $0.30 per contract will not alter the fact that retail brokers prefer to route orders to exchanges that charge no transaction fees and offer NBBO "step-up" opportunities. Flash trading therefore is an attractive option for broker-dealers and market makers apart from its effect on execution costs.[12]

Finally, it is worth noting that the concerns that others have expressed over flash opportunities are meritless. Only marketable orders that would otherwise be routed to another exchange pursuant to Trade-Through Rules are eligible for flash trading; it is not possible for market participants who use flash to trade ahead of resting orders on the exchange. Furthermore, submitting orders into a flash process is entirely voluntary. Nevertheless, because of the cost savings it represents to market participants who could avoid transaction fees on away exchanges, flash trading is very popular with brokers representing retail customers.[13]

* * *

In sum, the Commission cannot justify its proposed fee cap on options products merely by observing that the "proposed amendments would make the requirements for access to the listed options exchanges comparable to the requirements for access to markets that trade NMS stocks." Proposing Release, 75 Fed. Reg. at 20738. The imposition of price controls in the equities markets was itself controversial, and the proposal's "one-size-fits-all" approach ignores

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[12] In response to the Commission's question (No. 32), if flash functionality is banned, CBOE would cease absorbing the cost on behalf of customers for such routes and away executions because it would be precluded from matching the away price before the route. Customers, therefore, could pay up to $0.30 per contract for mandatory trades at the away exchange, rather than the $0.00 that they pay today when they execute on CBOE and "step up" is achieved. In response to the Commission's question (No. 23) regarding how flash functionality impacts exchanges with "Make or Take" pricing (the question implies that those exchange are unable to quote as effectively because of flash functionality), CBOE notes that the CBOE flash process was approved and in operation well before the "Make or Take" fee model was introduced into the options market. Thus, CBOE disagrees with the statement in the Proposing Release that CBOE "implemented this 'flash' functionality because of the high costs associated with routing an order to away exchanges to be executed, particularly one with a Make or Take model." Proposing Release, 75 Fed. Reg. at 20744.

[13] CBOE has commented separately on the Commission's proposed restrictions on flash trading. *See* Letter from William J. Brodsky, Chairman and Chief Executive Officer, CBOE, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Nov. 18, 2009) (available at https://www.cboe.org/publish/ComLet/20091118.pdf).

significant differences between the cash and options markets that, if the rule were implemented, would have material adverse consequences for options exchanges, competition, and ultimately, consumers.

III. Less Intrusive Alternatives Exist To Accomplish The Commission's Stated Objectives.

As noted, price controls are a drastic form of government intervention. Even supposing some form of regulatory intervention in options fees were needed—in fact, as shown above, intervention is unnecessary—the Commission's stated goal of intermarket price protection for investors could be achieved without the "one-size-fits-all" solution of an access fee cap. The following alternatives would achieve the Commission's stated objectives in a less intrusive manner that does not impose the multi-million dollar losses projected by the Proposing Release.

1. *Modify The Trade-Through Rules To Permit "Trade Throughs" If An Exchange's Fees Exceed A Certain Amount.* The Commission could permit exchanges to "trade through" the NBBO if the fees of an exchange that quotes at the NBBO exceed a certain amount, such as $0.50. This would provide exchanges with an incentive to adopt lower access fees without mandating an absolute cap. Exchanges would weigh the benefits of higher access fees against the risk that they will lose orders routed from other exchanges when they display the best quote. In addition, brokers would have more flexibility in performing their duty of best execution when confronted with an exchange that quotes at an incrementally better price but charges high access fees. In such cases, factors such as the characteristics of the listed security, the size of an order, or the speed of execution may weigh in favor of "trading through" the best quoted price. *See* Proposing Release, 75 Fed. Reg. at 20759. Modifying the Trade-Through Rules to provide brokers with more discretion to take access fees into account when executing trades on behalf of customers is also consistent with the Commission's oft-stated goal of allowing "market forces and the dynamics of competition [to] determine the level of exchange fees whenever possible." Proposing Release, 75 Fed. Reg. at 20742. This approach would be less burdensome to options exchanges than a fee cap.

2. *Modify The Trade-Through Rules To Permit "Trade Throughs" When The Exchange Displaying The NBBO Charges $0.30 Or More In Access Fees Than The Originating*

Exchange. The stated aim of the proposed rule is to create price predictability and transparency for exchanges subject to Trade-Through Rules by limiting the access fees that an exchange can charge to $0.30 or less per options contract. The Commission therefore acknowledges that some variation in access fee prices (within a $0.30 range) is acceptable and consistent with its stated goals. Accordingly, if intervention by the Commission were needed (in fact, it is not), another less intrusive approach would be for the Commission to require the options exchanges to modify the Trade-Through Rules to allow exchanges to "trade through" the NBBO if the exchange displaying the best price charges access fees that are $0.30 or higher than the fees charged by the originating exchange. By not imposing a fee cap, this approach would allow a greater role for market forces to determine access fee prices, and would save options exchanges millions of dollars that would be lost under the current proposal. At the same time, the "all-in" cost of a trade would fall within a narrower range, as intended by the proposed rule; investors can initiate a trade at an exchange whose fees they find attractive and know in advance the range of fees (within $0.30 per contract) they might be assessed if the trade is routed out.

3. *Apply The Fee Cap Only When Trades Are Routed From One Exchange To Another With A Better Displayed Quote.* As the proposed rule currently is written, it applies not only to trades routed from one exchange to another pursuant to linkage rules, but also to trades that are routed to and executed by a single exchange. Proposing Release, 75 Fed. Reg. at 20751. A primary rationale for the rule, however, is to prevent opportunistic exchanges from acting as "toll booth[s]" by charging excessive prices when linkage rules require the routing of trades to an away exchange. *Id.* at 20755. The rule therefore is overbroad and can be narrowed to fit the stated rationale. The Commission could clarify that access fees will only be capped when a trade is routed from one exchange to another pursuant to linkage rules, and *not* when the originating exchange itself executes the trade, either because it displays the NBBO or because it provides its market makers with "step up" opportunities. Indeed, this alternative is consistent with the July 2008 petition by Citadel Investment Group, LLC, requesting an access fee cap. Citadel specifically sought to exempt from any cap "fees that options exchanges may charge their members who initiate transactions on their exchange," because members can avoid fees by

"voting with their feet."[14] The same reasoning applies to any customer order initiated and executed on the same exchange.

4. *Apply The Fee Cap Only To Intermarket Sweep Orders.* The Commission could limit the proposed fee cap to the execution of orders that sweep displayed best bids or offers on one exchange in order to trade at additional price points on another exchange (*i.e.*, orders that are required to be routed to a particular destination). These orders should be subject to a minimum $0.50 cap.

5. *Only Apply the Fee Cap to Contracts Using a "Make or Take" Pricing Model.* As the Commission notes, under a "Make or Take" pricing model, options exchanges generally charge customers fees for access to the displayed quote, whereas under a "traditional" or "Broker Payment" model, exchanges typically charge customers "no or low" fees. *See* Proposing Release, 75 Fed Reg. at 20740-41. Therefore, the Commission's stated rationale of preventing exchanges from imposing unanticipated fees on customers whose orders are routed to the exchange pursuant to Trade-Through Rules applies primarily to "Make or Take" platforms. In addition, as noted above, the Commission's concerns about putative opportunistic pricing behavior mainly involved assumptions about how market makers react to the incentives provided by maker rebates. *See supra* pp. 14-15. For these reasons, Citadel's initial July 2008 petition to adopt a fee cap was specifically concerned with the access fees charged under the "Make or Take" model. *See, e.g.*, Proposing Release, 75 Fed Reg. at 20743 n.70. The Commission should therefore consider limiting any fee cap to contracts that are traded pursuant to "Make or Take" pricing.

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14 *See* Letter from John C. Nagel, Managing Director & Deputy General Counsel, Citadel Investment Group, LLC, to Nancy M. Morris, Secretary, Securities and Exchange Commission, at 7 (July 15, 2008) (available at http://www.sec.gov/rules/petitions/2008/petn4-562.pdf).

Each of these alternatives is superior to the proposed across-the-board fee cap. CBOE respectfully requests that the Commission give them careful consideration before adopting a fee cap for options access fees.

IV. No Fee Cap Should Be Applied To Orders That Do Not Access Displayed Best Bids And Offers, Or That Otherwise Are Not Subject To Routing Under The Intermarket Price Protection Rules.

If the Commission applies a cap on access fees for options products, the cap should only apply to trades whose execution ***requires*** access to the ***displayed*** best bid and offer on the exchange. The purposes underlying the Exchange Act, Regulation NMS, and the proposed rule itself all support limiting the access fee cap to transactions requiring ***intermarket*** price protection and access to the ***displayed*** quote.

When it adopted Regulation NMS, the Commission noted two different forms of competition in the national market system—competition for orders and competition among markets. *See* 70 Fed. Reg. at 37498-99 ("Vigorous competition among markets promotes more efficient and innovative trading services while integrated competition among orders promotes more efficient pricing of individual stocks for all types of orders, large and small."). Regulation NMS sought to maximize the advantages of each of these forms of competition, avoiding the extremes of a fragmented marketplace where buyers and sellers could not execute orders at the best available prices, as well as "a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets." *Id.* at 37499.

Accordingly, Regulation NMS provided that investors have access to the best bid and offer of each exchange by "mandating the display to investors of consolidated prices and including the prices displayed internally by significant electronic markets." *Id.* Regulation NMS also "establishe[d] ***intermarket*** protection against trade-throughs for all NMS stocks," where a "trade-through" was defined as "one trading center execut[ing] an order at a price that is inferior to the price of a protected quotation, often representing an investor limit order, displayed by another trading center." *Id.* at 37501 (emphasis added). The Trade-Through Rules, however, would "protect[] only quotations that are immediately accessible through automatic execution," not quoted prices from "floor-based" or "manual" markets. *Id.*

To facilitate the protections of Rule 611, the Commission determined it was necessary to place a limit on the fees that equities markets could charge for accessing the displayed best bid or offer on the stock trading center. Applying the reasoning discussed above, the Commission concluded that "the fee limitation is necessary to address 'outlier' trading centers that otherwise might charge high fees to other market participants required to access their quotations by the Order Protection Rule." *Id.* at 37545.[15]

At the same time, however, Regulation NMS recognized that in areas that did not implicate the Order Protection Rule or intermarket price protection, competitive forces, rather than government regulation, should determine prices. For example, the rule provided that exchanges could charge market prices for proprietary depth-of-book market data, because the Order Protection Rule did not require such prices to appear in the national market system's consolidated data feed. *See id.* at 37569 ("Beyond disclosure of this basic information [*i.e.*, the NBBO and national last sale price], market forces, rather than regulatory requirements, will be allowed to determine what, if any, additional data from other market centers is displayed.").

In part, the proposed options rule at issue here would appear to track the Commission's reasoning in Regulation NMS: (a) investors should have access to displayed quotations and execution at the best bid or offer, and (b) where possible, market forces should be used to promote competition among the exchanges. The Proposing Release thus states repeatedly that fees not tied to accessing the displayed quote should be determined by market forces, and not subject to an across-the-board cap. With respect to payment for order flow and "other fees for providing liquidity," for instance, the Release states that "market forces and the dynamics of competition should determine" prices. Proposing Release, 75 Fed. Reg. at 20748-49. Similarly, with respect to depth-of-book access fees, "[t]he proposed access fee limitation in Rule 610(c)(2) would apply only to quotations that market participants are required to access to comply with the

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[15] The Commission ordered options exchanges to develop their own NMS "linkage" plan that would ensure that investors could execute options transactions at the best bid or offer among listed exchanges. *See* Order Directing Options Exchanges To Submit an Inter-Market Linkage Plan Pursuant to Section 11A(a)(3)(B), Release No. 34-42029, 64 Fed. Reg. 57674 (Oct. 26, 1999).

Trade-Through Rules; it would not apply to depth of book quotations." *Id.* at 20747. The Release explains: "By proposing to apply the fee cap only to the best bid or offer of an options exchange, the limitation is designed to have ***minimal impact on competition and individual business models*** while furthering the objectives of the Exchange Act by preserving the fairness and usefulness of quotations, and by providing support for the proper functioning of the Trade-Through Rules, as discussed above." *Id.* (emphasis added).[16] These findings are consistent with the Commission's general policy that "market forces and the dynamics of competition should determine the level of exchange fees whenever possible." *Id.* at 20742.

Moreover, throughout the Proposing Release, the Commission states that the purpose of the fee cap is to ensure that investors have fair and efficient access to each exchange's displayed best bid and offer, pursuant to the Trade-Through Rules, without fear of paying excessive fees charged by the executing exchange. *See, e.g., id.* at 20738 (the "objectives [of a national market system cannot] be achieved if brokers cannot fairly and efficiently ***route orders*** to execute against the best quotations, ***wherever such quotations are displayed*** in the NMS"); *id.* at 20742 ("the Commission is concerned that because of the requirements for ***intermarket price protection***, competitive forces, by themselves, are not, and will not be, enough to prevent fees from being charged that interfere with fair and efficient access to an option exchange's displayed prices"); *id.* at 20748 ("The basis for the proposal . . . is to (1) provide for fair and efficient access to displayed quotations to support the ***integrity of the price protection requirement*** contained in the Trade-Through Rules, and (2) further the objective that quotations be fair and useful by limiting the extent to which the all-in price can vary from the ***displayed price***.") (emphases added).[17]

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[16] In response to the Commission's Questions 29 and 30, CBOE agrees with the Commission that the rationale for the proposed rule does not and should not apply to payment for order flow or depth-of-book access fees, because neither fee relates to access to the displayed best or bid or offer on an exchange.

[17] *See also id.* at 20739 ("broker-dealers responsible for routing customer orders, as well as customers making their own order-routing decisions, must have fair and efficient access to the best displayed quotations to achieve best execution of those orders, and the exchanges

[Footnote continued on next page]

And yet, despite the Commission's stated objectives and rationale, the Commission makes plain elsewhere in the Proposing Release that there are instances where the rule could sweep more broadly, encompassing numerous orders that are not routed and do not access displayed quotations, such as orders for FLEX options, non-multiply listed options, and complex orders. *See infra*, pp. 27-29. In its calculation of revenue losses that would be incurred by the exchanges as a result of the fee cap, the Commission included transactions that did not involve "access" to the displayed quotation. And, the proposed rule itself does not expressly state that the cap would apply only to transactions accessing the best "displayed" bid or offer.

By the Commission's own reasoning, market forces should be allowed to determine fees for orders that do not involve access to displayed quotes. Therefore, if a fee cap is adopted at all, the Commission should expressly state in the rule that the cap applies only to access of

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[Footnote continued from previous page]
themselves must have the ability to execute orders against the displayed quotations of other exchanges"); *id.* at 20743 ("a limit on fees for accessing quotations would support the integrity of the rules limiting trade-throughs because a fee limitation would prohibit individual exchanges from raising their fees substantially in an attempt to take improper advantage of protection against trade-throughs"); *id.* at 20744 ("The proposed fee limitation is designed to preclude individual exchanges from having fee structures that take improper advantage of the required protection against trade-throughs and undermine the overall benefits of the new private routing regime."); *id.* at 20745 ("the Commission preliminarily believes that the benefits of intermarket price protection and more efficient linkages could be compromised if options exchanges charge substantial fees for accessing their best bids and offers, and that a fee limitation is necessary to support the integrity of the price protection requirement under the Trade-Through Rules, but it requests comment on this issue"); *id.* at 20747 ("The proposed access fee limitation in Rule 610(c)(2) would apply only to quotations that market participants are required to access to comply with the Trade-Through Rules; it would not apply to depth of book quotations."); *id.* at 20755 ("The requirements under the Trade-Through Rules and the use of private linkages could provide an exchange the opportunity to take advantage of intermarket price protection by acting essentially as a toll booth between price levels."); *id.* at 20756 ("The purposes of the Trade-Through Rules would be thwarted if market participants were allowed to charge high fees that distort quoted prices in a listed option."); *id.* at 20760 ("Precluding option markets from taking improper advantage of trade-through protection and making sure that all option markets compete under the same regulatory landscape should strengthen the ability of option markets to compete fairly for business."); *id.* at 20761 ("A fee limitation is necessary to preclude individual markets from having fee structures that take improper advantage of the protection against trade-throughs in the Trade-Through Rules.").

"displayed" quotations. The Commission should also amend its proposal to address the products and orders discussed below.

A. No Fee Cap Should Apply To FLEX Options And Complex Orders.

By its terms, the proposed rule would apply to FLEX options and complex orders. Proposing Release, 75 Fed. Reg. at 20751. FLEX options and complex orders are generally individually-tailored investment vehicles that, because of their unique properties, do not have a listed quotation and do not require accessing a displayed quote. *See, e.g.*, *id.* at n.139 (FLEX options are "customized option contract[s] that provide[] the ability to customize key contract terms"). Therefore, the intermarket price protection concerns that underlie the rule do not apply to FLEX options and complex orders.

FLEX options and complex orders are not quoted through the Options Price Reporting Authority ("OPRA"), and are generally priced through competitive auctions. FLEX option orders can only trade with other FLEX option orders. Similarly, complex orders are executed at a net price and overwhelmingly trade against other complex orders (on CBOE, approximately 85% of complex orders are executed against other complex orders). In addition, neither is subject to the Trade-Through Rules or intermarket price protection. Accordingly, there is no reason why a fee cap that is justified as necessary to preserve intermarket integrity is appropriate for FLEX options and complex orders. Both are used by investors seeking to implement a specific investment strategy.[18] No market participants or exchanges are compelled to route complex orders to other markets and such routing is actually impossible for FLEX options. There is no danger, as a practical matter, of investors sending FLEX options or complex orders to an exchange and being surprised by the transaction fees associated with the execution.

In short, the rationale for the Commission's proposed rule—that investors accessing a displayed quote should be protected from opportunistic behavior by away exchanges—does not apply to FLEX options and complex orders. Therefore, in response to the Commission's

[18] Indeed, FLEX options are increasingly viewed as an OTC alternative as they do not pose systemic risks that are prevalent with OTC derivative contracts.

question (No. 18), we strongly recommend that the Commission revise its proposal to exempt fees charged for trades in FLEX options and complex orders, as well as any other fees that do not involve accessing the displayed quote.

B. No Fee Cap Should Apply To Non-Multiply Listed Options.

The Commission has stated that the rule as proposed would apply to options traded on a single exchange. *Id.* at 20751 ("As proposed, the fee limitation . . . would apply to fees charged for executions of orders in all listed options, including those that are listed and traded only on one options exchange ('non-multiply listed options')."). Once again, however, the rule's animating purpose—to constrain opportunistic behavior resulting from the intermarket price protection requirements—is not implicated when a product is traded on a single exchange: The product is only available on the exchange where the order is placed, and accordingly there is no risk that an "outlier" market will impose excessive fees in the hope of earning a windfall when it has the NBBO and the trade is routed there.

Moreover, the detrimental impact of a fee cap for non-multiply listed products will be particularly high, impairing innovation and capital formation in the options markets as a whole. Non-multiply listed products are proprietary products that entail substantial costs, including costs for research and development staff and consultants; licensing negotiations and fees; significant systems changes; and legal and regulatory costs for product-specific rule filings, Options Disclosure Document modifications, and Options Clearing Corporation rule modifications. These expenses simply do not exist when options exchanges start trading a new equity option on a stock.

The fees the CBOE (or any other exchange) can command for non-multiply listed products are directly related to the desirability of the products it develops—if a product is no more desirable than any other product available, then the fee an exchange can charge will be modest; whereas if an exchange develops an innovative and desirable product, it may charge a higher fee before investors will choose an alternative product. Fees are further constrained by potential competition from the introduction of alternative, competitor products.

The returns an exchange earns on such desirable and innovative products are simply the fruits of innovation—they are consistent with, and central to, effective competition. The incentives the returns create for exchanges—to innovate new products—deliver a benefit to consumers as well, who can purchase new financial products that would not have existed otherwise. For all these reasons, exchanges should be able to charge for these products free of a government-imposed price cap. *Cf.* 70 Fed. Reg. at 37567 (Commission, in relying on market forces to set prices for proprietary depth-of-book data in Regulation NMS, acknowledging importance of competitive incentives for exchanges to develop new products).

The Proposing Release states in passing that a cap on options fees will further "transparency" because consumers will know in advance that fees will not exceed $0.30 per contract. *See* Proposing Release, 75 Fed. Reg. at 20744 ("An access fee limit also creates more transparency in the cost of accessing quoted prices.") The costs of non-multiply listed products are already fully transparent and even easier to ascertain than for multiply-listed products, because the listing exchange's fees are publicly available (on CBOE's website, for instance). Accordingly, there is no chance that a user of one of these products will incur an unexpected fee, and the proposal's "transparency" rationale has no bearing on non-multiply listed products. In addition, under current practice sophisticated firms or broker-dealers are primarily responsible for ascertaining and paying transaction fees; therefore, transparency is typically not a primary concern of the ultimate customer. Therefore, in response to the Commission's question (No. 17), it is our strong belief that the proposed fee cap should not apply to non-multiply listed products.[19]

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[19] In question No. 17 the Commission also seeks comment on how a non-multiply listed option should be defined. CBOE submits that a non-multiply listed option should be defined as any options product whose best bid and offer are only displayed on a single options exchange. Most non-multiply listed options, however, are also proprietary products, which require investment of a significant amount of resources to develop. Because of the substantial costs associated with proprietary options products (*see infra* pp. 33-34), CBOE respectfully submits that no fee cap should apply to proprietary products, including products that are only available for trading on an options exchange pursuant to a license.

V. A Fee Cap Lower Than $0.50 Would Be Particularly Harmful To Exchanges And Difficult For The Commission To Justify.

A. A Cap Lower Than $0.50 Would Be Particularly Onerous.

For the reasons given above, no fee cap should be adopted. The fee cap that has been proposed, moreover—$0.30 per contract—is particularly unjustified and restrictive, for multiple reasons.

First, and as an initial matter, the Commission should recognize that its stated rationale for setting the cap at $0.30 is exceedingly thin. The fact that the cap for stocks was set at that amount, for example, is hardly an economically sound rationale for imposing the same cap on options—especially given that the $0.30 cap for stocks was selected in part because it approximated or exceeded prevailing rates, whereas $0.30 is substantially below many prevailing rates for options transactions. The Commission provides no factual basis or substantiation for the $0.30 figure, yet it is the Commission's burden to justify it. *See supra* p. 13. If it adopts a final rule imposing a fee cap of $0.30 per contract, the Commission will require significantly more economic justification than provided in the Proposing Release.

Second, as explained in detail at pages 16-17 above, options exchanges incur costs that are not borne by equities trading platforms, and lack other sources of revenue that are available to stock exchanges (such as listing fees and substantial market data fees). Exchange transaction fees are the most important source of revenue for options exchanges to recoup their costs and earn a reasonable return on investment; they should not be set at the same level as access fees for equities.

Third and related, options exchanges frequently charge more than $0.30 in transaction fees. For example, CBOE currently charges $0.45 per contract for electronically executed broker-dealer orders. Proposing Release, 75 Fed. Reg. at 20743; *see also id.* at 20741 (recent NYSE Arca proposed rule change to increase certain "Take" fees from $0.45 to $0.55 per contract); *id.* (NASDAQ "Take" fee of $0.45 per contract for non-customers). When it imposed a cap in Regulation NMS, the Commission purposely set the cap at a level that ***exceeded*** most equities access fees existing at the time, so as to avoid unduly interfering with revenues. *See* 70 Fed. Reg. at 37503 (noting that the fee cap "will not seriously interfere with current business practices, as trading centers have very few fees on their books of more than $0.003 per share or earn substantial revenues from such fees"). A very different approach is being taken toward options exchanges, which the Commission acknowledges will lose tens of millions of dollars in revenues. *See* Proposing Release, 75 Fed. Reg. at 20762. This apparently arbitrary change in approach is troubling, and will have grave economic consequences.

Fourth, under the Commission's reasoning, a fee cap of $0.50 per options contract or higher would still further the stated goals of promoting predictability and transparency in pricing. A $0.50 access fee would allow investors to execute their trades closer to the displayed price than the next worse price, even taking into account the "all-in" cost.[20] Exchanges, meanwhile, would not have to adjust fees drastically from current levels, and market forces could determine the prevailing fee rates between zero and fifty cents. While CBOE remains gravely concerned that any fee cap would jeopardize its ability to earn future revenues—as noted, CBOE generates nearly 75% of its operating revenues from transaction fees—a cap of at least $0.50 would reduce the impact on CBOE.

Fifth, in response to the Commission's question (No. 20), a fee cap lower than $0.50 would have a disproportionate effect on options exchanges that have not adopted a "Make or Take" fee model. As the Commission points out in the Proposing Release, a "Make or Take" exchange can, in large part, offset the effects of the cap by sliding its fees under the cap. For example, a "Make or Take" exchange that charges $0.50 per contract for orders taking liquidity and rebates $0.40 per contract for orders making liquidity collects as net revenue $0.10 per contract executed. With the fee cap, that same exchange could adjust fees to charge $0.30 for taking liquidity and rebate $0.20 for making liquidity and still collect $0.10 per contract. By contrast, a "traditional" exchange that charges transaction fees without maker rebates only stands to lose revenue if fees are capped. CBOE, for example, currently charges orders for the accounts of broker-dealers $0.45 a contract for equity option executions. The proposed fee cap would deprive CBOE of revenue of $0.15 per contract in this important customer segment. Broker-

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[20] This assumes the Commission continues to treat licensing fees and regulatory fees as components of "all-in" cost, which as we argue later, it should not (*see infra* pp. 33-34).

dealers are sophisticated, well aware of fee levels across exchanges, and have a choice in where to initially route equity options orders. They hardly need the protection of a fee cap. By contrast, retail public customers—the market participants who appear to be the primary intended beneficiaries of the proposal—routinely receive free executions on CBOE already. Yet CBOE is the exchange that is disproportionately harmed by the proposed fee cap, as reflected in the Proposing Release.

Sixth, as discussed in further detail at pages 33-34 below, CBOE currently charges regulatory fees to recoup costs incurred as a result of its responsibilities as an SRO, as well as licensing fees to recoup proprietary licensing costs associated with some of its index products, like SPX. As the Commission notes, these licensing fees can run as high as $0.22 a contract. *See* Proposing Release, 75 Fed. Reg. at 20746 n.93. A $0.30 cap would make it difficult, if not impossible, for CBOE to adequately recover regulatory and licensing costs and make a reasonable profit from its transaction fees.

Finally, CBOE notes that any cap must be periodically reexamined and increased as appropriate. That is particularly the case given the many Commission initiatives to modify market structure, such as its recommendations regarding the proposed proposals regarding consolidated audit trails and market access. These and other proposals are likely to impose considerable additional costs that CBOE and other exchanges must recoup through transaction-based fees. Simply, once it enters the business of "rate setting" with respect to options exchanges' principal source of revenue, the Commission will be compelled to routinely revisit the price cap to ensure that exchanges are able to cover their costs and earn reasonable profits.

B. Any Fee Cap Must Also Account For The Notional Value Of The Option's Underlying Assets.

Although as stated above we strongly oppose fee caps, if any cap were adopted, it should take into account the notional value of underlying assets, rather than merely the price of the options contract itself. It is not fair, reasonable, or necessary to cap fees at $0.30 for an option overlying a security trading at $3 (for a notional contract value of $3 x 100 shares, or $300) as well as for an option overlying securities trading at $1000 (for a notional contract value of $1000 x 100 shares or $100,000).

The inequity resulting from not taking notional value into account is most pronounced in scenarios where different option contracts offer higher multipliers for the same or similar underlying assets. For example, the iShares Russell 2000 Index Fund ("IWM") is an ETF that seeks to provide investment returns that closely correspond to the price and yield performance of the value of the Russell 2000 Index ("RUT") based on a 1/10 ratio. Because the notional value of 10 IWM ETF option contracts approximates 1 RUT Index option contract, the fee cap would effectively be $3.00 for IWM options ($0.30 x 10 contracts) and $0.30 for a RUT option ($0.30 x 1 contract). In other words, there would be a pricing disparity of $2.70 between comparable IWM and RUT options, adjusting for notional value. This outcome is neither equitable nor reasonable.

Accordingly, if a fee cap is imposed, options contracts offering higher "multiples" of the same or similar underlying assets must be permitted to charge proportionally more in access fees.

C. An "Access Fee" Should Exclude Fees That Are Not Related To Accessing The Displayed Quote, Such As Licensing And Regulatory Fees.

As noted above, CBOE charges "access" or "transaction" fees in order to recoup costs, attract order volume and liquidity, and to generate a return on investments for popular proprietary products. The Commission should exclude from the definition of "access fee" any fees for services that are not related to accessing the displayed quote—in particular, licensing fees and regulatory fees.

Certain index options—such as NDX—are subject to proprietary licensing fees and are brought to market only after considerable research and development expense. These additional costs are generally recouped through transaction-based licensing or royalty fees that range as high as $0.22 per NDX option contract. The Commission proposes, however, to include licensing fees in its "all-in" $0.30 fee cap. Proposing Release, 75 Fed. Reg. at 20745-46. The effect of this would be that an exchange could only charge $0.08 per NDX option contract after licensing fees (or even less if other transaction-based fees are included, such as regulatory fees). That is insupportable. Options subject to proprietary licensing fees indisputably involve costs that other options do not—exchanges must be able to recoup those costs. If they cannot, indexed products will be at a distinct disadvantage relative to other options products, and relative to comparable futures products that are subject to no fee cap at all. Innovation and capital formation would be stifled. In addition, licensing fees are less prevalent in the stock market; therefore, the treatment of such fees presents a new issue that was not considered in the equities context in Regulation NMS.

The rule should also exempt regulatory fees imposed on national securities exchanges, such as the transaction fees set forth in Section 31 of the Exchange Act, and regulatory fees charged by SROs to recoup regulatory costs (such as CBOE's Options Regulatory Fee ("ORF")). This is especially necessary if the Commission adopts its proposed consolidated audit trail. The audit trail would impose substantial additional costs on SROs, including options exchanges, and the Commission's proposed fee cap would it make it difficult for exchanges to recoup these costs.

Alternatively, if the Commission does not exempt these fees from its proposed "all-in" transaction fee cap, it will be all the more important for the Commission to set any cap higher than $0.50, and to vary the cap based on the notional value of the option's underlying assets, so that exchanges may cover the costs these fees represent.

VI. The Cap Would Have Significant Adverse Economic Effects On Options Exchanges And On Efficiency, Competition, And Capital Formation.

As the Commission notes (Proposing Release, 75 Fed. Reg. at 20758-59), the Exchange Act requires the Commission to consider the effect of a proposed rule on efficiency, competition, and capital formation, 15 U.S.C. § 78c(f), and prohibits adopting a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act, *id.* § 78w(a)(2). These are not pro forma requirements. Rather, the Commission has a "statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure." *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) (describing identical language in the Investment Company Act of 1940).

CBOE respectfully submits that the proposed fee cap will adversely affect efficiency, competition, and capital formation for the following reasons:

1. *The Proposed Rule Would Impede Capital Formation Through Its Substantial Negative Economic Impact On Options Exchanges.* The Commission's proposed fee cap would have an adverse economic impact on options exchanges. The Commission estimates that CBOE alone would lose $23.9 million in annual revenue from the proposed $0.30 cap. Although CBOE is not aware of how the Commission specifically arrived at this number, CBOE agrees that the proposed cap would have a significant adverse impact on its revenue. For example, if the cap were to apply only to orders that access CBOE's displayed quotes, including quotes for non-multiply listed products, CBOE estimates the revenue loss at approximately $14.2 million annually. The Commission does not explain how it is justified in imposing these economic losses on options exchanges, especially when the fee cap adopted in the equities market purportedly sought to avoid causing the stock exchanges economic harm.

The Commission errs in speculating that the exchanges could simply recoup their losses by raising other fees. *See, e.g.* Proposing Release, 75 Fed. Reg. at 20758 ("exchanges are likely to amend their fees that would not be impacted by the access fee limitation to make up for the reduction in access fee revenue, thus keeping the overall level of fees paid by members, and the amount of revenue received by the exchange, relatively constant"). Currently, access (or "transaction") fees constitute 73.8% of CBOE's total annual revenue, which in 2009 was $314,506,000. CBOE's second-highest source of revenue in 2009 was member dues and fees assessed to temporary members for the right to trade at CBOE, totaling $45,084,000. CBOE's third highest source of revenue, non-transaction exchange fees such as floor rental fees, totaled approximately $22,647,000 in 2009; its fourth-highest source of revenue, market data fees, totaled $20,506,000.[21]

If the proposed access fee cap were adopted, CBOE would need to recoup the $23.9 million in lost annual access fees estimated by the Commission, or roughly half of its second-highest source of income or all of its third- or fourth-highest sources of income. The Commission cites no evidence that CBOE could increase other fees by that amount, and it is not

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[21] *See* CBOE Holdings, Inc., Prospectus Filed Pursuant to Rule 424(b)(4), at F-3 (Jun. 15, 2010).

reasonable to speculate that it could. Exchanges, like any businesses, cannot increase fees indiscriminately. Like any rational business, CBOE (and, presumably, other options exchanges) currently charges what it believes to be the profit-maximizing price for each of its products and services. The Commission's notion that CBOE and other options exchanges are leaving tens of millions of dollars on the table that they could capture simply by raising prices for various products and services makes no economic sense and is supported by no evidence. It conflicts with the elementary principle that if a business is currently charging the profit-maximizing price for its products or services (as one must assume to be the case), an increase in price would not result in an increase in revenues.

That is particularly true when a business's different products or services are sold to different customers with different needs and preferences and with different competitive options in different market segments. For example, if the government were to impose a restriction on the price that department stores could charge for electronics, it would be erroneous to assume that the department store could simply recoup those lost revenues by increasing the price of clothing. Those two sets of products are likely to attract different customers, and even if the same customers were in the market for both, they might choose to purchase electronics from one store and clothing from another store with lower prices.

The same holds true here. If CBOE significantly raised membership fees, users might choose to transact elsewhere and route their orders to CBOE only when necessary through another participant. If CBOE raised membership fees again to make up for lost users, the cycle would repeat. Similarly, if CBOE responded to the access fee cap by increasing the rates it charged for floor space or for market data, some market participants would simply forgo those services. Other market participants, such as broker-dealers, who may require floor access or market data to do business, could decide to trade on another options exchange with lower prices or to obtain market data from a third party. Market participants would not expect (or tolerate) access fees that are "hidden" elsewhere in an exchange's fee structure.

2. *The Proposed Rule Would Impede Capital Formation By Reducing Incentives For Exchanges To Innovate To Create New Options Products.* The ability to set exchange fees at competitive rates provides CBOE and other exchanges "operating leverage," *i.e.*, the ability to

profit based on the volume in transactions of a particular product. CBOE invests millions of dollars annually to research and develop new products, in addition to licensing, operational, and related regulatory costs and marketing efforts. (Not every product developed by an options exchange is successful; an exchange makes research and development expenditures on many potential products to produce the occasional highly-successful new offering.) Consumers value these products—which, among other things, help retail investors and other market participants hedge their risk, and benefit consumers when exchanges compete with each other to develop innovative products. To dampen the exchanges' incentive to invest and innovate by placing arbitrary caps on the price an exchange can command for its proprietary products would reduce an important form of competition among exchanges, and ultimately harm investors and the marketplace as a whole. Reduced incentives to create proprietary options products could also eliminate job opportunities for researchers and consultants who develop such products. The Commission's proposed rule creates disincentives for popular and useful products to be created. This threatens to make the market for options products less robust and competitive, and ultimately to impede capital formation.

3. *The Proposed Rule Could Impede Transparent Pricing If Exchanges Shifted Access Fees Elsewhere Within Their Fee Structure.* As noted above, CBOE cannot recoup lost access fees by simply increasing fees elsewhere within its pricing model. However, to the extent that exchanges *did* respond to the options fee cap by adjusting other fees upward, it would undermine one of the justifications given for the fee cap, *i.e.*, increasing transparency in fees for investors accessing a displayed quote that purports to be the national best bid or offer. Nothing has been gained if what was a transaction fee is now embedded in some other charge, such as higher member fees.

Generally, to the extent the Commission is correct that the proposed rule would not affect the total fees paid to options exchanges, then the proposal is inefficient and pointless: exchanges would incur new compliance costs, such as rule filings, but market participants would experience no reduction in total fees paid, and the bid/ask spread on options would likely widen if exchanges had less flexibility in setting the level of transaction fees.

4. *The Proposed Rule Would Impede Competition By Providing Futures Exchanges With An Additional Competitive Advantage Over Options Exchanges.* As explained at page 17 above, many derivatives can be developed as either an options product or a futures product. Both vehicles, moreover, may be used to hedge against risk on particular positions and strategies. Therefore, there is competition between options and futures that does not exist to the same extent between the equities market and other markets.

The lack of regulatory harmonization between the futures and options markets has put options markets at a competitive disadvantage for years. This disadvantage will be magnified by the proposed fee cap. Going forward, developers of derivatives products will be incentivized to structure these products as futures, since the absence of a fee cap will mean that potential revenues for futures are unlimited, whereas revenues from options will be subject to a federally-ordained limit.[22] The Commission should not adopt a fee cap that creates such a disparity in the fee structures of two competitor markets in like products.[23]

VII. The Commission Lacks The Statutory Authority To Impose The Proposed Price Controls.

Finally, CBOE respectfully submits that the Commission has not provided sufficient evidence to demonstrate that it has the statutory authority to make this rule amendment under Exchange Act Section 11A or any other section of the Act cited in the proposed rule. Proposing

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[22] For example, CBOE lists and trades options based on the Dow Jones Industrial Average. The Chicago Mercantile Exchange ("CME"), a futures and options exchange, recently purchased the Dow Jones indexes. Therefore, CBOE already has to pay proprietary licensing fees to CME for the right to use those indexes. If the Commission adopts its proposal, CBOE would be placed at a further competitive disadvantage, because its fees would be capped while the fees of its competitor, CME, would not.

[23] The proposed rule would also, in effect, abrogate all access fees filed by options exchanges that exceed \$0.30 and are charged against an investor that accesses the best bid or offer of a listed options exchange. The rule would therefore require exchanges to prepare and file modified rules proposing fees that are consistent with the new cap. For this reason, and for other reasons identified above, the proposal would impose unjustified costs and inefficiencies on options exchanges and the options market.

Release, 75 Fed. Reg. at 20762. In particular, the Commission has not demonstrated that it has the authority to impose "across-the-board" price controls on access fees, nor that it has the authority to cap fees that do not require access to the displayed NBBO and therefore are not necessary to the efficient functioning of a national market system.

First, as described above, Congress's intent in enacting the 1975 Amendments to the Exchange Act was to enable competition—rather than government fiat—to determine prices. The principal purpose of the amendments was to facilitate the creation of a national market system for the trading of securities. Congress intended that this "national market system evolve through the interplay of *competitive forces* as unnecessary regulatory restrictions are removed." See H.R. Rep. No. 94-229, at 92 (1975) (Conf. Rep.) (emphasis added). Other provisions of the Act confirm that intent. For example, the Act provides that an exchange must design its rules "to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest." 15 U.S.C. § 78f(b)(5). Likewise, the Act grants the Commission authority to amend or repeal "[t]he rules of [an] exchange [that] impose any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter." 15 U.S.C. § 78f(8).

In short, the promotion of free and open competition was a core congressional objective in creating the national market system. *See also* 15 U.S.C. § 78k-1(a)(1)(C)(ii) (purposes of Exchange Act include to promote "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets"); Order, 73 Fed. Reg. at 74781 ("The Exchange Act and its legislative history strongly support the Commission's reliance on competition, whenever possible, in meeting its regulatory responsibilities for overseeing the SROs and the national market system."). As discussed above, the Commission has historically interpreted that mandate to promote competitive forces to determine prices whenever compatible with a national market system. *See supra* pp. 23-25.

The Commission's proposal conflicts with the purposes of the Exchange Act and departs from Commission precedent to the extent that it purports to cap fees for transactions that do not implicate intermarket price protection or access the displayed quote, such as trades for non-multiply listed options, FLEX options, and complex orders.

Second, across-the-board price controls are inconsistent with Section 19(b)(3)(A) of the Exchange Act, which provides that ". . . a proposed rule change may take effect upon filing with the Commission if designated by the self-regulatory organization as . . . (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization." 15 U.S.C. § 78s(b)(3)(A). This section of the Act plainly contemplates that *exchanges*, rather than the Commission, will make an initial determination as to the price of a particular product or service, and that the price will take effect immediately upon filing. To be sure, the Act also provides that the Commission may abrogate such rules within 60 days if it determines that abrogation is in the public interest. *Id.* §§ 78s(b)(3)(C). But that is a limited, reactive authority that provides the Commission with a short amount of time to investigate particular cases of abuse and to abrogate anti-competitive rules. In most cases the Commission takes no action within 60 days, and the fee takes permanent effect.[24]

The proposed fee cap disrupts this statutory balance by making an *across-the-board* determination that *all* access fees charged by *all* exchanges for *all* products be subject to a $0.30 cap. That squarely conflicts with the immediate filing/abrogation process chosen by Congress, which created a system whereby *market forces* determine access fees in the vast majority of cases, subject to oversight only in particular cases of abuse or market failure.

Third, as both the Commission and academic commentators have noted, price controls are an extraordinary, disfavored form of government regulation. *See supra* n.4. For that reason, numerous federal agencies have abandoned price-setting in favor of more market-based approaches to reviewing fees for reasonableness—even in such traditionally heavily regulated industries as energy and telecommunications.[25] Indeed, in a related context, a blue-ribbon

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[24] The Commission has adopted a policy restricting this statutory authorization to fees assessed on SRO members. 17 C.F.R. § 240.19b-4(f)(2). The statute contains no such limitation, however, and CBOE respectfully submits that, with regard to this proposal, the Commission reads the Exchange Act too narrowly.

[25] *See, e.g.*, *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993) (upholding FERC's approval of market-based price for natural gas, and finding that "when there is a competitive market, the FERC may rely upon market-based prices in lieu of cost-of-service

[Footnote continued on next page]

advisory committee appointed by the Commission to review exchanges' market data fees rejected a cost-based approach because it too closely resembled "ratemaking." Blueprint for Responsible Change, at § VII.D.3 (noting that "the Commission's proposed flexible cost-based approach essentially is a 'ratemaking' approach, . . . is unwise and, ultimately, would prove unworkable"). And as noted, the Commission likewise concluded when it approved NYSE Arca's depth-of-book product that it was reasonable for the Commission to rely on market prices when there existed robust competitive forces in the relevant market. *See supra* p. 9. The Commission should adopt a similar approach to options access fees—reviewing individual rates for reasonableness rather than adopt an across-the-board cap, and then only abrogating fees in cases of demonstrated market failure.

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regulation to assure a 'just and reasonable' result"); Open Video Systems, 61 Fed. Reg. 28698, 28701 (Jun. 5, 1996) (FCC review of rates for video programming services would be presumed "just and reasonable" as long as the programming provider did not exercise a monopoly over channel capacity and its rates were comparable to that of unaffiliated providers).

Conclusion

For all the foregoing reasons, the Chicago Board Options Exchange respectfully submits that the Commission should not proceed with its proposal to impose a cap on options exchange access fees. A cap is unnecessary and would impose significant costs on options exchanges to the detriment of consumers and efficiency, competition, and capital formation. If any regulatory action in this area were needed, there would be numerous superior alternatives means of accomplishing the Commission's stated objective. We would be pleased to discuss our views further. Please contact the undersigned if you have any questions as a result of this comment letter.

Respectfully submitted,

William J. Brodsky, /ssd

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Robert W. Cook, Division of Trading and Markets
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