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December 3, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

RE: Supplemental CBOE Comments on File No. S7-21-09; Release No. 34–62445

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") submits this letter to supplement two previous comment letters submitted by CBOE regarding the proposal ("Proposal") by the Securities and Exchange Commission ("Commission" or "SEC") to amend Rule 602 of Regulation NMS under the Securities Exchange Act of 1934 ("Exchange Act") to eliminate the use of "flash orders" by equity and options exchanges.[1] CBOE strongly opposes the Proposal, particularly with respect to its application to listed options. The purpose of this letter is to respond to contentions made by other commenters and to express additional concerns with the proposed rulemaking.

While the mechanics of flash trading have been misunderstood and mischaracterized by many commenters and observers, we will refrain from explaining yet again how step-up processes actually work.[2] We will reiterate, however, that the purpose of CBOE's step-up process is to allow CBOE to match prices available on other exchanges in order to avoid sending business to our competitors. We only flash marketable orders that are received when we are not the national best bid/offer ("NBBO"). Because CBOE's quotes overwhelmingly comprise the NBBO, we flash only approximately 1% of marketable contracts received by the Exchange.[3]

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[1] The Proposal originally was published on September 18, 2009. See Exchange Act Release No. 60684 (Sept. 18, 2009), 74 FR 48632 (Sept. 23, 2009) ("Proposing Release"). The Commission determined to reopen the comment period on the Proposal on July 2, 2010. See Exchange Act Release No. 62445 (Jul. 2, 2010), 75 FR 39626 (Jul. 9, 2010) ("Reopening Release").

[2] For an explanation of CBOE's flash process, see CBOE's first comment letter from William J. Brodsky, Chairman and Chief Executive Officer, CBOE, to Ms. Elizabeth M. Murphy, Secretary, Commission, submitted on Nov. 18, 2009 (http://www.sec.gov/comments/s7-21-09/s72109-75.pdf).

[3] For additional comprehensive statistics regarding CBOE's flash process, see CBOE's second comment letter from William J. Brodsky, Chairman and Chief Executive Officer, CBOE, to Ms.

CBOE's electronic step-up process has been in place since *early 2006*. Self-serving criticisms of flash processes surfaced over three years later. Without offering any evidence of harm, these critics posture that step-up processes are suddenly ruining our national market system. Meanwhile, CBOE has repeatedly offered ample data evidencing the benefits that accrue to retail customers as a result of our step-up program.

Response to Recent Criticisms of Flash

Some exchanges, like CBOE, provide free executions for public customer orders and offer step-up in relatively rare cases when a marketable order is received while the NBBO is posted on other markets and not CBOE. Some exchanges take a different approach and structure their pricing around providing high rebates to liquidity providers which are paid for by charging even higher transaction or "taker" fees to those that remove liquidity. The liquidity providers in these situations are typically professional market makers or high-frequency traders that fall into the "customer" range, while the liquidity removers are often retail customers.

CBOE's view is that competing market models are healthy for the industry and that all customers benefit when they have choices regarding how to route orders. In that regard, CBOE vigorously competes for business by constantly evaluating, refining and enhancing our order handling processes and pricing. However, exchanges supporting a flash ban have, instead of focusing on competition, opted to pursue a regulatory intervention that is favorable to their market models. Importantly, the justifications offered by these exchanges are completely unsupported by data and are highly hypocritical when examined in conjunction with comments offered by these same exchanges in response to other Commission rulemakings.

Little or no data has been provided by exchanges opposing flash trading to substantiate their claims that their own disseminated quotations are somehow degraded because competing exchanges offer step-up, that long-term investors are harmed by step-up processes, or that the options market is less competitive because of step-up processes. To the contrary, these same exchanges have very vocally expressed (in response to the Commission's proposal to cap transaction fees for listed options) that "competition is working" in the options market and that the "U.S. options marketplace is a model for global markets." Importantly, when commenting on the *fee cap proposal*, these exchanges have decried that the rulemaking record contains insufficient evidence or analysis to support the proposed rulemaking. In other words, complete data supporting a rulemaking is vital to proceeding with the rulemaking. We agree. However, unlike opponents of flash trading, we believe every Commission rulemaking should be supported by empirical evidence. Interestingly, the Proposal actually provides data highlighting the cost *savings* to customers who route orders to exchanges offering step-up. Yet, little to no data has been provided in support of a flash ban, only unsubstantiated rhetoric.

For example, NYSE Euronext ("NYSE") recently submitted a letter claiming that "allowing flash order mechanisms to continue in the listed options market will harm investors...". Yet, NYSE offered no proof illustrating or quantifying how investors are actually harmed. NYSE also postures that "continuation of flash mechanisms will move the U.S. markets

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Elizabeth M. Murphy, Secretary, Commission, submitted on August 9, 2010 (http://www.sec.gov/comments/s7-21-09/s72109-140.pdf).

away from a robust price discovery structure towards a more fragmented, European-style market characterized by off-exchange negotiation." That is a provocative claim, but it is not backed by any semblance of evidence. The fact that CBOE's step-up mechanism has been in place since 2006 and continues to be used only with respect to 1% of the total contracts received by CBOE in multiply listed options proves that NYSE's claim is false. Also, exchanges supporting a flash order ban continue to assert that such a ban should apply equally in the equity and options markets without any real explanation as to why this should be the case. As we have indicated in our previous letters, there are critical distinctions between the options and equity markets that make a flash order ban particularly unsupportable for the options markets. A primary difference is the fact that dozens or even hundreds of series exist for each options class, many of which have little trading volume. The ability of an options exchange to provide valuable liquidity for many of these lesser-traded series depends upon the ability of its market makers to be able to step up to match an away market when they might not be quoting at the best price at a given point in time in a particular series. We have also noted the significant cost savings to options customers as a result of our step-up feature and its popularity with option retail brokers.

CBOE has provided data quantifying the cost savings afforded by flash processes to customers as well as plentiful (albeit less relevant)[4] data highlighting the quality of CBOE's markets. We note that the recent NYSE letter did contain quoting data purporting to contradict statistics submitted by CBOE. More specifically, CBOE previously provided statistics related to the percent of time CBOE and NYSE Arca disseminate quotes at the NBBO. NYSE's letter claims that the CBOE statistics are "inaccurate" and "fundamentally flawed". NYSE suggests that the discrepancy may be a result of NYSE using data that "does not include quotes that have been mitigated in accordance with industry-wide efforts to minimize the bandwidth consumed by quotes in inactive series."

First, we do not know what that statement means. For CBOE, quote mitigation involves ceasing to disseminate quotes for certain products under certain circumstances. If a series is not quoted, we did not (and could not) count it in our calculations. If a series is quoted (and thereby accessible to customers), we count it. Thus, we do not see how quote mitigation could factor into the discrepancy between CBOE's data and Arca's data. Second, we stand by the data we provided to the SEC. While we are not certain as to why CBOE and NYSE calculated such different statistics, we can make clear that our statistics were compiled using data provided to the exchanges by the Options Price Reporting Authority ("OPRA"). We used the OPRA data to measure every exchange's quotes, *including CBOE's*. We do not know what data NYSE used to calculate its statistics, but we find it curious that NYSE calculated Arca as an impressive 10 percentage points better than *every* other options exchange (including other maker-taker exchanges) when measuring percent of time alone at the NBBO (our data showed CBOE and Arca each alone on the NBBO less than 1% of the time).

Of course, if, somehow, NYSE's data is actually correct, it only highlights that the competitiveness of its quotes are not at all adversely affected by the fact that CBOE employs a

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[4] We say "less relevant" because a flash order ban should be predicated on actual harm to investors caused by the use of flash orders as opposed to whether particular market models encourage certain quoting behavior under certain circumstances.

step-up mechanism. To that end, we want to stress that the statistics provided by NYSE (which we dispute) as well as statistics recently provided by one non-exchange commenter critical of flash trading only illustrate why those commenters believe that maker-taker exchanges provide better incentives to turn the market sooner in certain option series. *They do not, in any way, substantiate the notion that flash trading is harmful to customers or that it adversely affects the quotations offered at maker-taker exchanges.* Thus, while these comments are academically interesting and they may explain why certain users with certain business models might want to trade more on maker taker exchanges, they do not in any way explain or justify why step-up should be banned. We strongly believe that the viewpoint that traditional and maker-taker market models cannot coexist and offer different benefits to different users is false.

The Reopening release contemplates two general forms of quoting- "aggressive" and "matching." The release asserts that aggressive quotations are price leaders that help narrow the NBBO spread while matching quotations follow prices set elsewhere and only add size to the NBBO. The discussion on aggressive and matching quotations implies that market-making firms (and perhaps even exchanges) must fall into only one of these two buckets. CBOE disagrees with that notion.

As the Commission is aware, exchanges seek to attract quotes and orders that will result in trades so the exchanges may charge transaction fees for those trades (the overwhelming primary source of revenue for options exchanges is transaction fees). It is no mystery that market makers and other professional trading firms trade to make a profit. In connection with posting bids and offers, market makers calculate a theoretical price for an option. The theoretical price calculation is formulaic. Market makers generate quotes based on the theoretical price by posting quotes outside of this price to capture a bid-ask spread. The quotes reflect several economic factors including fees and/or rebates associated with trades resulting from those quotes. Those factors may cause a market maker to improve its quoted price on one exchange sooner than on another exchange. This does not mean that the market maker is either an aggressive market maker or a matching market maker. It just means that economic factors cause its quotes to be different in certain products and on certain venues under certain conditions.

We offer the following basic example: Market Maker A calculates a 1.0500 theoretical value for a very liquid option. This market maker quotes on numerous options exchanges including CBOE, Arca, and Phlx. Generally, Market Maker A's bid is .02 lower than the calculated theoretical price, and typically its quotation size is larger on CBOE and Phlx than on Arca (reflecting differences in matching algorithms). However, as the theoretical price moves upwards to 1.0535, Market-Maker A's bid on Arca adjusts from 1.03 to 1.04. That same market maker will not adjust its Phlx quote and CBOE quote to 1.04 until the theoretical price moves slightly higher. The earlier adjustment on Arca primarily reflects the substantial subsidy provided by Arca via rebate for providing liquidity. Simple economics determine pricing changes on each venue. One thing is obvious: the economics causing Market Maker A to improve first on Arca are not adversely affected by the fact that CBOE offers step-up. If they were, then Market Maker A would not improve on Arca. No maker-taker exchange has demonstrated that flash trading on "away" exchanges creates a disincentive to liquidity providers to post competitive quotes on maker taker exchanges. Yet, proponents of a flash ban claim that Market Maker A's quote on Arca is disadvantaged because a customer chose to route an order to

CBOE where executions are free- a decision also based on economic factors. Shouldn't all market participants be able to make routing and quoting decisions based on economic factors?

As highlighted, exchanges offer different matching algorithms (including price based or size based) that are each more advantageous or popular with certain users versus other users. CBOE has provided data demonstrating that the size of its disseminated quotations are considerably larger that those posted by Arca. Larger quotes are clearly more beneficial to investors than smaller quotation sizes. However, unlike what some of our competitors have done when they comment negatively about our step-up process, we would not suggest that Arca's matching rules should be banned since CBOE's NBBO quotes are larger than Arca's NBBO quotes. It would be inappropriate for commenters to suggest that one matching structure should be banned because not everyone likes it. The same is true with regard to step-up. No commenter has demonstrated that step-up prevents quoters from posting competitive prices. Instead, only theoretical suppositions about hypothetical disincentives caused by flash trading have been offered. That is not a sufficient basis to proceed with the subject rulemaking.

Concerns with the Rulemaking

In approving the C2 Options Exchange, Incorporated application for registration as a national securities exchange, the Commission stated that "...investors should benefit as markets compete on service, price, and execution." In that same approving release, the Commission also noted that "the Act does not mandate a particular market model for exchanges..."[5] Yet, by proposing to ban an exchange's ability to match a price offered by a competing exchange, the Commission is effectively endorsing the displayed price (regardless of size) as the only factor on which exchanges should compete thereby mandating that exchanges gravitate to a particular market model. We are confused by these conflicting messages.

While only a modest percentage of contracts routed to CBOE get flashed for step-up processing (which is voluntary),[6] our step-up program is an important aspect of our overall options offering. On a larger scale, the Proposal conflicts with a most basic tenet of commerce. CBOE believes that the ability to match a competing price is such a fundamental component of a competitive, efficient, free, and open market, that serious questions are presented regarding the Proposal's validity and standing, if approved.

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, Section 23 or any other section of the Act cited in the Proposal.[7] In particular, in denying one exchange the ability to match the price offered by another exchange, the Commission is limiting competition in a manner contrary to decades of precedent and in

[5] See Exchange Act Release No. 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009).

[6] Indeed, as we have stated many times, routing to CBOE is voluntary.

[7] See Proposing Release at 48645.

contravention of Sections 3(f) and 23 of the Exchange Act and Congress' intent in creating the national market system.

The Act states that the Commission, in promulgating rules and regulations,

> "shall consider among other matters the impact any such rule or regulation would have on competition. The Commission and the Secretary of the Treasury shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of (the Act)."[8]

The Act further clarifies that "[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure...fair competition...among exchange markets."[9] Indeed, Congress' intent in enacting the 1975 Amendments to the Exchange Act was to enable competition. 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."[10]

By preventing one exchange from matching the prices offered by another exchange, the Commission is hindering competition in direct contravention of Congress' statutory mandate to encourage competition.

Additionally, CBOE respectfully submits that the actual rule language offered by the Commission to achieve a flash order ban is fraught with ambiguities and considerably flawed. The Proposal contemplates the existence of a "flash order exception" to Rule 602 of Regulation NMS (the "Quote Rule"). The relevant portion of Rule 602 reads as follows:

> "**Rule 602(a)(1)(i)** Each national securities exchange shall at all times such exchange is open for trading, collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any national securities exchange by any responsible broker or dealer, but shall not include:
>
> > (A) Any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication; and
> >
> > (B) Any bid or offer communicated during a period when trading in that security has been suspended or halted, or prior to the commencement of trading in that security on any trading day, on that exchange."

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[8] 15 U.S.C. Section 78w(a)(2).

[9] 15 U.S.C. Section 78k-1(a)(1)(C).

[10] <u>See</u> H.R. Rep. No. 94-229, at 92 (1975) (Conf. Rep.) (emphasis added).

To achieve a flash trading ban, the Commission is proposing to delete paragraph (A) above from Rule 602. While we fail to see what that paragraph has to do with step-up processes which involve the flashing of orders that exchanges are prohibited from displaying due to the terms of the SEC-mandated Linkage Plan, we completely fail to see how the entire Rule comports with trading as it occurs in today's marketplace. Moreover, we question how numerous orders that are not displayed (*e.g.* reserve orders and orders awaiting the execution of a related linkage order routed to another market) as well as price improvement auctions that involve undisplayed orders and responses, would be compliant with the Rule. The language in the Rule is so vague that compliance will be difficult to ascertain. CBOE believes these serious ambiguities call into question the validity of the Proposal.

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CBOE continues to strongly believe that the Commission should not go forward with the Proposal with respect to the listed options markets. As explained by CBOE, eliminating the step-up process in the options market will be harmful to the markets and to investors, and no evidence has been put forth to sufficiently support proceeding with the rulemaking.

We appreciate the opportunity to comment on the Proposal. Please contact the undersigned at (312) 786-7001, Joanne Moffic-Silver, General Counsel & Corporate Secretary, at (312) 786-7462 or Angelo Evangelou, Assistant General Counsel, at (312) 786-7464 if you would like to discuss our views further.

Sincerely,

William J Brodsky

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
James A. Brigagliano, Division of Trading and Markets
Heather Seidel, Division of Trading and Markets
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