CBOE C2℠

April 20, 2011

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

Re: Response to Comments on SR-C2-2011-008

Dear Ms. Murphy:

On February 28, 2011, C2 Options Exchange, Incorporated ("Exchange" or "C2") filed with the Commission a proposed rule change that would allow C2 to list and trade p.m.-settled S&P 500 index options on a pilot basis. The filing was noticed for comment on March 2, 2011, and the comment period closed on March 29, 2011. Three comments were submitted regarding the proposal. This letter responds to the March 18, 2011 comment from Randall Mayne and the March 29, 2011 comment letter from the International Securities Exchange, LLC ("ISE"). As we make clear below, none of the issued raised provide any justification for delaying the pilot.

Randall Mayne

In his comment submission, Mr. Mayne, while not objecting to the proposal or suggesting that it not be approved, recommends that the Commission revisit the history of the transition twenty-plus years ago of many index option products to an a.m. settlement convention. The crux of Mr. Mayne's comment is that in the mid/late 1980s, index option traders (he focuses on S&P 100 index options) submitted large same-sided market-on-close trading interest on expiration dates in the individual stocks underlying the S&P 100, and that this large influx of closing orders caused NYSE specialists to close the stocks at temporarily dislocated prices.

In the filing, the Exchange does discuss why we believe that the historical "concerns" with p.m. settlement are not applicable in today's trading environment. Moreover, a March 24, 2011 comment letter from IMC Chicago, LLC supplies an industry participant's perspective on why p.m. settlement concerns from over twenty years ago are no longer relevant. We are pleased to provide additional thoughts on p.m. settlement to supplement what was covered in the filing.

As an initial matter, we note that since its inception in 1983, S&P 100 index options (OEX) trade with a p.m. settlement convention. That is, OEX never converted to a.m. settlement. While OEX volume is not what it once was, we do not believe that its continued use of p.m. settlement has created any undue volatility concerns in the stocks underlying the index. Thus, to the extent Mr. Mayne's comments pertain to OEX trading, we agree that the "abatement of the negative press" is an indication that what was once perceived as a problem is certainly not a problem today. However, he seems to attribute the diminished press scrutiny on the matter to a transition to a.m. settlement, a transition which, in fact, never occurred. We believe perceived concerns subsided as a result of the evolution of the stock-trading marketplace over the past twenty years.

Recognizing that Mr. Mayne's comments could be applied to S&P 500 index options (which did convert to a.m. settlement and which do trade at higher volume levels than OEX today), we would like to expound further on why marketplace changes ameliorate concerns over index option driven volatility changes in the underlying stocks on expiration dates. In the 1980s, the stocks of the largest capitalized U.S. companies were either listed on the NYSE or the Nasdaq. A stock listed on one of those markets did not trade on the other market. Most of the stocks in the S&P 100 and 500 were listed and traded on the NYSE.[1] Further, the NYSE relied on a single specialist to "manage" all order flow directed to NYSE in his specialty stocks.

Today, NYSE, Nasdaq, and other execution venues, compete for market-on-close interest in the same stocks and, more importantly, the closing process is largely automated. Imbalance indications are disseminated via real time data feeds and a much wider array of market participants (including non-specialist market makers and other liquidity providers) have both access and technology to submit orders to offset any imbalance.

Another meaningful difference between today and twenty years ago is the expansion of after-hours trading. Entities concerned with absorbing a large expiration market-on-close imbalance have more tools at their disposal to mitigate the risk of taking on a large position. One of those is the ability to trade after hours. The stocks in the S&P 500 are available for trading after hours. Thus, the extension of the price discovery process allows traders to more aggressively absorb market-on-close imbalances.

It seems quite clear that the concerns that once prompted the move of some products to a.m. settlement have been negated by substantial changes in the marketplace, including increased competition, significantly enhanced automation, the ability to trade after-hours, the replacement of the NYSE specialist system, and the added dimension of off-exchange venues accepting market-on-close orders and honoring the closing print price on the primary market. In today's national market system, no single market participant faces the same degree of index-arbitrage unwinding imbalance pressure as the NYSE specialists purportedly faced over twenty years ago. No single market participant today would have to absorb the full brunt of an order imbalance.

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[1] In fact, at year-end 1990, 426 component stocks of the S&P 500 index were NYSE listed. These components made up 95.2 percent of the index by weight, where the index weights are based on market capitalization.

ISE

The ISE letter is comprised of five distinct areas and we respond to each below.

1. *Linkage*. ISE suggests that the proposed p.m. settled S&P 500 index option offering should be "linked" with SPX (which is a.m. settled). ISE expounds on the congressional intent behind linked markets and chronicles the ever evolving history of order protection provisions in the equity and option markets. However, ISE fails to mention one critical fact: that the linkages contemplated by Congress and implemented by the Commission and industry participants, only apply to trading by different exchanges *of the same product*. An a.m. settled index option is not the same product as a p.m. settled index option.

The difference between an a.m. settled S&P 500 index option and p.m. settled S&P 500 index options is a material one. The two products are not and cannot be fungible. An investor seeking to buy 20 SPX calls could not be sold 20 S&P 500 p.m. settled calls just as an investor seeking to buy 10 Jan puts could not be sold 10 Mar puts. The fact that these are two different products is indisputable. By definition they cannot be linked.

2. *Investor Confusion*. ISE notes that investors will be confused by the introduction of a p.m. settled product while an a.m. settled product is also available for trading in the marketplace. The fact is that p.m. settled S&P 500 index options already exist in several forms: SPX FLEX options, SPX options with settlements on the last day of each quarter, the last day of each month, and every Friday of the month other than the third Friday. We have observed no customer confusion as a result of these offerings. In fact, these products were offered based on customer demand.

In addition, the U.S. exchange markets offer thousands of products available for trading and many of these products are considered quite similar. For example, there can be numerous exchange-traded funds (ETFs) on the same index. There are S&P 500-based ETFs, S&P 500 futures and options on futures. It would be absurd to suggest that the existence of these products generates customer confusion. Further, CBOE lists and trades American-style S&P 100 index options (OEX) as well as European-style S&P 100 index options (XEO). The only difference between the two products is the exercise style, and we have not observed any customer confusion as a result of offering both products.

In this section of its letter, ISE references that the Commission staff previously rejected a proposal by ISE to list and trade DAX options and mini-DAX options. While we agree that ISE should be permitted to trade both contracts, we believe the ISE's reference to its DAX option proposal (full and mini) is misplaced. We understand that the Commission staff's concerns about mini-DAX options were in regard to scaled contracts on the same index,[2] a concern that obviously does not apply to our proposal. Additionally, the Exchange disagrees that the introduction of new p.m. settled S&P 500 index options will result in market fragmentation. Rather, the Exchange believes that the new product will provide an exchange-traded alternative to the popularly traded OTC S&P 500 index p.m. settled options and (hopefully) will attract order flow to the Exchange. Finally, the Exchange believes that the new product should increase trading flexibility and transparency which serves many public policy goals.

3. *P.M. Settlement*. ISE warns that reintroducing p.m. settlement in S&P 500 index options would undermine the reason for migrating to a.m. settlement over twenty years ago. ISE observes that "the Commission urged the exchanges to move settlement based on opening prices, where markets had better-established mechanisms for finding equilibrium prices." Fortunately, as we mentioned earlier, closings are handled on stock exchanges today very differently from how they were handled twenty years ago. In fact, today's automated closing procedures operate very similarly to opening procedures. Thus, to the extent that stock exchange opening procedures were deemed acceptable twenty years ago to mitigate one sided order flow driven by index option expiration, today's more sophisticated closing procedures should afford a similar if not greater level of comfort.

As noted earlier, the specialist system has been phased out and replaced by designated market makers. In 1990, the specialist held inventories of stocks, provided two-sided quotes, and manually executed trades. Orders that were submitted electronically to the exchange were routed to the specialist's post, where the orders were then handled manually. Automatic execution was introduced at the NYSE in 2000, but with restrictions on the number of shares and frequency of use. At the end of 2006, the NYSE introduced its revamped market as a way to comply with Regulation NMS. The revamped platform removed the execution share and frequency restrictions and also introduced Liquidity Replenishment Points, a volatility control designed to curb wide price movements resulting from automatic executions. Subsequently, the NYSE replaced specialists with designated market makers. The NYSE is a dramatically different place than it was twenty years ago and, as we identified earlier, a significant portion of NYSE-listed stock volume, including market-on-close volume, trades on other venues including Nasdaq. We believe that concerns with p.m. settlement are misplaced and that our proposed pilot is an appropriate way for the Commission to carefully measure the effects of another p.m. settled S&P index option product.

4. *Position Limits*. In its letter, ISE objects that the proposed product would not have position limits. However, the ISE discussion of position limits is unconvincing. The letter argues "[t]he application of the Dutt-Harris model would not permit the total absence of position limits for the P.M.-settled S&P 500 options and the Commission should require the application of the Dutt-Harris model to these new products." Footnote

[2] The SEC staff raised similar concerns with respect to a CBOE proposed rule change regarding scaled options on the CBOE S&P 500 BuyWrite Index. See Securities Exchange Act Release No. 58207 (July 22, 2008), 73 FR 43963 (July 29, 2008) (SR-CBOE-2008-026).

18 of the letter refers to a table presented in the published paper allegedly supporting this argument. However, the power of this argument is significantly diminished after considering other information contained in the same paper. For example, Dutt and Harris observe that position limits may be used as a tool to control manipulation "when surveillance and prosecution is inadequate."[3] In other words, the authors view market surveillance as a substitute for position limits. The authors further acknowledge this point when explaining variation in observed position limits across markets.[4] At C2, market surveillance will always be rigorous and more than adequate to serve as a substitute for position limits for the manipulation concerns posed by Dutt and Harris.

Further, the paper specifically acknowledges that the S&P 500 options contract "has—and should have—very large position limits." In fact, the calibration exercise conducted by Dutt and Harris found the S&P 500 option contract to be an extreme outlier within their model.[5] The position limits suggested by their model are so large as to make them irrelevant. Positions that would breach a level in the Dutt-Harris model would certainly attract a degree of surveillance scrutiny that would satisfy any reasonable definition of adequate surveillance and that would serve as an effective substitute for position limits. Importantly, the authors conclude:

> In practice, position limits need not apply to broad-based index derivative contracts that are cash settled because they are composed of highly liquid and well-followed securities. Behind this assertion is an assumption that surveillance would be more effective detecting manipulation of highly liquid underlying securities. This is based on the premise that it would require very high trading volume to manipulate such securities and would consequently be more easily detectable and prosecutable.[6]

Having ignored the author's conclusion, the ISE letter suggests that the SEC attach significance to the absolute "prudent position limit" reported in Table II of Dutt and Harris' calibration exercise. However, as the authors point out, there are limitations to attaching too much significance to the absolute levels of their reported numbers. The Exchange agrees with the authors' conclusion that position limits are not relevant for options on broad-based indexes like the S&P 500 index. We find the position limit argument offered by ISE to be a red herring and we do not believe that it should factor into the Commission's deliberations on the proposal.

In further support of the Exchange's request that the proposed product have no position limits, C2 notes that the circumstances and considerations relied upon by the Commission in approving the elimination of position and exercise limits for options on

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[3] Dutt and Harris, page 950.

[4] Dutt and Harris, footnote 10, page 956.

[5] Dutt and Harris, page 959.

[6] Dutt and Harris, page 965.

the S&P 500 Index continue to apply.[7] In approving the elimination of position limits for SPX options, the Commission considered the enormous capitalization of the index and the deep and liquid markets for the securities underlying the index, which significantly reduced concerns of market manipulation or disruption in the underlying markets. The Commission also noted the active trading volume for SPX options. As of April 19, 2011, the approximate market capitalization of the S&P 500 Index was $12.54 trillion and the average daily trading volumes ("ADVs") for all underlying components of the index is 3,398 million shares.[8]

In approving the elimination of position and exercise limits for SPX options on October 26, 2001, the Commission also noted that the financial requirements imposed by both Chicago Board Options Exchange, Incorporated ("CBOE") and the Commission serve to address concerns that a CBOE Trading Permit Holder ("TPH") or its customer(s) may try to maintain an inordinately large unhedged position in the indexes. These identical financial requirements will also apply to the proposed p.m. settled S&P 500 index options. Under C2's rules, the Exchange has the authority to impose additional margin and/or assess capital charges and is further able to monitor accounts to determine when such action is warranted.[9]

Finally, the Commission relied on the CBOE's ability to provide enhanced surveillance and reporting safeguards to detect and deter trading abuses arising from the elimination of position and exercise limits in options on these indexes. The Exchange represents that it will monitor trading in p.m. settled S&P 500 index options in much the same manner as trading in other broad-based index options with no position limits and that its current surveillance procedures are more than adequate to continue monitoring the proposed options. Additionally, C2's reporting requirements will subject the proposed product to 100,000 contract hedge reporting requirement.[10] Each TPH or TPH organization that maintains a position on the same side of the market in excess of these contract thresholds for its own account or for the account of a customer must file a report that includes, but is not limited to, data related to the option position, whether such position is hedged and if so, a description of the hedge. If applicable, the report must contain information concerning collateral used to carry the position. The Exchange may also specify other reporting requirements, as well as a threshold at which the reporting requirement may be triggered.

5. *Exclusive Listings*. ISE seizes on the proposal to rehash its longstanding argument that the federal securities laws should be used to strip an index owner of its property right to decide who may license its index as the basis of index options, including the right to

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[7] See Securities Exchange Act Release No. 44994 (October 26, 2001), 66 FR 55722 (November 2, 2001) (SR-CBOE-2001-022).

[8] ADVs are calculated over the previous three months of trading.

[9] See, e.g., C2 Chapter 24, which cross references CBOE Rule 24.4.04 and also refers to Rule 15c3-1 under the Securities Exchange Act of 1934, as amended.

[10] See, e.g., C2 Chapter 24, which cross references CBOE Rule 24.4.03.

choose to license that index exclusively when that suits the index owner's business interests. The many comments submitted in opposition to ISE's petition demonstrated why ISE's approach would deprive index owners of their lawful property rights without compensation and would disserve the public interest by constraining product innovation. ISE's petition would have prevented "preferential" licensing arrangements and therefore inevitably would involve the Commission in assessing what is fair – *i.e.* non-preferential – value for a licensing arrangement, issues that are far removed from the Commission's expertise and statutory responsibilities. The Exchange believes that the Commission's unwillingness to do so has been prudent policy, which has served both the Commission and investors well. Any careful balancing of competition and incentives to innovate is best addressed by intellectual property law, not by federal securities law.

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The Exchange anticipates that a p.m. settled index option would be a positive addition to the marketplace. The p.m. settlement convention is practical and intuitive for investors and there is user demand for the product. Brokerage firms have conveyed to the Exchange that a.m. settlement can create an unnecessary complication when introducing index option products to retail investors. We believe that the vast over-the-counter index options market utilizes p.m. settlement and extending its use to more listed option products would allow retail investors this same benefit enjoyed by large institutional OTC traders. The proposal provides another investment vehicle to trade the S&P 500 index. Adding a p.m. settled cash index option offers one of many choices to trade this product.

We also wish to reiterate that our proposal is to establish a pilot program. This should give the Commission and interested observers sufficient comfort that the effects of p.m. settlement can be safely measured.

C2 appreciates the opportunity to respond to comments on its proposed rule filing to list and trade p.m. settled S&P 500 index options. Please do not hesitate to contact us to discuss this letter or if you would like additional information.

Sincerely,

Joanne Moffic Silver

C2 Options Exchange, Incorporated
Joanne Moffic-Silver
Secretary

cc: Robert Cook
James Brigagliano
Heather Seidel
Richard Holley