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August 20, 2007

VIA ELECTRONIC DELIVERY

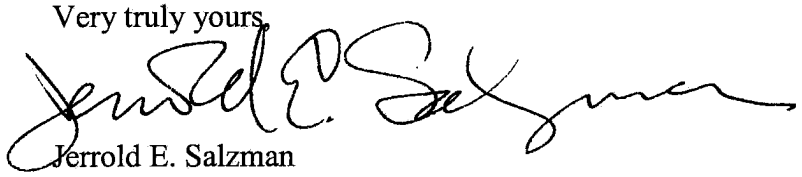
Erik R. Sirri
Elizabeth K. King
Division of Market Regulation
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: SR-CBOE-2007-77

Dear Mr. Sirri and Ms. King:

In connection with our meeting scheduled for tomorrow, we prepared the attached memorandum as a basis for our discussion. I look forward to the opportunity to meet with you regarding these issues.

Very truly yours,



Jerrold E. Salzman

Enclosures

CBOE asserts that the rule was properly filed under Section 19(b)(3)(A), stating,

> The interpretation is designated by the Exchange as constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the Exchange – namely, CBOE Rule 3.19 – thereby qualifying for effectiveness on filing pursuant to Section 19(b)(3)(A)(i) of the Exchange Act and subparagraph (f)(1) of Rule 19b-4 thereunder.

("Interpretation" at 10 (footnotes omitted).)

The "Interpretation" provides, among other things, that:

- Each person who was an Exerciser Member on July 1, 2007, and satisfies certain conditions will be granted "temporary CBOE membership status."
- Commencing July 1, 2007, no additional CBOT full members or their delegates will be granted CBOE membership status until the SEC acts on the Proposed Rule Change.

CBOE has created and implemented a permit program that temporarily permits some Exerciser Members to continue trading on CBOE. But CBOE will require those Exerciser Members who qualify for temporary trading rights under this permit program to pay CBOE a monthly access fee that CBOE says will be based on lease rates for a CBOT B-1 membership, or about $4700 per month.[2] This is yet another step in CBOE's efforts to make improper use of the Commission and its own self-regulatory authority to resolve in its favor a private property dispute that is pending in the Delaware court. As with its Proposed Rule Change filed in December, CBOE seeks to use the "Interpretation" to resolve issues of state law in order to shift

[2] A holder of the new temporary trading rights will not be required to lease or hold the CBOT B-1 membership that Article Fifth(b) of CBOE's Certificate of Incorporation requires Exerciser Members to hold in order to qualify for CBOE membership. In the case of Exerciser Members who previously leased CBOT full memberships in order to qualify as Exerciser Members, CBOE is essentially appropriating these lease payments for itself in the form of access fees. CBOE says the access fees will be held in escrow pending the Commission's decision on the Proposed Rule Change. In the event the Commission disapproves the Proposed Rule Change, CBOE would return the consideration to the holder of the temporary trading rights, not the lessor from whom it was wrongfully appropriated.

membership structure or member ownership rights, nor do they allow rule changes that completely alter the costs of exercising membership privileges. The "Interpretation," however, does exactly this. Indeed, the "Interpretation" radically changes CBOE's membership rules as they apply to a substantial number of members. Specifically, the "Interpretation" provides that Exerciser Members are no longer members by virtue of possessing a CBOT B-1 membership, and CBOT full members who formerly leased their CBOT B-1 memberships to Exerciser Members will no longer be able to do that. Instead, under the "Interpretation," Exerciser Members who qualify will pay a monthly access fee directly to CBOE for temporary trading permits.

To date, the "Interpretation" has had a significant impact on the market for both CBOT and CBOE memberships and membership leases. Specifically, (1) the lease market for CBOT Series B-1 memberships − which were inextricably tied with CBOE memberships under the CBOE Certificate of Incorporation and subsequent contracts between the exchanges −has been destroyed; (2) CBOT full members who leased their B-1 memberships to Exerciser Members are being denied the opportunity to collect lease payments; (3) the lease value of all CBOT B-1 memberships is being diminished; and (4) the sale value of all CBOT B-1 memberships is being diminished.[8] Such drastic changes would not result from a mere "interpretation" of an existing rule as contemplated by Section 19(b)(3)(A) of the Exchange Act.

The precise financial impact on the CBOT B-1 membership lease market will be difficult to quantify over a given period of time because multiple market factors can affect both the lease and market values of the B-1 memberships. These factors would include, among others,

[8] Although CBOE says otherwise, the "Interpretation" also necessarily eliminates the voting rights and other indicia of membership of the Exerciser Members even if they qualify for temporary trading permits.

With respect to the proposed rule change (SR-CBOE-2006-106), I understand that the interpretation of Article Fifth(b) was approved by CBOE's board of directors (the "CBOE Board"). I submit this letter because the CBOE Board's interpretation of Article Fifth(b) in connection with the proposed rule change implicated a number of principles of Delaware law that should be brought to the Commission's attention. These principles were not discussed in the letters submitted on behalf of CBOE to the Commission in support of the proposed rule change. More specifically, the letter submitted to the Commission on behalf of CBOE by Richards, Layton & Finger on January 16, 2007 (the "Richards Letter")[1] stated that "when questions arise as to the application of Article Fifth(b) in circumstances not directly addressed by that Article, it is within the general authority of the Board to interpret Article Fifth(b) so long as in doing so the Board acts in good faith, in a manner consistent with the terms of that Article and not for inequitable purposes." The CBOE Board's action does not meet any of these three prongs, and the Richards Letter does not address them or opine on whether the Board acted properly in light of the standard. Furthermore, the Richards Letter failed to explain the fiduciary duties that the CBOE Board owed to its members or potential members in connection with any such interpretation or the level of review that applies to such an interpretation.

This letter briefly explains certain important concepts of Delaware law and their application to the proposed rule change. First, the CBOE Board owes fiduciary duties to *all* members of CBOE, including the Full Members of CBOT who have exercised their right to become members of CBOE (the "Exerciser Members"), and may owe fiduciary duties to the Full Members of CBOT who hold the right ("Exercise Rights") to become Exerciser Members. These fiduciary duties include the duty to act in good faith, consistent with the terms of Article Fifth(b), and not for any inequitable purpose. Second, when examining whether directors have met their fiduciary duties under Delaware law, directors will not be entitled to the protection of the business judgment rule if a majority of directors have a personal financial interest in the decision. In such circumstances, the directors bear the burden of demonstrating the entire fairness of their decision.

Here, because a majority of the CBOE Board has a material, financial interest in the decision to interpret Article Fifth(b), the CBOE Board bears the burden, under Delaware law, of demonstrating the fairness of its decision.

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[1] Richards, Layton & Finger submitted a second letter to the Commission on June 28, 2007, in response to the Commission's request for an opinion that the change to Article Fifth(b) was not an amendment but an interpretation. This letter, like the January 16 Richards Letter, acknowledged that the CBOE Board's interpretation of Article Fifth(b) must be made "in good faith, consistent with the terms of Article Fifth(b) and not for inequitable purposes." Furthermore, the June 28 letter conceded that in "the event of a legal challenge to an interpretation, the reviewing authority would interpret Article Fifth(b) and would not be bound by the interpretation of the [CBOE] Board."

Fiduciary Duties to Exerciser Members and Holders of Exercise Rights. As noted above, the CBOE Board owes fiduciary duties to the Exerciser Members, and arguably owes fiduciary duties to the holders of Exercise Rights. The Delaware Court of Chancery, in a recent decision in the litigation between CBOT and CBOE, addressed the fiduciary issues raised by the proposed rule change:

> In addition, if the CBOE Board owed fiduciary duties to the Exerciser Members (and arguably others), those duties may well protect the interests of these CBOT members because those decisions which caused the claimed harm to them were made by the CBOE Board while, under any interpretation of the various documents, at least many of the CBOT members were Exerciser Members of the CBOE. In sum, it is not immediately and conclusively obvious why a regulatory act voluntarily (and not necessarily) taken by the CBOE Board can be isolated from the reach of fiduciary duty law, especially when the consequences (great benefits to the Seat Members and great detriment to the CBOT Full Members) were so apparent at the time when the CBOE Board decided to act.[2]

The fiduciary duties owed by the CBOE Board to the holders of Exercise Rights and the Exerciser Members include, by CBOE's own admission, the duty to act in good faith and in a manner that is consistent with the terms of Article Fifth(b), and not to act for any inequitable purpose. The CBOE Board failed to satisfy these fiduciary duties in determining to extinguish the rights of the Exerciser Members and all of the holders of Exercise Rights.

Entire Fairness Standard Applies Where A Majority Of The Directors Have An Interest In The Decision. In determining whether a board of directors has satisfied its fiduciary duties under Delaware law, a board is typically entitled to the presumption of the business judgment rule. If, however, a majority of the directors are not independent or have an interest in the transaction, the directors bear the burden of proving the entire fairness of the transaction or decision. *See, e.g, Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). Under Delaware law, a director is interested in a decision if the director will experience some benefit that is not shared by *all* of the stockholders or members. *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002).

A Majority Of The CBOE Directors Have A Material Interest In The Interpretation Of Article Fifth(b). A majority of the directors serving on the CBOE Board and interpreting Article Fifth(b) are either regular members of CBOE (who stand to benefit

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2 *CBOT Holdings, Inc. v. Chicago Board Options Exchange, Inc.*, C.A. No. 2369-VCN, slip op. at 30 n.48 (Del. Ch. August 3, 2007).

financially from the proposed rule change) or are affiliated with, or beholden to, such regular members. More specifically, 11 of the 23 members of the CBOE Board are CBOE regular members or are affiliated with or employed by regular members, such that they have a significant financial interest in eliminating the rights of the Exerciser Members and those holding Exercise Rights. In addition, CBOE's chairman and CEO is beholden to the regular members because his continued employment with CBOE rests in such members' hands. Thus, 12 of CBOE's 23 Board members are not independent with respect to the decision on how to treat Exerciser Members and holders of Exercise Rights in connection with the Merger.

The CBOE Board recognized that these conflicting personal interests prevented it from making a disinterested decision regarding the treatment of the holders of Exercise Rights in the CBOE demutualization. Because of that recognition and in an effort to satisfy its fiduciary duties, the CBOE appointed a special committee of independent directors to act in place of the CBOE Board in connection with the demutualization of CBOE. The same fiduciary duties that required the formation of the special committee of disinterested directors in the demutualization context should have compelled the formation of such a committee in these circumstances, where the CBOE Board has determined to extinguish the rights of the Exerciser Members and the Exercise Rights through regulatory action. Simply put, a majority of the CBOE directors stood to gain financially from a decision to extinguish those rights (or were beholden to such persons), and, thus, were not in a position to exercise business judgment on the treatment of all Exerciser Members and the holders of Exercise Rights.

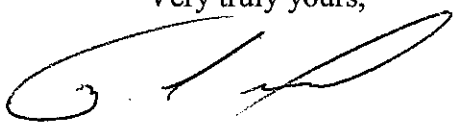
The CBOE Board did not appoint a special committee to interpret Article Fifth(b), nor did it seek independent financial and legal advice for purposes of making its decision. Accordingly, in determining whether the CBOE Board met its fiduciary duties with respect to its proposed interpretation of Article Fifth(b), the CBOE Board must demonstrate that its decision with respect to Article Fifth(b) is entirely fair to all of the members of CBOE, including the Exerciser Members, under Delaware law.

As noted above, Delaware law is clear that the board bears the burden of demonstrating the fairness of its decision in circumstances where the board makes a determination based on its own self-interest. Delaware law is also clear that this fairness requirement applies in circumstances where the Board's decision favors certain groups of stockholders or members with whom the particular directors' interests are aligned. *See, e.g., Oliver v. Boston University*, 2006 Del. Ch. LEXIS 75, at *119 (Del. Ch. Apr. 14, 2006) (holding that allocation of merger proceeds between various stakeholders was unfair and finding that "[m]ore disturbing is that, although representatives of all of the priority stakeholders were involved to some degree in the negotiations, no representative negotiated on behalf of the minority common stockholders"); *In re Tele-Communications, Inc. S'holders Litig.*, 2005 Del. Ch. LEXIS 206 (Del. Ch. Dec. 21, 2005) (stating that "because a clear and significant benefit of nearly $300 million accrued" to board members because of their holdings of Series B common stock "at the expense of another class of shareholders to whom was owed a fiduciary duty," the entire fairness test applies); *In re FLS Holdings, Inc. S'holders Litig.*, C.A. No. 12623, 1993 Del.

Ch. LEXIS 57 (Del. Ch. Apr. 2, 1993) (requiring a board comprised exclusively of directors owning large amounts of common stock or directors who were affiliates of the company's controlling stockholder to demonstrate the fairness of an allocation of consideration that clearly favored the common stock over the preferred stock). Accordingly, the CBOE Board must demonstrate to the Delaware court the fairness of its interpretation of Article Fifth(b) in connection with the proposed rule change in light of the direct financial interest of a majority of the directors serving on the CBOE Board.

This letter is solely for the benefit of CBOT in connection with the matters addressed herein and may not be relied upon for any purpose or by any other person or entity, other than the Commission, without my prior written consent. In the event that you have any questions with respect to this letter, please do not hesitate to contact me at (302) 351-9228.

Very truly yours,



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August 16, 2007

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Via E-Mail and U.S. Mail

Paul E. Dengel, Esq.
Schiff Hardin LLP
233 South Wacker Drive
Suite 6600
Chicago, IL 60606

Re: ***CBOT Holdings, Inc. et al v. Chicago Board Options Exchange,*** **Case No. 2369-N**

Dear Paul:

In response to your August 14, 2007 letter, described below is an alternative to the Interim Access Rule that would avoid disrupting CBOE's markets, cover regulatory issues addressed by the Interim Access Rule, and not prejudice CBOE's position. This alternative could take either the form of a stand alone agreement or an agreed order before the Court. It would include a stipulation that the parties reserve all rights in the pending proceedings and two principal components.

First, CBOE would agree to immediately withdraw the Interim Access Rule. In its place, CBOE would simultaneously file an interpretation to CBOE Rule 3.16 in the form enclosed with this letter.

Second, the agreement or order would maintain the *status quo* as of July 1 with the exception that CBOE can collect a monthly access fee from Exerciser Members to be held in escrow pending a resolution of both the court and SEC proceedings and distributed to either CBOE or the Exercise Member (or his or her lessor as the case might be) if the plaintiffs prevail.

The plaintiffs are prepared to put this alternative in place as soon as possible.

Sincerely,

Gordon B. Nash, Jr.

Enclosure

CH01/ 12517156.1

Rule 3.16. Special Provisions Regarding Chicago Board of Trade Exerciser Memberships

(a) *Termination of Nontransferable Memberships.* A nontransferable membership acquired by a person pursuant to Paragraph (b) of Article Fifth of the Certificate of Incorporation shall terminate (i) upon receipt by the Membership Department of written notice from the person that the person is surrendering the membership or (ii) at such time that the person is no longer entitled to membership on the Exchange in accordance with Paragraph (b) of Article Fifth of the Certificate of Incorporation. Notice of each such termination shall be published in the Exchange Bulletin.

(b) *Board of Trade Exercisers.* For the purpose of entitlement to membership on the Exchange in accordance with Paragraph (b) of Article Fifth of the Certificate of Incorporation of the Exchange ("Article Fifth(b)") the term "member of the Board of Trade of the City of Chicago" (the "CBOT"), as used in Article Fifth(b), is interpreted to mean an individual who is either an "Eligible CBOT Full Member" or an "Eligible CBOT Full Member Delegate," as those terms are defined in the Agreement entered into on September 1, 1992 (the "1992 Agreement") between the CBOT and the Exchange, and in the Agreement entered into on December 17, 2003, ("the 2003 Agreement") between the CBOT and the Exchange, in the Agreement entered into on August 7, 2001, ("the 2001 Agreement") between the CBOT and the Exchange as amended and supplemented by the Letter Agreement among CBOT Holdings, Inc., CBOT and the Exchange entered into on October 7, 2004, and by the Letter Agreement among CBOT Holdings, Inc., CBOT and the Exchange entered into on February 14, 2005, as further interpreted in accordance with that certain proposed rule change filed with the Securities and Exchange Commission as File No. SR-CBOE-2002-41, and shall not mean any other person. In order to permit Eligible CBOT Full Members and Eligible CBOT Full Member Delegates to participate in an offer, distribution or redemption of the kind referred to in the last two sentences of Paragraph 3(a) of the 1992 Agreement, and solely for such purpose, the Exchange agrees to waive all membership dues, fees and other charges and all qualification requirements, other than those that may be imposed by law, that may be applicable to the application for membership on the Exchange of each Eligible CBOT Full Member and Eligible CBOT Full Member Delegate who wishes to exercise the Exercise Right during the period commencing on the date the Exchange gives notice to the CBOT pursuant to Paragraph 3(b) of the 1992 Agreement and ending on the date such individual participates in such offer, distribution or redemption (as the case may be); provided, however, that (i) no Exerciser Member (as defined in the 1992 Agreement) for whom dues, fees and other charges and qualification requirements are waived in accordance with the foregoing shall have any rights as a member of the Exchange other than to participate in such offer, distribution or redemption, and (ii) the membership on the Exchange of each such Exerciser Member shall terminate immediately following the time such individual participates in such offer, distribution or redemption.

Amended October 8, 1976; April 23, 1978; December 12, 1978; June 2, 1980; October 28, 1987 (87-23); June 8, 1993 (92-42); July 19, 2000, effective August 18, 2000 (99-15); July 29, 2002 (02-41); July 15, 2004 (04-16); May 24, 2005 (05-19).

... Interpretations and Policies:

.01 This interpretation and policy is temporarily adopted to avoid any uncertainty respecting the membership status of a person who acquired a membership pursuant to Paragraph (b) of Article Fifth of the Certificate of Incorporation. The term "member of the Board of Trade of the City of Chicago" (the "CBOT"), as used in Article Fifth(b), will be interpreted as provided in this Rule 3.16, except any requirement that such person own shares of CBOT Holdings, Inc. shall be interpreted to require that such person hold the number of shares of Chicago Mercantile Exchange Holdings, Inc., exchanged for the 27,338 CBOT Holdings, Inc. shares previously required to be held by such person. If any such person took action in reliance on Interpretation.01 of Rule 3.19 and would be disqualified as a result of that good faith reliance on Interpretations and Policies .01 to Rule 3.19 (Amended August 3, 2007 (07-91)), such person may retain his membership status for thirty days to enable him to obtain a membership a substitute nominee, or a substitute person to register his or her membership for the member, as applicable, all in accordance with Rule 3.19.