CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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

RE: Rule File No. SR-CBOE-2009-007 (Tied Hedge Transactions)

Dear Ms. Murphy:

We are writing in reference to the above-captioned rule filing and in response to a comment letter submitted by the International Securities Exchange, Inc. ("ISE").[1] The filing seeks to adopt a procedure that will allow hedging stock, security future or futures contract positions to be represented concurrently with option facilitations and solicitations in the trading crowd subject to certain conditions (referred to as "tied hedge" orders). Use of the tied hedge procedure will be a limited exception to CBOE's existing restrictions on anticipatory hedging. ISE has raised questions about the effects of anticipatory hedging in the manner proposed, the classification of certain tied hedge transactions as "complex trades" or "qualified contingent trades," and the execution mechanics of the procedure. We respond to these questions below.

Anticipatory Hedging

ISE indicated that it does not believe there is any justification for allowing firms to engage in anticipatory hedging and that it views the activity as a form of frontrunning that may disadvantage the trading crowd competing for the order in the auction process and the order being executed. We disagree.

By way of background, all the options exchanges have rules that restrict anticipatory hedging (*e.g.*, CBOE Rule 6.9(e) and ISE Rule 400.02). CBOE's policy is designed to permit solicitations while at the same time providing the options trading crowd with a fair and full opportunity to make informed trading decisions and to compete on filling options orders with the same access to a hedge as the solicited parties. Under our policy, a person who has knowledge

[1] *See* letter from Michael J. Simon, Secretary, ISE to Nancy M. Morris, Secretary, SEC (March 25, 2009).

of an imminent undisclosed solicited transaction generally cannot enter an order to hedge in the same option class, underlying security or related instrument until all the terms and conditions of the original order are disclosed to the trading crowd.

As set out in our filing, changes in the marketplace have caused us to re-evaluate our existing anticipatory hedging policy. Increased volatility, as well as the advent of penny trading in underlying stocks and resultant decreased liquidity at the top of each underlying market's displayed national best bid or offer, has made it increasingly difficult for members and member organizations to assess ultimate execution prices and the extent of available stock to hedge related options solicitation activities, and to manage that market risk. This risk extends to simple and complex orders, and to all market participants involved in the transaction (whether upstairs or on-floor) because of the uncertainty of the extent to which the market participant will participate in the transaction, the amount of time associated with the auction process, and the likelihood that the underlying stock prices in today's environment may be difficult to assess and change before they are able to hedge. These circumstances make it difficult to obtain a hedge, difficult to quote orders and difficult to achieve executions, and can translate into less liquidity in the form of smaller size and wider quote spreads, fewer opportunities for price improvement, and the inefficient handling of orders.

In response, we have proposed our tied hedge procedure, which is fully consistent with the basic principle underlying our anticipatory hedging policy but simply presents an alternative way to level the playing field between the options trading crowd and solicited parties. The procedure will be limited to "tied hedge" orders, which are orders involving a combination of (i) an option order, including a complex order, in an eligible option class for at least 500 contracts (the "option order") and (ii) a hedge position in a related stock, security futures or futures contract (the "hedge position"). We do not believe a firm that establishes a hedge position pursuant to the procedure would be taking advantage of material, nonpublic information as contemplated by the frontrunning prohibitions.[2]

ISE said that the proposal may disadvantage the trading crowd competing for the option order in the auction process because the member with knowledge of the pending transaction would have an advantage over the trading crowd, which may result in less competition and worse prices for customers. We disagree. Consistent with our existing anticipatory hedging policy, the

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[2] "Frontrunning" refers to trading that is calculated to take advantage of other market participants who are unaware of the market impact of an impending block transaction. Consistent with our existing anticipatory hedging policy, compliance with the tied hedge procedure would not provide a safe harbor from possible violations of our frontrunning policy. *See* CBOE Rule 6.9.06. Consider an example where a member is solicited to participate in a block order to buy 500 call ABC options, which has a delta of 50. Using the tied hedge procedure, the member would purchase 25,000 shares of ABC stock for an average price of $25 per share. Once the stock is executed, the member announces the 500 contract option order and 25,000-share stock hedge position at $25 per share to the trading crowd. After providing an opportunity to the trading crowd to provide competing quotes for the tied hedge package, an execution would occur with the option leg reported on CBOE and the stock leg reported on the relevant stock market. There is generally no frontrunning issue here. If in the same scenario the member buys 500 puts before executing the hedge position and while in possession of the material, nonpublic information concerning the imminent execution of the related stock-option orders, the member may have a frontrunning issue if the 500 put contract transaction is calculated to take advantage of market participants who are unaware of the impending block transaction.

proposal contains safeguards that provide the options trading crowd with a fair and full opportunity to make informed trading decisions and have the same access to a hedge as the solicited party. The trading crowd is able to compete on the same terms because the procedure requires that the tied hedge position[3] be brought without undue delay to the trading crowd and announced concurrently with the option order, offered to the crowd in its entirety, offered at the execution price received by the member to any in-crowd market participant who establishes parity or priority for the related option order,[4] and not exceed the option order on a delta basis. To participate, the rule also requires that in-crowd market participants must trade the tied hedge position – they may not prevent the option transaction from occurring by giving a competing bid or offer for one component of the tied hedge order. This requirement to participate in the entire package is another condition designed to keep the initiating member and in-crowd market participants on equal footing. This requirement is not novel or unique – CBOE Rule 6.74.03 already provides that members may not prevent the cross of a complex order or inter-regulatory spread by giving a competing bid or offer for one component of such an order. Since the trading crowd will have access to the same downside protection as the solicited party that executed the hedge position, the crowd should be willing to provide price improvement to the tied hedge order just as much as, if not more than, any other facilitation/solicited order.

ISE also indicated that transactions in the underlying may move the price in the underlying security and consequently the options, resulting in a worse price for the option order being executed. Underlying price changes are already a factor in options valuation, whether or not the tied hedge procedure is used. It is the very issue we are trying to address by providing additional flexibility and means to avoid the uncertainty and instances where these scenarios may occur. We believe the tied hedge procedure will generally provide additional price improvement opportunities. We do not believe that the procedure will be inherently harmful or detrimental to the larger-sized option orders being hedged or have an adverse affect on the auction market. Moreover, participants will continue to be governed by, among other things, their best execution responsibilities.[5]

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[3] ISE incorrectly indicated that the tied hedge procedure would permit a firm to take hedging securities from inventory. The proposal explicitly requires that the hedge position be bought or sold "following receipt of an option order, including a complex order, but prior to announcing such order in the trading crowd." *See* introductory language to proposed Rule 6.74.10.

[4] ISE inquired whether the phrase "any in-crowd market participant who has established parity or priority for the related options . . ." (*emphasis added*) limits who is permitted to participate in the auction for the order under the procedures contained in Rule 6.74. The answer is no. Any in-crowd market participant is eligible to participate in the auction. Any in-crowd market participant that does establish parity or priority to trade against the original option order through bidding or offering in response to the original option order will be offered the hedge position at the same execution price received by the initiating member. Any in-crowd market participant that does not establish parity or priority (*e.g.*, because the in-crowd market participant does not participate in the auction or provide a bid or offer at the best price(s)), would not be entitled to trade the hedge position.

[5] The fact that the parties to a tied hedge trade end up fully hedged will contribute to the best execution of order. By limiting delta risk in the manner proposed, we believe it makes it more desirable for market-makers in our trading crowds to compete for orders exposed through the solicitation process. As market participants are better able to hedge risk associated with completing these transactions, CBOE believes that quotes may narrow and result in increased price improvement opportunities.

Additionally, our procedure includes a requirement that, before entering a tied hedge order on behalf of a customer, the member must deliver to the customer a one-time written notification informing the customer that his option orders may be executed using CBOE's tied hedge procedure. We believe this notification is sufficient in light of the minimum size requirement of at least 500 contracts per option order, which effectively limits use of the procedure to institutional or high, net worth investors' orders. This notification requirement is similar to a one-time notification required in ISE rules where, for example, there is a risk that a customer could get a worse priced execution or no execution when a member firm utilizes ISE's solicited order mechanism for orders of 500 contracts or more (*see* ISE Rule 716).

Classification of Tied Hedge Transaction

Under the proposal, each tied hedge order will be represented and executed as a package on CBOE (*i.e.*, the original option order leg and the related hedge position leg will be represented concurrently) and will be treated the same as a complex order under CBOE's priority rules, regardless of whether the original option order is a simple or complex order. Any resulting tied hedge transactions will be subject to the existing NBBO trade-through requirements for options and stock, as applicable. In this regard, our filing discussed that tied hedge packages may qualify for various NBBO trade-through exceptions including, for example, the complex trade exception to the Options Linkage Program[6] and the qualified contingent trade exception to Rule 611(a) of Regulation NMS for the stock component.[7]

ISE has inquired about the status of tied hedge transactions in the scenario where the original option order is a simple order (*e.g.*, an order to sell 500 contracts in a single option series). In particular, ISE questioned whether the execution of such a tied hedge transaction should be excepted from the NBBO as a complex trade or qualified contingent trade, asserting that allowing the option order and stock hedge of an unrelated party to be packaged together and deemed "contingent" is not the intent of either definition. We disagree and note further that the particular structure of a tied hedge transaction is consistent with both the written and current operation of the definitions. It is important to note that these orders are presented to the trading crowd as a complex order package. From the perspective of each in-crowd market participant that trades as a contra-party against the tied hedge order, they will be trading all legs of a tied hedge package like any other complex order and their contra-side executions will clearly qualify as complex trades. In addition, we note that under existing option exchange rules, a complex order can trade with individual series quotes and orders from different accounts without consideration of any prices that might be available on other exchanges and, vice versa, individual series quotes and orders from different accounts can trade with a complex order without consideration of any prices that might be available on other exchanges. (*See*, *e.g.*, ISE Rule 723 and CBOE Rule 6.53C.) In those instances there is no requirement that the interest in the individual legs even be packaged together, which is a requirement of the tied hedge procedure.

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[6] *See* paragraph (4) of CBOE Rule 6.80, Definitions (applicable to Options Intermarket Linkage), and subparagraph (b)(7) to CBOE Rule 6.83, Order Protection.
[7] *See* Securities Exchange Act Release No. 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008).

ISE also indicated that the definition of a stock-option order requires the stock leg to be on the opposite side of the option leg, but thought that the stock leg in a tied hedge transaction would be on the same side as the option leg and not satisfy the requirement. This is incorrect. The stock leg of the tied hedge package is actually on the opposite side from the option leg. For example, assume an introducing member receives an option order to buy 500 ABC call options with a delta of 100. If the member wants to facilitate the options order, the member would be selling calls, so the member would obtain a stock hedge position by buying 50,000 shares of ABC stock. Once the stock is executed, the introducing member, without undue delay, would announce an order to buy 500 ABC call options and an order to sell 50,000 shares of ABC stock – which is on the opposite side of the market from the call options.

All that said, in the interest of moving forward we are limiting our proposal to provide that, in the scenario where the original option order is a simple order, the execution of a tied hedge order package by the trading crowd will be treated the same as a "complex order" for purposes of CBOE's priority rules and may qualify as a "qualified contingent trade" for purposes of the Regulation NMS trade-through exception for the stock leg. In the future CBOE may file a rule change seeking to provide that in such a scenario the execution of the option component by the trading crowd would also qualify for the "complex trade" exemption from the Options Linkage Program, however, we are no longer seeking to do that through the instant rule change proposal. In the scenario where the original option order is a complex order, the execution of the tied hedge order package will comply with the new Options Linkage Program's complex trade definition and trade-through exception and it will also comply with the existing Options Linkage Program's complex trade definition and trade-through exception.[8]

Execution Mechanics

ISE expressed some confusion as to how tied hedge orders will be executed on the CBOE floor. As explained in detail in our rule filing, tied hedge transactions will be treated the same as any other complex orders (regardless of whether the original order was a simple or complex order). Therefore, priority will be afforded in accordance with the Exchange's existing open outcry allocation and reporting procedures for complex orders (*see*, *e.g.*, Rule 6.74, as well as Rules 6.45A(b)(ii), 6.45B(b)(ii) and 6.48). As discussed above, tied hedge transactions will also be subject to the existing NBBO trade-through requirements for options and stock, as applicable. In this regard, the option and stock components of the tied hedge transactions may qualify for various NBBO trade-through exceptions, including the exceptions for complex orders (subject to the limitation noted above in the scenario where the original option order is a simple order).

We recognize that, at the time a tied hedge transaction is executed in a trading crowd, market conditions in any of the non-CBOE market(s) may prevent the execution of the non-options leg(s) at the price(s) agreed upon. For example, the execution price may be outside the

[8] *See* Securities Exchange Act Release No. 60405 (June 30, 2009), 74 FR 39362 (August 6, 2009)(order approving the national market system plan relating to options protection and locked/crossed markets submitted by CBOE, ISE, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc.)

non-CBOE market's best bid or offer ("BBO"), *e.g.*, the stock leg is to be executed at a price of $25.03 and the particular stock market's BBO is $24.93 - $25.02, and such an execution would normally not be permitted unless an exception applies that permits the trade to be reported outside the BBO. In the event the conditions in the non-CBOE market continue to prevent the execution of the non-option leg(s) at the agreed price(s), the trade representing the options leg(s) of the tied hedge transaction, as with any other complex order, may ultimately be cancelled in accordance with CBOE's existing rules (*see* CBOE Rule 6.48). The possibility of this scenario occurring exists with complex order executions today and tied hedge transactions present nothing unique or novel in this regard.

Lastly, ISE inquired how stock would be executed in the event the average price was in a sub-penny increment (*e.g.*, $10.0242 per share in ISE's example) given the restriction contained in Regulation NMS regarding sub-penny orders. In such a scenario, the hedge would be executed with orders at multiple price points to receive the same overall net price in much the same manner that the original stock hedge was obtained (*e.g.*, orders for 9,500 shares at $10.01, 11,000 shares at $10.03 and 4,500 shares at $10.04 average to $10.0242 per share).

Thank you for your time and consideration. We are happy to answer any further questions you may have in connection with the proposal.

Best regards,

Jennifer M. Lamie

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cc. Elizabeth King
Richard Holley