

November 24, 2009

File Number SR-CBOE-2009-078

Please find the following comment on the CBOE proposed rule change. The rule change is fundamentally flawed, disingenuous, vague and inconsistent with the principles of and purposes of the "Exchange Act".

The basis under the Securities Exchange Act of 1934 ("Exchange Act") for this proposed rule change is the requirement under Section 6(b)(5) of the Exchange Act /8/ that an exchange have rules that are designed to promote just and equitable principles of trade, and to remove impediments to and perfect the mechanism for a free and open market and a national market system, and in general, to protect investors and the public interest.

1. This rule change and the rule change initiated by the ISE merely a change designed to eliminate price competition from the marketplace.
2. This rule change is another example where the CBOE and ISE have acted to put its own self serving interest above that of a fair and efficient marketplace.
3. The effect of this rule change will be to eliminate competition which ultimately results in wider and less liquid markets.
4. The fundamental basis for the existence of the exchange is to provide liquidity and a fair an orderly marketplace. This rule simply addresses the issue of who gets to be on the Contra side of an order.
5. The CBOE rule change will create a new class of "public customer" known as "Professional customer". The CBOE argues that "Professional customers" "compete effectively with broker-dealer orders and market maker quotes for execution opportunities in the **CBOE marketplace.**" By its own admission the CBOE points out that they are seeking a rule change to eliminate competition from the marketplace. The CBOE argues the purpose is to protect the "public customer." This argument is disingenuous and has no basis in fact. The CBOE nor the ISE have any research or documentation to support the argument that the public customer, is in fact being denied order execution opportunities as a result of the competition from the "Professional".
6. The SEC needs to realize that the real reason for this rule change is that the CBOE and ISE are attempting to protect its members, PROFIT making opportunities by eliminating its competition.
7. The CBOE argues the "Professional" behaves in "much the same manner as a market-maker." While it may be true that some use theoretical pricing models in their decision making process. However, the "Professional" does not have the marketplace advantages of the CBOE member. The "Professional" does not have the time and place advantage that still exists in the marketplace. The "Professional" is not on both sides of the markets and is not permitted by the CBOE rules. More importantly, the "Professional" is not afforded the leverage that is available to the member as a result of the differences in the capital requirements. (i.e. risk based haircut versus REG-T) For these reason alone this

- new class of “Professional” is at a disadvantage to the member, and should not be forced to compete unfairly with market makers. Pricing models are widely available on the internet to all the public domain. The choice to use or not use these models by a public customer as the basis for execution is readily available to all public customers.
8. There is a simpler and more constructive solution to the unsupported CBOE concern, whereby they wish to “level the playing field for retail investors over market “Professionals.” The solution should be to use the 390 order threshold to create a “Competitive Customer” designation that retains priority but secondary to the public customer. In essence there would be two-tiers of priority. This would protect the “Competitive Customer” and alleviate the fictitious, unsubstantiated concern, raised by the CBOE. This would also keep the competition in the marketplace. It would work as an incentive for the market-makers to make more competitive pricing.
 9. The CBOE basis for the “Professional” of 390 orders is arbitrary and capricious without foundation. The CBOE argument note 15 attempts to justify the 390 by comparing to retail customer statistics from SEC ACT Release 57254 at note 11 which is a comparison to a retail customer. If the CBOE and ISE want to claim that the “Professional” designation is valid then the SEC should use the number of orders a market-maker sends in a day for a comparison, and obtain a better understanding, before allowing this rule to be placed in effect. For example, on any given day due to price fluctuations in a stock a market-maker would cancel and enter an order at a new price conservatively 10 times in a given option series. Now consider the fact that the market-maker would be on both sides of the market, the number of orders increases to 20 per option series per day. Now consider the stock symbol TIE which has in excess of 50 series of calls and puts for a total of greater than 100 series. 100 series per day multiplied by 20 orders per day equals 2000 orders per day entered by a market-maker in one symbol. Now it has been reported that some market-makers are using their trading technology to make markets in excess of 250 underlying symbols per day. So now you have market-makers entering orders in excess of 500,000 per day, per exchange and the CBOE wants to create a designation of Professional customer based on a 390 order threshold. Even if one were halve the parameters the number would be 250,000 orders per day per exchange. Now multiply that number by 5 active exchanges (Note there 7 exchanges but not all participate in all series), and you can conservatively compute 1.25 million orders per market maker or market-maker entity per day. At 5 percent that would represent 62,500 orders per day. It is incredible that the SEC would be so ignorant to allow the ISE 390 rule to be adopted. It should be noted that this information can be documented by the exchange and should be required before any decision should be made. It should also be noted that if in fact the alleged “Professional” canceled orders in the capacity of a market-maker then the adopted cancellation charges would in fact compensate the exchange handsomely. Clearly, the exchanges’ attempt to eliminate competition by adopting cancellation charges has not worked, and they are initiating this action to remove competition.

10. The rule does not sufficiently define “order.” The rule is vague and uncertain when it comes to application the number of orders. For example, a customer enters an order to buy 20 calls. The customer buys 3 calls, then buys 6 calls 10 minutes later, and finally buys 11 calls 8 minutes later. Is this 3 orders or 1 order. The rule should only be applicable on a per exchange basis. The rule is currently being calculated by the ISE on a total order basis of all exchanges. This is not clearly defined in the rule nor is it fair. In simple terms, it is ok for a market-maker to cancel and enter orders at the rate of hundreds of thousands per day but not a customer.
11. The rule creates an unfair burden on competition. There is no argument Market-makers clearly enjoy a marketplace advantage over non-member public customers. Some of the customers operate as small business entities and have entered into those businesses based on the current priority, and REGT rules. Now in attempt to remove competition and further the interest of its market-makers the CBOE has fabricated an argument based on the idea it is trying to protect its retail customer. As pointed out previously, if that concern were genuine then there is a much fairer way to address the concern.
12. The SEC needs to understand how the electronic order entry system works for the maker-maker, to realize how this rule change will remove competition from the market place. I could cite numerous examples where a market in an option series is 15 cents wide from bid to offer, and the market-makers are willing to better their bid or offer on one side. The customer that the CBOE is attempting to thwart creates the competition that forces the market-maker to improve its pricing. I will be happy to provide examples in a real-time environment. Posting examples here will only serve to have the market-makers temporarily modify their behavior until the rule is adopted.
13. With respect to liquidity in the marketplace, it is no secret that this Countries financial system was on the brink of collapse essentially due to the fact that there was not enough capital in place to support the price fluctuations in the marketplace. While this issue was not specific to Equity options, it represents an ideology whereby it would be better to have more capital underlying an execution than less. With that in mind the SEC needs to consider the fact that the capital requirement for customer is a minimum 10 x greater (in some situations 50 x greater) than that required for a market-maker. With that in mind would it not be better for the markets if the capital the Contra side of the executions were REGT as opposed to the risk based margin. Clearly, the CBOE would argue that the capital requirements are sufficient and the risk management tools are sufficient to protect the marketplace. I would not disagree, given the choice between more or less capital underlying an execution one would have to choose more. This rule change effectively removes that capital and essentially reduces liquidity.

Finally, it is crucial that the SEC realize that the primary function of the secondary exchanges is not to profit but to perfect the mechanism for a free and open market and a national market system, and in general, to protect investors and the public interest. It should also be noted that the spirit whereby the option exchanges were allowed to be established was such that customer priority be the cornerstone to promote a level

playing field, NOT to attract retail order flow as the CBOE filing would have you believe. I fear the SEC somehow has lost its sense of priority and purpose when it would consider any rule change cloaked with the idea of protecting the public when in fact, it is designed to advance the profits of its market-makers. It is not in the public interest to thwart competition and to put small business at an additional disadvantage, which will effectively be the result of this rule change. The SEC needs to rescind the adopted ISE rule change and not allow the adoption by CBOE. The Competitive customer needs to be protected by the SEC and not pushed out of the marketplace by this rule change. It is paramount that the SEC move forward with the ideology that the CBOE market-marker has all the marketplace advantages and the CBOE purpose for existence is not to advance market-maker profits.

Please note I wish to provide additional comment on the subject.

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