

April 27, 2017

**Via Electronic Mail**

Mr. Brent J. Fields  
Secretary  
U.S. Securities and Exchange Commission  
100 F. Street, N.E.  
Washington, D.C. 20549-0609  
[rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Re: File No. SR-CBOE-2016-082

Dear Mr. Fields:

The Chicago Board Options Exchange, Inc. (“CBOE” or the “Exchange”) filed a proposed rule change to specify that when an open outcry transaction occurs between a Floor Broker and a Market-Maker, compliance with priority and national best bid and offer (“NBBO”) Trade-Through requirements will be enforced against the “initiator” of the transaction (the “Proposal”).<sup>1</sup> On March 17, 2017, the Securities and Exchange Commission (“SEC” or “Commission”) instituted proceedings to determine whether to approve or disapprove the Proposal.<sup>2</sup> The Exchange submits this comment letter in support of the Proposal and to address the issues raised by the Commission.

Background and Issues Raised by the Commission

A typical open outcry transaction consists of a Floor Broker initiating the transaction by representing an order and requesting a verbal quote from Market-Makers in the trading crowd. Market-Makers respond to the representation with a quote – indicating a willingness to buy or sell at prices specific to each Market-Maker. The Floor Broker completes the transaction by executing the order against the quote(s). The Floor Broker’s function and obligation is to execute the client’s order at a price that satisfies the terms of the order. The Market-Maker’s function and obligation, on the other hand, is to abide by strict quoting requirements, including that the Market-Maker’s quotes be firm. When a Floor Broker verbally executes a client’s order against a Market-Maker’s quote, the Market-Maker cannot back out of the execution. Thus, for a typical open outcry transaction Floor Brokers not only control the precise timing of an execution

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<sup>1</sup> See Securities Exchange Act Release 79540 (December 13, 2016), 81 FR 91967 (December 19, 2016) (SR-CBOE-2017-082).

<sup>2</sup> See Securities Exchange Act Release 80270 (March 17, 2017), 82 FR 14926 (March 23, 2017) (Order Instituting Proceedings)

(as commenters have noted),<sup>3</sup> but they effectively control the price at which an order executes. Furthermore, Floor Brokers operate the tools that capture the precise times at which an open outcry order is systematized, represented, executed and reported – times which form the audit trail that permits CBOE’s regulatory surveillances to determine whether a transaction was executed in accordance with priority and Trade-Through rules.

Regardless of a Floor Brokers control over an execution’s timing, price, and reporting for audit trail purposes, CBOE rules currently require the exchange to enforce priority and Trade-Through violations against both parties to an open outcry transaction – regardless of the participant type involved (i.e., Floor Broker or Market-Maker). Recognizing the inequity of such rules and desiring more clear and sensible rules that would facilitate compliance by members, the Exchange determined to amend its rules to assign responsibility for ensuring compliance with priority provisions and Trade-Through prohibitions. Thus, the Exchange submitted the proposed rule change to specify that when an open outcry transaction occurs between a Floor Broker and a Market-Maker, compliance with priority and Trade-Through requirements will be enforced against the “initiator” of the transaction, which the Exchange believes is a fair allocation of responsibility based, in part, on the fact that the initiator controls the timing and price of open outcry transactions.

The Commission’s Order Instituting Proceedings stated the following:

[T]he Commission wishes to consider further whether CBOE has sufficiently demonstrated how absolving from liability for Book Priority and Trade-Through rule violations one party to a trade (i.e., the responder, for trades involving a Floor Broker on one side and a Market Maker on the other) while placing sole liability on the other party (i.e., the initiator, for trades involving a Floor Broker on one side and a Market Maker on the other) will foster compliance with those rules by its members and not diminish the Exchange’s ability to ensure compliance with these critically important rules.

Further, the Exchange’s stated justification for its proposal, which relies on the control an initiator has over the execution and price of the order as well as the fact that CBOE supplies its Floor Brokers with a system (PAR) that helps automate the necessary pre-trade checks, appears inconsistent with continuing to hold both parties to a trade liable when the trade is between two Market Makers or two Floor Brokers. Similarly, the proposal raises questions under Section 6(b)(5) of the Exchange Act, in that not enforcing Trade-Through and Book Priority

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<sup>3</sup> See Letter dated April 13, 2017 from Steve Crutchfield, Head of Market Structure, CTC Trading Group, LLC, Keven Coleman, Chief Compliance Officer, Belvedere Trading LLC, Scott Kloin, Chief Compliance Officer, Citadel Securities LLC, Steven Gaston, Chief Compliance Officer, Consolidated Trading LLC and Lamberson Capital LLC, Rob Armour, Chief Compliance Officer, DRW Securities, LLC, John Kinahan, Chief Executive Officer, Group One Trading L.P., Daniel Overmyer, Chief Compliance Officer, IMC Financial Markets, Patrick Hickey, Head of Market Structure, Optiver US LLC, to Brent J. Fields, Secretary, Securities and Exchange Commission (“Industry Letter”).

violations against a party based on the identity of its counter-party (i.e., not enforcing against the responder when a Market-Maker trades with a Floor Broker, but enforcing against both parties when a Market-Maker trades with a Market-Maker or a Floor Broker trades with a Floor Broker) may be unfairly discriminatory.<sup>4</sup>

### Exchange Response to Issues Raised by the Commission

As noted in our previous comment letter, the Proposal will not, in any way, change priority or Trade-Through requirements.<sup>5</sup> The Proposal simply amends CBOE rules to provide that when an open outcry transaction occurs between a Floor Broker and a Market-Maker, the initiator (generally the Floor Broker) is responsible for compliance with existing priority provisions and Trade-Through prohibitions.

The Commission is considering whether placing sole liability on one party will foster compliance with priority and Trade-Through rules by CBOE members or diminish the Exchange's ability to ensure compliance with these rules. We agree with commenters that explicitly allocating responsibility to the initiator when Floor Brokers trade with Market-Makers will increase overall compliance with these rules by CBOE members because any party henceforth initiating an open outcry transaction will be on notice that they are responsible for ensuring compliance with these rules. As noted, Floor Brokers generally initiate open outcry transactions and, importantly, already have the ability (and indeed are already obligated) to prevent priority and Trade-Through violations regardless of whether their Market-Maker counterparty is cognizant of protected prices. Floor Brokers are able to prevent priority and Trade-Through violations due, in large part, to their use of the Public Automated Routing System (PAR), which, unavailable to Market-makers, provides all relevant market data and alerts Floor Brokers when a proposed execution price may violate priority or result in a Trade-Through. In fact, Floor Brokers currently need not and should not rely on Market-Maker counterparties in order to comply with priority provisions and Trade-Through prohibitions; thus, relieving a Market-Maker's liability in this limited situation will not diminish the Exchange's ability to ensure compliance with these rules. Additionally, this standard will allow Market-Makers to more quickly and efficiently make markets, which is their primary function and obligation. Furthermore, limiting liability for priority and Trade-Through violations to one party is not novel. When an exchange receives an intermarket sweep order ("ISO") that executes against an order resting in the exchange's book, the exchange does not enforce priority or Trade-Through violations against the booked customer or its broker if it turns out the firm that routed the sweep order caused a Trade-Through by not clearing protected prices on other exchanges.

The Commission is also concerned that "the Exchange's stated justification for its proposal, which relies on the control an initiator has over the execution and price of the order as well as the fact that CBOE supplies its Floor Brokers with a system (PAR) that helps automate

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<sup>4</sup> See Order Instituting Proceedings at 14928.

<sup>5</sup> See Letter dated March 14, 2017 from Kyle Edwards, Counsel, Chicago Board Options Exchange, to Brent J. Fields, Secretary, Securities and Exchange Commission.

the necessary pre-trade checks, appears inconsistent with continuing to hold both parties to a trade liable when the trade is between two Market Makers or two Floor Brokers.”<sup>6</sup> It is not inappropriate or inconsistent for the Exchange to evaluate the typical open outcry transaction (i.e., Floor Broker to Market-Maker) and hold accountable the party that caused the transgression. As noted with ISOs, if a customer’s order resting in the book gets traded against at a Trade-Through price, the Exchange would clearly not charge the customer or its broker with violating Trade-Through prohibitions. The Exchange should similarly not be required to enforce such violations against a Market-Maker that provides a quote against which a Floor Broker executes.

The Commission also questions whether it is unfairly discriminatory to enforce priority and Trade-Through rules against the initiator when a Market-Maker trades with a Floor Broker, but enforce these rules against both parties when a Market-Maker trades with a Market-Maker or a Floor Broker trades with a Floor Broker.<sup>7</sup> It is unclear if the Commission is questioning whether the Proposal unfairly discriminates against the initiator of a transaction that occurs between a Floor Broker and a Market-Maker or unfairly discriminates against a non-initiating party when Floor Brokers trade with each other or Market-Makers trade with each other. Regardless, the Proposal is consistent with the Securities Exchange Act of 1934 (the “Act”) as it is not designed to permit unfair discrimination between customers, brokers, or dealers. First, the Exchange currently enforces priority and Trade-Through rules against both parties to an open outcry transaction. Thus, the Exchange in effect already enforces priority and Trade-Through rules against all initiators – regardless of the initiator’s identity or the identity of the initiator’s counterparty. The Proposal is consistent with the Act’s requirements that Exchange rules not be designed to permit unfair discrimination between customers, brokers, or dealers because all initiators will continue to be held responsible for priority and Trade-Through violations regardless of the initiator’s identity or the identity of the initiator’s counterparty. Second, it is not unfairly discriminatory to enforce priority and Trade-Through rules against both parties to a transaction when the counterparties are equally positioned. When Floor Brokers trade with each other and Market-Makers trade with each other, they are otherwise on equal footing because the respective parties perform similar functions; have access to similar tools; and have access to similar information. No party is more advantaged or disadvantaged than the other and, thus, it is not unfairly discriminatory to enforce priority provisions and Trade-Through prohibitions on both the initiating party and the non-initiating party in those circumstances.

Multiple commenters have expressed support for the Proposal, stating, among other things, that the Proposal assigns responsibility for compliance with priority and Trade-Through rules in a “fair, reasonable, and logical manner”<sup>8</sup> and offers a “clear and predictable framework” for enforcing such violations.<sup>9</sup> However, Lakeshore Securities L.P., expressed the belief that “all participants to a trade should share responsibility for compliance with applicable rules and

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<sup>6</sup> See Order Instituting Proceedings at 14928.

<sup>7</sup> *Id.*

<sup>8</sup> See Industry Letter.

<sup>9</sup> See Letter dated April 13, 2017 from Joanna Mallers, Secretary, FIA Principal Traders Group, to Brent J. Fields, Secretary, Securities and Exchange Commission.

Trade-Through requirements.” In response – the Exchange posits whether Floor Brokers should bear liability if a Market-Maker fails to respond to a request for a quote or fails to quote within the bid/ask differentials set by the Exchange or fails to adhere to any other requirement that arises out of the market-making function. The same logic applies in the context of this Proposal. Should a Market-Maker be responsible when a Floor Broker simply executes against the Market-Maker’s quote, which was provided as part of their market-making function? We believe it is not unreasonable for the Floor Broker to bear such responsibility.

Finally, we disagree with Lakeshore’s assertion that PAR’s capabilities are overstated. As noted, PAR provides relevant market data and alerts Floor Brokers to potential priority and Trade-Through violations. Contrary to Lakeshore’s comments, this is true for reserve orders and non-reserve orders. Even if, *in arguendo*, PAR was flawed, we agree with the FIA that Market-Makers are indeed passive participants in the typical open outcry transaction and that enforcing priority and Trade-Through prohibitions against Market-Makers generally has a negligible benefit to priority and Trade-Through compliance. With regards to the definition of “initiator,” the Exchange will consider the facts and circumstances of open outcry transactions to determine which party – Market-Maker or Floor Broker – is the initiator.

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We encourage the Commission to consider the supportive comment letters and approve the Proposal as a logical, equitable allocation of responsibility for compliance with the Exchange’s priority and Trade-Through rules. If you have any questions please contact the undersigned at [REDACTED].

Sincerely,



cc: Heather Seidel, SEC Division of Trading and Markets  
Gary Goldsholle, SEC Division of Trading and Markets  
David S. Shillman, SEC Division of Trading and Markets  
John Roeser, SEC Division of Trading and Markets