CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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OFFICE OF THE SECRETARY

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

RE: CBOE Comments on Rule File No. SR-ISE-2009-35

Dear Ms. Murphy:

We are writing in reference to the above-captioned rule filing by the International Securities Exchange, LLC ("ISE"). The filing seeks to allow certain large orders to be crossed on ISE without auction or exposure and without providing priority to orders resting on the ISE book. As detailed below, Chicago Board Options Exchange, Incorporated ("CBOE") believes that the manner in which ISE characterizes the proposal is misleading, and that the proposal should not be approved because it would set a harmful precedent in the option markets and because the proposal is wholly unnecessary to achieve ISE's stated purpose.

Summary of the Proposal

ISE is proposing a new cross order type called the Qualified Contingent Cross. As proposed, an ISE user could enter qualifying buy and sell option orders to trade against each other (*i.e.* cross) *without any exposure* to ISE participants (thus bypassing any potential price improvement), and *ahead of* any interest on the ISE best bid/offer including resting public customer orders. The cross trade would not violate the NBBO. Thus, it could not trade through quotes disseminated by other exchanges but it could trade ahead of all interest on the ISE quote. To be eligible for entry as a Qualified Contingent Cross, the cross must involve at least 500 contracts and must meet the definition of a Qualified Contingent Trade as set forth in a Commission order[1] exempting certain contingent trades from the Order Protection Rule of Regulation NMS.[2]

The Proposal is Misleading

ISE proposes to implement this new cross order type in connection with the implementation of the new options linkage plan, as if this order type were a necessary component of ISE's implementation of the new linkage. Indeed, ISE spends most of the rule filing discussing the new options linkage plan, the old options linkage plan (which is being phased out later this year), and Regulation NMS in the stock market. A common thread running through all three of those regulatory frameworks is that they involve regulation of intermarket trade-throughs and order protection. However, the ISE proposal has absolutely nothing to do with intermarket trade-throughs or order protection. As noted above, ISE's proposed Qualified Contingent Crosses would not violate the NBBO (*i.e.* they would not cause trade-throughs)- therefore they would not be in conflict with the new linkage plan, the old linkage plan, or even Regulation NMS if it applied to options. Instead, the ISE proposal conflicts with order protection principles in that public customer orders resting on ISE lose priority to Qualified Contingent Crosses and are not protected when Qualified Contingent Crosses are executed.

ISE further confuses matters by discussing the old linkage plan's block order exemption (for trades involving 500 or more contracts and with a premium value of $150,000), which allows an exchange to execute qualifying trades through the NBBO but *not* ahead of that exchange's own BBO, and how that exemption is not being carried over to the new linkage plan because there is no such block exemption in Regulation NMS and the new linkage plan is patterned after Regulation NMS. ISE eventually states that its proposal is necessary as a surrogate for the soon-to-be-eliminated block exemption because "without a Block Trade exemption, it will be extremely difficult for ISE members to effect the execution of the options leg [of a contingent trade] on the ISE." That is very misleading. It is worth restating: the linkage block trade exemption allows trades to be effected without regard for the NBBO but does not allow for such trades to gain priority over all existing interest on the executing venue's BBO. The ISE proposal would do the opposite, it would allow for trading ahead of the ISE BBO, but would not allow trade-throughs of the NBBO. Thus, an ISE user who would rely on the block

[1] Release No. 34-57620 (April 4, 2008).

[2] In the stock market's Qualified Contingent Trade Exemption, the Commission granted an exemption from Rule 611(a) for any *stock* trade-throughs caused by the execution of an order involving one or more NMS stocks that are components of a qualified contingent trade. The release defined a "qualified contingent trade" as a transaction consisting of two or more component orders, executed as agent or principal, where: (1) at least one component order is in an NMS stock; (2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent; (3) the execution of one component is contingent upon the execution of all other components at or near the same time; (4) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined at the time the contingent order is placed; (5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled; and (6) the Exempted NMS Stock Transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade.

exemption to execute a trade would NOT be able to execute that same trade under the ISE proposal. They have nothing to do with one-another.

ISE expresses its concern for the execution of stock option trades by lamenting the loss of a block trade exemption. This is puzzling because the new linkage plan (and, actually, the old linkage plan) already contains a trade-through exemption for true stock-option orders that are represented at a net price. In fact, that exemption does not even contain a 500 contract minimum. Thus, ISE members that need help in the execution of genuine Qualified Contingent Trades already have relief in the form of the Complex Trade exemption in the options linkage plans and in the Qualified Contingent Trade exemption to Regulation NMS. Thus we fail to follow ISE's assertion that the proposal "will provide customers with the flexibility needed to achieve their investment objectives."

We believe that the ISE is actually more concerned with appeasing users who regret the loss of the block trade exemption than with trying to facilitate the execution of stock option trades. This belief is supported by ISE's repeated attempts at trying to insert the block trade exemption into the new plan as it was being finalized, and by ISE's subsequent creative assertions that simple option crosses effected through any of ISE's option crossing mechanisms actually qualify for the Complex Trade exemption because they are somehow tied to stock (despite the fact that they are not negotiated and represented at a net price and even though the option traders participating in the option crosses have no idea there may be a stock "component" to the order).[3]

To clear up some of the confusion, there are stock-option strategies that are "legged into" and stock-option trades that are represented and negotiated as a package. The SEC Qualified Contingent Trade exemption and the Complex Trade exemption only apply to stock-option trades negotiated and represented as a package. It so happens that these complex/contingent orders are represented on options markets and that options markets require exposure of packaged orders before an option component can get executed on an option exchange and, consequently, before the stock component can get crossed on a stock venue (where exposure for price improvement is generally not required in connection with a cross). ISE proposes to turn this concept on its head by allowing parties to "off-line" negotiate a stock-option trade and cross *both* the options and stock without exposure. ISE confuses the matter by invoking the linkage plans and linkage exemptions (both the SEC's Qualified Contingent Trade Exemption and the Block Order Exemption *which only concern intermarket trade-throughs*) even though the proposal has nothing to with intermarket trade-throughs and everything to do with *not* requiring exposure of option orders.

The Proposal is About Order Exposure and Priority

To our knowledge, if the proposal were approved, it would be the first time the option markets allow for orders to cross without exposure to market participants and

[3] ISE now concedes in the filing that to qualify for the complex trade exemption, orders must be announced at a net price.

ahead of resting public customer orders. The ISE is not seeking to work around a linkage nuance. It is seeking to bypass its own market (public customers and liquidity providers alike) in a significant departure from the established practice of auction and exposure in the option industry.

The filing makes no attempt to explain why bypassing exposure and priority are appropriate and/or beneficial to the option markets. As previously stated, the filing doesn't even explain how the proposal really facilitates the execution of stock option orders. Further, the filing makes no mention as to why these orders need to be greater than 500 contracts to bypass exposure and priority.

The priority rules in the option markets have historically been geared toward protecting non-professional retail customer orders and, more recently on some exchanges, towards establishing priority algorithms that are applied equally to all participants with no special priorities for any subset of users. The ISE proposal, on the other hand, clearly disadvantages resting public customers (including those that turn the market). Even a large-sized public customer order on the ISE book would get bypassed and lose priority when a Qualified Contingent Cross is effected at the customer order's price. This seems detrimental to customer protections currently in place in the option markets and harmful to option market structure.

CBOE does not dispute that there may be a time and place to discuss as an industry whether extremely large options orders, by virtue of their size and potential market impact, could receive certain customized order handling treatment (although we may ultimately never support such customized treatment in listed options). What is imperative, however, is that any such potential standards be considered in a transparent and measured manner with input from all industry participants (as opposed to via a rule filing pretending to adopt some linkage-related functionality).

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In conclusion, we urge the Commission to institute proceedings to disapprove the ISE filing. Please feel free to contact us if you would like to further discuss our views.

Sincerely,

Angelo Evangelou

Angelo Evangelou
Assistant General Counsel

cc: Elizabeth King
Joanne Moffic-Silver