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CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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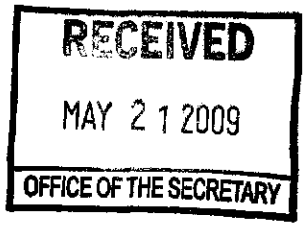

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

RE: CBOE Comments on Rule File No. SR-Phlx-2009-32

Dear Ms. Murphy:

We are writing in reference to the above-captioned rule filing by NASDAQ OMX PHLX, Inc. ("Phlx"). The filing seeks to implement enhancements to the Phlx electronic options trading platform. As detailed below, Chicago Board Options Exchange, Incorporated ("CBOE") believes that certain aspects of the Phlx proposal would have an adverse impact on CBOE as well as fair and orderly trading in the options markets, and that certain aspects of the proposal merit further review.

Use of Illusory Quotations

A central component of the Phlx proposal is to change the Phlx order handling process in instances where the Phlx quote is exhausted by an incoming order or quote. Instead of trading the balance of the inbound order at the next best price (or routing away to other exchanges), the Phlx intends to disseminate a locked market at the initial execution price comprised of (i) the balance of the inbound order, AND (ii) an exchange generated quote that has a size of ZERO. Below is an example of how this feature would work.

> Example A: The Phlx best offer is 1.30 (it is the NBBO) for 10 contracts. The 1.30 offer is a market-maker quote. An order to buy 50 at 1.33 is received. Phlx executes 10 at 1.30 exhausting the market-maker quote. Then Phlx posts a 1.30 bid for 40 contracts (the balance of the buy order) and a 1.30 offer for ZERO contracts. Per the proposed Phlx rules, this lock remains disseminated for up to one second.

The stated purpose for disseminating the locked condition is to achieve price improvement for the balance of the buy order before it trades at inferior prices or is linked to away exchanges. While that is a fine objective, it can be achieved by posting the balance of the order as the new Phlx bid WITHOUT also posting a "fake" 1.30 offer for zero contracts. Disseminating a quote with no size and that can't be hit creates significant (and unnecessary) operational problems for CBOE and undermines the

objectives of the Options Order Protection and Locked/Crossed Market Plan ("Linkage Plan").

The fake quote is operationally problematic on several fronts. First, if CBOE is disseminating a 1.31 offer, we will suspend trading at our price because Phlx is disseminating a 1.30 offer even though the 1.30 offer is not real and our price really is the new NBBO. In evaluating inbound orders for execution, our system looks to prices on away exchanges – it does not look to see if a price is quoted with a size of zero. This will cause us to unnecessarily block customer orders from obtaining timely NBBO fills because of a quote condition on another market that is not real and that serves no useful purpose. Further, it would be patently unfair if CBOE was required to divert resources to modify our systems to account for the Phlx artificial quote condition. Second, the fake quote will cause CBOE members and traders across the industry to avoid posting 1.30 bids out of concern that such bids would create or contribute to a locked market in violation of exchange rules and the Linkage Plan.

While Phlx does not state the reason for the artificial quote in its filing, we do notice that it does alleviate the obligation to honor what would otherwise be a firm quote at the next best offer price on the Phlx. We fail to see how this is in the best interest of investors or the national market system.

Phlx also proposes to use these illusory quotes in other order handling scenarios as well, including scenarios that could result in a zero size quote for up to ten seconds. For example:

> Example B: The Phlx best offer is 1.30 (it is the NBBO) for 10 contracts. The 1.30 offer is a market-maker quote. An order to buy 50 at the market is received. Phlx executes 10 at 1.30 exhausting the market-maker quote. Then Phlx posts a 1.30 bid for 40 contracts (the balance of the buy order) and a 1.30 offer for zero contracts. The lock remains disseminated for up to one second. At the conclusion of the lock timer, Phlx determines that the next best price is on CBOE which is quoting 1.70 for 15 contracts. 1.70 also happens to be the last price point at which a trade would be permitted under Phlx's proposed "Acceptable Price Range Parameters". Under that scenario Phlx would route the order to CBOE and after 15 contracts trade at 1.70, Phlx would disseminate a locked market involving the balance of the inbound buy order (25 contracts) and a 1.70 offer for ZERO contracts- for up to **10** seconds.

Although the chances of this occurring are more remote, this obviously creates the same unnecessary issues described above.

Market Exhaust Auction

In instances where there are no Phlx market-maker quotes present in a series when an order is received, Phlx proposes to initiate a "Market Exhaust Auction". This involves issuance of a notification by Phlx to Phlx market makers (specialist, SQT, and

RSQT). The notification contains series, order size and side. Market makers may respond by submitting 2-sided quotes, single-sided auction responses (called Sweeps by Phlx), and limit orders. At the end of the auction if Phlx has a quote that meets the prescribed "valid auction width", it will look at the lowest valid bid and the highest valid offer and call that the Auction Quote Range. If the order can be filled within that range, it will trade at the best price in which the entire order can be executed.

CBOE questions why better priced auction responses are ignored just because they are not large enough to fill the entire order, when the order, by its terms, is eligible for a partial fill? In the example provided by Phlx, a freshly submitted specialist quote is bypassed as part of the market exhaust auction process so the order can trade at a worse price against a limit order, an away market, and a single-sided quote response *from that same specialist.* In the Phlx-provided example: the specialist is given an auction notice that contains the size of the order. The specialist responds with a quote that is used by the system to set a valid auction width, but the size of that quote is conveniently smaller than the order being auctioned. The specialist also submits a worse priced response. The order gets filled at the worse price. We fail to see how the customer order benefits in this process.

Also of concern is that the proposal seems to contemplate that certain entitlements (such as directed order, preferred, and specialist entitlements) carry over to the final execution price in an exhaust auction. Thus, if the aggregate contra interest at the final auction price is over-subscribed (i.e. greater in size than the order being auctioned), it seems Phlx will employ its usual matching rules to allocate the order. CBOE seeks clarification on whether the entitlement would be applied despite the fact that the recipient of the entitlement (the specialist and/or directed market maker) was not even quoting the series at the time the order was received.

Lastly, we note that the exhaust auction seems to take place even if there are orders on the Phlx book. We question if those orders are allowed to participate in the auction. It seems that the auction notification is only made available to Phlx market makers.

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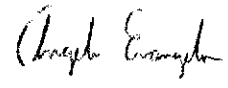
CBOE appreciates the opportunity to comment on the Phlx proposal. We are happy to discuss our comments with SEC staff.

Sincerely,



Angelo Evangelou

cc. Joanne Moffic-Silver
Timothy Watkins