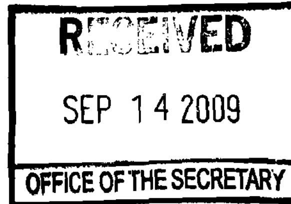

Joanne Moffic-Silver
Executive Vice President
General Counsel &
Corporate Secretary

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September 14, 2009

VIA FACSIMILE AND FIRST-CLASS MAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR-ISE-2009-35, Securities Exchange Release No. 60584
Petition for Review

Dear Ms. Murphy:

I am writing as General Counsel for Chicago Board Options Exchange, Incorporated ("CBOE"). Enclosed please find the original and three copies of CBOE's Petition for Review regarding the above-captioned matter. Pursuant to Rule 154(c) of the Securities and Exchange Commission's Rules of Practice, I certify that the enclosed Petition for Review does not exceed 7,000 words. This Petition was sent via facsimile to telephone number 202-772-9324 and via first-class mail on September 14, 2009. Also enclosed, please find a Certificate of Service and a facsimile confirmation sheet. Please be advised that CBOE intends to respond, within the required timeframe, to ISE's September 1, 2009 Motion to Lift the Commission Rule 431(e) Automatic Stay of Delegated Action Triggered by Chicago Board Options Exchange, Incorporated's Notice of Intention to Petition for Review.

Any questions concerning this matter can be directed to me at:

Joanne Moffic-Silver
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Chicago Board Options Exchange, Incorporated
400 S. LaSalle Street
Chicago, IL 60605
(312) 786-7462 (phone)
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mofficj@cboe.com

Sincerely,

Joanne Moffic-Silver
General Counsel and Corporate Secretary for
Chicago Board Options Exchange, Incorporated

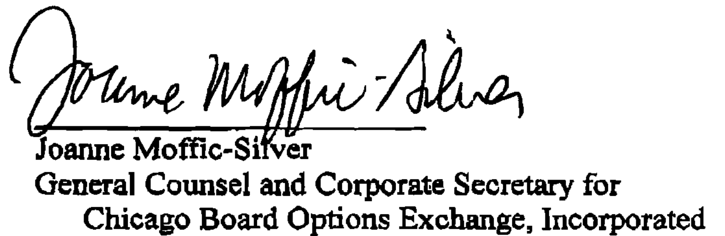
CERTIFICATE OF SERVICE

I, Joanne Moffic-Silver, General Counsel for Chicago Board Options Exchange, Incorporated, hereby certify that on September 14, 2009, I served copies of the attached Petition for Review of SR-ISE-2009-35 (Securities Exchange Act Release No. 60584) by way of facsimile, and that the original was sent that day by U.S. first-class mail to:

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Michael J. Simon
Secretary and General Counsel
International Securities Exchange, LLC
60 Broad Street
New York, NY 10004

September 14, 2009
Date



Joanne Moffic-Silver
General Counsel and Corporate Secretary for
Chicago Board Options Exchange, Incorporated

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Petition of:	)	
	)	File No. SR-ISE-2009-35
Chicago Board Options Exchange, Incorporated	)	
	)	
	)	

PETITION FOR REVIEW

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Petition of:	)	File No. SR-ISE-2009-35
Chicago Board Options Exchange, Incorporated	)	

PETITION FOR REVIEW

The Chicago Board Options Exchange, Incorporated ("CBOE") hereby requests, pursuant to Rule 430 of the Commission's Rules of Practice, 17 CFR 201.430, that the Securities and Exchange Commission ("Commission" or "SEC") review and set aside the approval by the Division of Trading and Markets ("Division" or "Staff") pursuant to delegated authority of a proposed rule change, File No. SR-ISE-2009-35 ("ISE-2009-35"),[1] filed by the International Securities Exchange, LLC ("ISE"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78s(b)(1). The Staff's approval of the filing pursuant to delegated authority involves prejudicial error, embodies a finding or conclusion of material fact or law that is clearly erroneous, and embodies an exercise of discretion or decision of law or policy that is important to investors, the options market, and CBOE, and one that the Commission should review and set aside. Indeed, the filing's approval order states that the ISE proposal represents "a change in certain long-held principles in the options markets because it

[1] *See* Exchange Act Release No. 60584 (August 28, 2009), 74 FR 45663 (September 3, 2009) ("Staff Approval Order").

would permit the execution of a cross order without requiring exposure or customer priority."[2] As described below, the filing will distort competition among exchanges, impair execution of customer orders, and violate longstanding Commission views on order exposure and options exchange markets. CBOE strongly believes that the Commission should set aside the delegated authority approval and institute disapproval proceedings.

Description of the Filing

ISE formally filed ISE-2009-35 with the Commission on June 15, 2009. The filing was noticed for public comment in the *Federal Register* on June 26, 2009.[3] CBOE submitted a comment letter on the filing on July 16, 2009,[4] which was within the prescribed comment period. Susquehanna International Group, LLP ("SIG") also submitted a comment letter on the filing on August 10, 2009.[5] CBOE understands that the Commission received ISE's final response to the comment letters ("Response Letter") on August 21, 2009.[6] CBOE was never forwarded the Response Letter and did not become aware of it until the week of August 24, 2009 when it was posted on the SEC website. The filing was expeditiously approved by the Division on August 28, 2009 pursuant to delegated authority, and published in the *Federal Register* on September 3, 2009.[7] Although CBOE drafted a response to the ISE Response Letter, it was never submitted

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[2] *See* Staff Approval Order, 74 FR at 45665.

[3] *See* Exchange Act Release No. 60147 (June 19, 2009), 74 FR 30651 (June 26, 2009) ("Notice of ISE-2009-35").

[4] *See* Letter from Angelo Evangelou, Assistant General Counsel, CBOE, to Elizabeth Murphy, Secretary, Commission dated July 16, 2009.

[5] *See* Letter from Gerald D. O'Connell, Chief Compliance Officer, SIG, to Elizabeth Murphy, Secretary, Commission dated August 10, 2009.

[6] *See* Letter from Michael Simon, Secretary and General Counsel, ISE, to Elizabeth Murphy, Secretary, Commission dated August 20, 2009.

[7] *See* Staff Approval Order.

because the filing was approved so abruptly. CBOE filed its Notice of Intention to Petition for Review with the Commission on September 4, 2009.

The filing adopts a new method to cross option orders called the Qualified Contingent Cross ("Qualified Contingent Cross" or "QCC"). As adopted, and in a drastic departure from longstanding requirements in the options industry, an ISE user could enter qualifying buy and sell option orders to immediately trade against each other (*i.e.*, cross) without any exposure to the marketplace (thus bypassing any potential price improvement), and ahead of any resting interest on the ISE best bid/offer – including resting public customer orders. Thus, the filing adopts a mechanism that facilitates unimpeded crossing. To be eligible for entry as a Qualified Contingent Cross, the cross must meet a minimum contract size threshold and must be part of a broader stock-option trading strategy that meets the definition of a Qualified Contingent Trade ("QCT") as set forth in a Commission order[8] exempting certain contingent trades from the Order Protection Rule of Regulation NMS, 17 CFR 242.611.[9]

<u>Applicable Legal Requirements</u>

CBOE is a national securities exchange registered with the Commission and is directly affected by ISE-2009-35, as described below. Rules 430 and 431 of the Commission's Rules of Practice, 17 CFR 201.430 and 201.431, provide for Commission review of Staff action taken by delegated authority upon request by a person aggrieved by the Staff's action. Rule 430 sets forth the procedural and timing requirements to file a petition for review, and Rule 431 contains the

[8] *See* Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006) ("QCT Exemption"), Exchange Act Release No. 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008) (order modifying the QCT Exemption).

[9] We note that the QCT Exemption relates only to relief from the Order Protection Rule, which generally prohibits trade-throughs in the stock market. The QCT Exemption was not drafted as a vehicle for ISE to allow option crosses without exposure.

requirements relating to the Commission's review of the petition. Rule 431 provides that the Commission, in determining whether to grant review in response to a petition such as this one, is required to look to the standards set forth in Rule of Practice 411(b)(2), 17 CFR 201.411(b)(2). This provision provides that the Commission should consider whether the petition for review makes a reasonable showing that (i) a prejudicial error was committed in the conduct of the proceeding; or (ii) the decision embodies: (A) a finding or conclusion of material fact that is clearly erroneous; (B) a conclusion of law that is erroneous; or (C) an exercise of discretion or decision of law or policy that is important and that the Commission should review. To be appropriate for review, an action by delegated authority needs to meet only one of these criteria. As we demonstrate below, however, the SEC Staff's action by delegated authority here clearly and convincingly meets each one.

Background on the Options Market

Exchanges provide a venue for buyers to meet sellers and for price discovery to occur. Market-makers perform an important function on exchanges in that they provide liquidity for the securities in which they make markets. In the stock market, a substantial percentage of trades do not involve market-makers. This reflects the significant amount of customer-driven buy/sell interest transmitted to stock exchanges on a daily basis. Customer stock orders frequently trade with other customer stock orders. The options market is different. For every stock listed on a stock exchange, there are usually hundreds of individual series listed in the options market, with each such series requiring its own bid/ask market. On CBOE, over 75% of trades consist of market-makers on at least one side of the transaction. Option market-makers provide liquidity where it otherwise would not exist. This function can only be performed, however, if market-makers have an opportunity to interact with order-flow.

This important distinction between the stock and options markets has historically been guided by a difference in how orders are permitted to be "crossed" by a broker in the stock market versus the options market. In the stock market, a broker may cross stock without subjecting the orders involved in the cross to an exchange auction. In the options market, there are strict limitations imposed by the SEC on the manner in which brokers may cross orders. Moreover, there are well-established percentage limitations on how much of an order a broker can cross with another order in that broker's custody ahead of other interest at the execution price. Importantly, those percentage limitations *only apply after a price-discovery exposure period or auction has allowed other market participants (including market-makers) an opportunity to provide price improvement.* Thus, for over 35 years a larger group of market participants have had a chance to engage in the price discovery process before any options cross could take place. This construct applies equally to electronic marketplaces and open-outcry marketplaces. In addition to allowing for price improvement for the orders being crossed, this structure also affords other market participants an opportunity to participate on trades. That participation incents a market-maker's ability to aggressively quote, which, in turn, benefits the marketplace as a whole.

In addition to general exposure of an order for price discovery, there are two other general pricing factors that come into play before a trade can be executed on an options exchange. First, the execution must be in accordance with the SEC-approved intra-market priority rules in effect for the executing venue. These priority rules may include "guarantee entitlements" such as specialist entitlements or the crossing percentages discussed above. In

those circumstances, the SEC Staff has always required customer orders to maintain priority over any "guaranteed entitlement."[10]

Second, the execution must be at a price that does not cause an inter-market trade-through in that security (*i.e.* in that option series). Until a few weeks ago, the options exchanges operated under a joint industry linkage plan (the "Old Plan") that,[11] among other things, specified the limited instances in which it was permissible to trade-through the quote of a competing exchange. One of those exemptions was for the execution of a qualifying complex trade.[12] In this context, complex trades include qualifying stock-option trades. Another exemption from

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[10] *See, e.g.*, Exchange Act Release No. 42808 (May 22, 2000), 65 FR 34515 (May 30, 2000) (order approving the ISE primary market maker ("PMM") participation entitlement for small orders of 5 contracts or less). The approval order stated in relevant part that:

> [a]lthough the Commission recognizes that intramarket competition, as well as protection of public customers, could be compromised if such a participation right constituted an absolute guarantee or if it consumed too great a percentage of order flow, the Commission believes that the ISE's proposal sets forth reasonable safeguards against such potential harms. The ISE's proposal prioritizes public customer limit orders on the book. Indeed, if sufficient existing customer interest exists, a PMM might not receive *any* allocation of a given incoming order. Moreover, a PMM's participation is directly dependent on the competitiveness of the PMM's quote as well as the number of non-customers who have entered competitive quotes at the same price at the time an order is received by the market. In addition, the size of a PMM's quote is important, because a PMM's execution is limited by the size of its quote, regardless of any participation right that ISE's allocation algorithm would otherwise prescribe. The Commission believes that these limits on a PMM's participation right should assure reasonable protection for public customers and prevent impediments to a free and open market that might otherwise result from an absolute specialist guarantee. (emphasis original)

See 65 FR at 34517.

[11] The Plan for the Purpose of Creating and Operating an Intermarket Option Linkage. *See* Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (File No. 4-429).

[12] A complex trade is defined as (i) the execution of an order in an option series in conjunction with the execution of one or more related order(s) in different option series in the same underlying security occurring at or near the same time in a ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.0) and for the purpose of executing a particular investment strategy; or (ii) the execution of a stock-option order to buy or sell a stated number of units of an underlying stock or a security convertible into the underlying stock ("convertible security") coupled with the purchase or sale of option contract(s) on the opposite side of the market representing either (A) the same number of units of the underlying stock or convertible security, or (B) the number of units of the underlying stock or convertible security necessary to create a delta neutral position, but in no case in a ratio greater than eight (8) option contracts per unit of trading of the underlying stock or convertible security established for that series by the Clearing Corporation. *See* CBOE Rule 6.80(4). Each of the other option exchanges has an identical rule. *See, e.g.*, ISE Rule 1900(d).

trade-through liability was for option trades involving 500 contracts or more (commonly referred to as the Block Exemption).[13] The new linkage plan (the "New Plan") that went into effect on August 31, 2009 does *not* contain a block exemption.[14] It does maintain the Old Plan's exemption for complex trades ("Complex Trade Exemption"). The New Plan is patterned after Regulation NMS (which applies to the stock market).

For stocks, the Order Protection Rule of Regulation NMS details the instances in which it is permissible to trade-through a protected stock quote. The Order Protection Rule does not contain an exemption for block-size stock transactions. With respect to stock-option trades, the Commission, pursuant to a request from the Securities Industry Association (now called the Securities Industry and Financial Markets Association or SIFMA), exempted certain contingent trades from the Order Protection Rule in the QCT Exemption. Like the options Complex Trade Exemption, the QCT Exemption recognizes that complex orders containing stock and option components (that meet certain ratio requirements) warrant certain flexibilities with respect to the execution of those various components which must be traded at the same time.

Background on Stock-Option Orders

Stock-option trading is a useful means to achieve investment strategies that involve stock and corresponding derivative positions. There are two methods that can be employed to fulfill stock-option investment strategies. First, a stock-option strategy can be "legged into" meaning that the investor fulfills the strategy by submitting a stock order and a separate option order directly into different marketplaces. If the various "legs" are executed, the strategy is achieved.

[13] The Block Exemption applied to trades involving 500 or more contracts and with a premium value of $150,000.

[14] The Options Order Protection and Locked/Crossed Market Plan. *See* Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546).

The other way to fulfill a stock-option strategy is through the use of a stock-option order. This is a single order transmitted to an exchange (historically these have been sent to options exchanges) that is represented and auctioned at a net price.[15] Once a net execution price is negotiated and determined on an exchange (it could be better than the price sought by the investor due to exposure of the order to price discovery on the exchange), the components of the trade are broken out and executed (the stock component is executed on a stock venue and the options component is executed at the venue where the package was represented). Importantly, execution of each component of a stock-option order is contingent on the successful execution of the other component(s).

When considering stock-option orders in the linkage context, CBOE firmly believes that the trade-through exemptions discussed in the previous section do not apply to stock-option strategies that are legged into. In those cases, the execution of each leg is subject to the regular trading, priority, and price discovery processes of the market on which the order is executed. Thus, an option leg seeking a fill must be auctioned/exposed pursuant to regular trading rules for an individual or "simple" options series order without special NBBO trade-through exemptive relief despite the fact that the investor who generated the order also has a stock leg that is part of that person's strategy. This is appropriate because the marketplace is unaware that multiple legs are involved and unaware that someone is seeking to fulfill a complex strategy.

If that same investor enters a stock-option *order*, the order is transmitted to an exchange and submitted to the price discovery process applicable to such complex orders (which is done at a net price). Once the net price is determined at the conclusion of the price discovery process,

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[15] For example, an order seeking to buy 100 shares of stock and sell 1 call (with a 55 strike price) on that stock would contemplate one total price. If the stock cost $50 a share (totaling $5,000) and the call could be sold for $2 a contract (totaling $200) the net price would $4,800. The investor would enter an order to buy the stock and sell the 55 call at a price of $48.

component orders are broken out for execution. The execution of these components qualifies for special NBBO trade-through exemptions such as the Complex Trade Exemption from the New Plan for the options leg, and the QCT Exemption from Regulation NMS for the stock leg. Importantly, though it would qualify for inter-market NBBO trade-through relief, the options leg of a stock-option order must still satisfy the respective exchange's intra-market priority rules for complex orders. In the case of a stock-option order, the Staff policy has consistently been that, at a minimum, the options leg must trade at or better than the exchange's Best Bid or Offer ("BBO") and yield to any resting public customer interest at the same price in the individual options series leg.[16]

Also importantly, whether a stock-option strategy is legged or submitted as a stock-option order, it may simply be executed with other interest represented on an exchange (a "one-sided order") or alternatively it may be presented along with a contra-side order such as a facilitation or solicited order. When crossing orders are used, the SEC policy and procedure has always been to require exposure or auction of the original options order, as described above.

Impact of the Filing

Through years of handling options exchange rule filings, Commission Staff has established, whether formally or informally, standards with respect to exchange auction and order exposure requirements and guarantee entitlements. These boundaries are very real as they are often cited by Staff as policies and long-held principles. For example, the Commission has stated:

> [T]he Commission has closely scrutinized exchange rule proposals to adopt or amend a specialist guarantee where the percentage of specialist participation would rise to a level that could have a material adverse impact on quote competition with a particular exchange. For instance, in 2000 the [Philadelphia Stock Exchange ("Phlx")] filed a proposal to raise its specialist participation to 80% for certain option orders. This

[16] *See*, *e.g.*, CBOE Rule 6.45A(b)(ii) and ISE Rule 722(b)(2).

specialist guarantee may have helped Phlx to compete with other exchanges because its specialists, all things being equal, may have been able to pay more to attract order flow than other exchanges' specialists that received a lesser guarantee. The Commission was concerned, however, that the Phlx proposal could have significantly discouraged price competition on that market by 'locking up' such a large proportion of each order that it would have hindered market makers in the crowd from competing with the specialist. The Commission believed that, over the long-term, the decrease in intramarket competition could have widened spreads and diminished the quality of prices available to investors. Moreover, the Commission was concerned that, if it approved the Phlx proposal, other exchanges could have proposed similar specialist guarantees to remain competitive, thereby permanently undermining intramarket competition on each exchange. Phlx ultimately withdrew the proposal.[17] (footnotes omitted)

Like specialist guarantees, the SEC has stated that facilitation or crossing guarantees raise competitive and regulatory concerns.[18] It is also worth noting that, to evaluate the Phlx 80/20 Proposal's potential impact - including the impact on the markets if similar proposals were implemented on all options exchanges - and determine whether it was consistent with the Exchange Act, the SEC included an extensive request for comments in the proposal release. The request for comments included, among other things, topics such as price discovery on the options markets, specialist guarantees, facilitation and customer crosses.

As acknowledged above, from time to time, approval of a filing that shifts these standards compels other exchanges to adopt the same or similar rules in order to remain competitively viable. ISE-2009-35 dramatically deviates from these established standards and, in our opinion, will have a major adverse impact on options market structure. Because the filing threatens to so significantly alter options market structure and the manner in which CBOE promotes a liquid and competitive marketplace for options, we seek to have approval of the filing reviewed before we are competitively compelled to adopt similar rules.

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[17] *See* Exchange Act Release No. 49175 (February 3, 2004), 69 FR 6124 (February 9, 2004) (Concept Release on Competitive Developments in the Options Markets ("Concept Release")), referencing Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778 (August 9, 2000) ("Phlx 80/20 Proposal").

[18] *See* Concept Release, 65 FR at 6129.

Because the proposal goes leaps and bounds beyond replacing a trade-through exemption that existed under the Old Plan, we are curious as to why ISE so feverishly seeks to eliminate exposure and priority to facilitate unimpeded crossing. Interestingly, ISE recently announced its investment in an entity which operates an Alternative Trading System ("ATS") geared towards the non-transparent execution of block size stock-option transactions. This ATS provides an electronic liquidity pool for users seeking execution of block-sized and complex order equity option trades. Like a dark pool, orders can be submitted to the ISE-affiliated ATS in search of a matching contra-side order from its subscribers. Once a match is found, the options leg of a stock-option strategy processed through the ATS must be submitted to an options exchange for execution. Important to the ATS's business model is that these option trades cross without exposure and price improvement from exchange participants. Indeed, it boasts on its website execution statistics demonstrating the high percentage of trades executed "without exchange participation." Exposing these orders to the marketplace for potential price improvement on an exchange is not an objective since it would interrupt the ability of the ATS's users to maximize participation on these trades.

The Filing is Inconsistent with the Exchange Act

CBOE believes that the Staff's approval of the filing should be set aside because the filing is inconsistent with the Sections 11A and 6 of the Exchange Act, 15 U.S.C. 78k1 and 78f. Section 11A(a)(1)(C)(ii) of the Exchange Act provides that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure "fair competition ... among exchange markets ... and between exchange markets and markets other than exchange markets," and to assure "the practicability of brokers executing investors' orders in the best market." Section 11A(a)(2) directs the Commission "to use its authority under this title to facilitate the establishment of a national market system for securities

(which may include subsystems for particular types of securities with unique trading characteristics) in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection." Section 6(b)(5) of the Exchange Act provides that the rules of an exchange must "promote just and equitable principles of trade" and "remove impediments to and perfect the mechanism of a free and open market and a national market system." Section 6(b)(8) of the Exchange Act provide that the rules of an exchange must "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title."

CBOE is a competing exchange to the ISE in the trading of standardized options. Approval of ISE-2009-35 dramatically affects the ability of CBOE and other options exchanges to compete with ISE in the trading of options in a manner that violates Sections 11A and 6 of the Exchange Act. In this regard, all of the options exchanges vigorously compete for order flow, including large options orders from market participants. Under the ISE's filing, upstairs firms will be able to arrange stock-option transactions, including the net price for such transactions, and then print the options portion of such transactions on ISE. Upstairs firms will be attracted to executing the options portions of such transactions on ISE because they will not be required to expose such orders (the option portion or the stock-option strategy) to the auction market at ISE. If such orders were sent to CBOE or other options exchanges, they would be required to be exposed to the auction markets at such exchanges. Accordingly, CBOE believes that ISE's filing gives ISE an unfair and unlawful competitive advantage to ISE over other options exchanges with respect to ISE's ability to attract large options orders from market participants. Section 3(f) of the Exchange Act requires that the Commission make a finding regarding the proposals impact on competition. The approval by delegated authority did not fully explore these competitive implications.

CBOE also believes that the ISE's filing is inconsistent with these statutory standards because it effectively establishes ISE as a print facility for large options orders rather than an exchange where orders are able to interact in an auction setting. In essence, under ISE's proposal, two upstairs parties could engage in a stock-option transaction and agree on a net price for the transaction, but choose not to transmit a stock-option order to an exchange for auction and execution. Instead, they simply would submit stock orders to cross on a stock market and separate option orders to cross on an options market. ISE's filing allows the option cross to be effected without any exposure to price improvement in the market, contrary to what has always been required on options exchanges, and to trade ahead of any resting interest (including public customer interest) at the cross price. This is a major departure from historic and existing practices in the securities markets, under which simple option orders (whether alone or paired with a crossing order) must be exposed to price discovery and under which complex orders (whether alone or paired with a crossing order) must be exposed to price discovery (at a net price).

Thus, the QCC is unfair to the customers of the sending brokers, since their orders will not be subjected to potential price improvement. It is also unfair to customers that have previously placed limit orders at the execution price of the option leg(s) since their orders are bypassed (this also creates market structure concerns since it serves as a disincentive to placing limit orders). Lastly, the QCC creates disincentives for market-makers to post liquidity – and market-maker liquidity is vital for price continuity in the options markets.

The Filing Raises Important Policy Concerns that the Commission Should Address

CBOE believes that ISE-2009-35 raises important policy concerns that the Commission should address, including whether the filing is consistent with the statutory standards discussed above. To our knowledge, this is the first time an option market would allow for orders to cross

(as a 100% guarantee) without any exposure to market participants and ahead of resting public customer orders. Yet, the filing makes no attempt to explain why bypassing exposure and priority is appropriate and/or beneficial to the option markets, especially at this time. The approval is detrimental to customer protections currently in place in the option markets and harmful to option market structure generally. In fact, it raises that same concerns that were raised in the Phlx 80/20 Proposal for specialist guarantees (see discussion on Impact of the Filing above), except to an even larger degree because here the ISE Qualified Contingent Cross would allow 100% crossing without exposure and customer yielding. Degradation of exposure and priority fosters a sluggish, nontransparent, and noncompetitive market structure, where brokers will solicit and match customer orders away from exchanges, and where neither customer limit orders nor market makers will have incentives to vie aggressively by exposing price improving orders or quotes to options exchanges.

Ultimately, the filing presents significant policy decisions for the Commission relating to (i) whether crossing straight or complex option orders without exposure is appropriate; (ii) whether effectively allowing a 100% crossing entitlement in front of public customer orders is appropriate; and (iii) whether stock-option strategies involving separate stock and option orders that are never represented on an exchange as a package (i.e. strategies that are legged-into) should qualify for any sort of relief. Such long-standing policies should not be thrown overboard by a confusing rule filing purporting to address new functionality relating to a new linkage structure. The Commission has in the past issued releases seeking industry comment on important policy matters, which would be a more appropriate vehicle for reviewing the policy issues highlighted above.[19]

[19] *See, e.g.*, Concept Release.

A. Crossing Without Exposure or Public Customer Yielding

With respect to crossing in the exchange-listed options markets, the SEC has had long-standing policies and practices to require exposure and/or yielding to public customer interest before two orders can be crossed. SR-ISE-2009-35 represents a significant departure from this precedent, because it would permit crossing of an original order with a contra-side order (such as a facilitation or solicited order) without requiring exposure or yielding to public customers.

These policies and practices balance the desire to permit internalization/solicitations to some degree while at the same time ensuring competition and price discovery and, to some degree, protecting public customers (including retail investors). Importantly, no execution entitlements – whether related to crossing or market-maker participation entitlements – have been permitted unless there is first yielding to public customer interest. Exposure requirements are satisfied on the exchanges by (i) entering a viewable agency order in the book and waiting for a minimum amount of time (i.e., one second) before entering a contra-side crossing order (the agency order must be entered first, any principal/contra-side order second); (ii) using an electronic crossing mechanism that exposes the proposed orders to other market participants for potential participation and price improvement (e.g., CBOE's Automated Improvement Mechanism or AIM, CBOE Rule 6.74A, or ISE's Price Improvement Mechanism or PIM, ISE Rule 723); or (iii) representing the orders in open outcry on a trading floor (e.g., CBOE Rule 6.74). To our knowledge, in all instances except one limited scenario, exposure is required before a cross of two paired option orders (*i.e.*, a buy order and a sell order) can occur.[20]

[20] The exception pertains to crosses involving two public customer orders, which can be crossed immediately without exposure but which must yield to resting public customer interest and meet certain other requirements, such as being priced in the standard increment and not provide an opportunity for an affiliated customer, or an arrangement where a firm realizes similar economic benefits from the transaction as the firm would achieve by executing agency order as principal, to regularly execute against agency orders as customer-to-customer immediate crosses. *See* CBOE Rule 6.74A.09 and ISE Rule 721.

The exposure requirement has been a significant matter for consideration by the SEC and options industry, as the SEC has expressed the importance of providing market participants with an opportunity to compete for exposed bids and offers. For example, when various options exchanges have sought to decrease their crossing exposure periods most recently from three seconds to one second, the SEC required the markets to survey whether other market participants would have capabilities to receive and respond to such exposed orders before the SEC allowed the timers to be decreased.[21] To allow two orders to be crossed without *any* exposure is inconsistent with these principles and is a policy matter of significant importance to the operation of the options markets, all of which warrants Commission review.

Lack of exposure also degrades transparency in the marketplace. In that regard, several Commissioners, including Chairman Schapiro, have expressed concerns about dark pools. Chairman Schapiro said in a recent speech that one of the concerns about dark pools "is that they potentially could impair the public price discovery function if they diverted a significant amount of valuable marketable order flow away from the 'lit' markets — the exchanges and ECNs that display quotes in the public quote stream," and that "it is ironic that dark pools rely primarily on the price discovery provided by the public markets to run their trading mechanisms, yet if dark pool volume were to continue to expand indefinitely, their success could threaten the very price discovery function on which their existence depends."[22] In light of these well-founded policy concerns, SR-ISE-2009-35 should not be approved without Commission input, because this ISE filing eliminates transparency and benefits, among other things, the ISE's substantial investment

[21] *See, e.g.*, Exchange Act Release No 58088 (July 2, 2008), 73 FR 39747 (July 10, 2008) (order approving reduction in exposure timers from three seconds to one second).

[22] *See* Speech by SEC Chairman Schapiro: Address before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009) (http://www.sec.gov/news/speech/2009/spch061809mls-2.htm).

in the ATS firm – a firm that matches orders off-exchange and seeks to cross those orders without exchange "interference." If the Commission intends to explore rulemaking with regard to dark pools in the near future, approval of this filing, which raises similar policy issues, seems premature at best.

B. Crossing Entitlement Limitations

To our knowledge, in all instances except two, the SEC policy and practice has been - after ensuring that all crossing entitlements are exposed and yield to public customer orders – to limit the percentage of that crossing entitlement to an amount below 50% (generally 40%) of the order being executed.[23] SR-ISE-2009-35 represents a significant departure from this precedent because it would provide a "clean" or 100% crossing entitlement without exposure and/or yielding to public customers.

C. Public Customer Priority For Simple and Complex Orders

The Exchange Act does not explicitly require public customer priority on an exchange. However, with respect to intra-market priority in the exchange-listed options markets, the long-standing industry policy and practice has been to require public customer priority for simple option orders. The exceptions relate to instances where, for example, a market ranks its resting trading interest based on a pure price-time or pro-rata matching algorithm (e.g., CBOE Rule 6.45A). However, in all instances where execution entitlements – whether they are related to crossing or market-maker participation entitlements – are applied, the SEC policy and procedure has been to require yielding to public customer interest (and exposure in the case where a market

[23] The exceptions pertain to paired orders of 500 contracts or more that are exposed and executed through an electronic auction process via ISE's Solicited Order Mechanism and CBOE's similar AIM Solicitation Auction Mechanism (ISE Rule 716(e) and CBOE Rule 6.74B), and orders for 250 contracts or more executed using open outcry "sizequote" trading procedures (*e.g.*, CBOE Rule 6.74(f), which is expired and not longer utilized). In these of these scenarios, market participants are provided with an opportunity to participate and provide price improvement. There is also exposure and yielding to public customer orders before a crossing entitlement is permitted.

participant is attempting to trade a buy (sell) principal or solicited order against a resting sell (buy) order).[24] ISE-2009-35 represents a significant departure from this precedent because it would allow the options leg(s) of a Qualified Contingent Cross that is executed through a "legging" process to take precedence over public customers.

Multi-part complex orders, such as spreads, straddles, combinations, and stock-option orders are complex transactions involving executions in multiple options series and – in the case of stock-option orders – involving related products and more than one market. Though a market participant can choose to leg into a complex strategy, this may be difficult to perform and not without risk.[25] In order to accommodate the fair and orderly execution of complex order transactions, the options exchanges have rules in place that specify special trading increments and intra-market priority provisions for complex orders that are presented and executed on a exchange as a net priced package.[26] All of these special net-priced complex order priority rules require that each options leg(s) of the complex order trade at or inside the BBO and, at a minimum, price improve public customer orders in at least one component options leg. In the case of a stock-option order net priced package, the SEC policy and procedure has been to require that the option leg of the stock-option order either yield to same priced public customer orders represented in the individual options series or trade at a better price (a stock-option order

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[24] *See, e.g.*, ISE Rules 716, 717(d) and (e) and 723, as well as CBOE Rules 6.45A.01 and .02, 6.74A and 6.74B.

[25] For example, with legging there is no certainty that the executions will be achieved at the desired price in each component series. With legging there is also a risk of receiving executions in some series but not others and thus having unhedged positions that do not satisfy all the contingency requirements of the customer's complex strategy.

[26] With respect to trading increments, bids and offers for complex orders generally can be expressed, represented and executed on the Exchange on a packaged, net price basis in any increment. *See, e.g.*, CBOE Rule 6.42(4). This allows a member that is representing a complex order to more efficiently and effectively seek liquidity from interested buyers and sellers that are willing to satisfy all the contingencies of the complex order, not simply an individual component part.

involving multiple options series, such as a conversion or reversal, is subject to the same requirements as other complex orders).[27]

ISE-2009-35 represents a significant departure from this precedent in various respects. A Qualified Contingent Cross would not be presented as a complex order – but rather the strategy would be "legged" – yet would be subject to the regular simple order priority typically applicable to legging. Instead, a Qualified Contingent Cross would be given special priority that goes beyond the priority afforded to packaged stock-option orders by permitting to be crossed without exposure and have priority over public customers.

D. Legging Should Not Warrant Special Relief

As far as whether legging into a complex strategy warrants any special relief, the ISE acknowledges that only trades announced to exchange members as a single trade at a net price are eligible for the options Complex Trade Exemption.[28] Yet, ISE contends – and the Staff apparently has determined – that the QCT Exemption does not necessitate exchange representation of a single stock-option order at a net price. This inconsistent result can only lead to confusion in the trading community. The options trade-through exemption for the option portion of a stock-option order (the Complex Trade Exemption) requires that the stock-option order actually be an order that is exposed on an exchange at a net price, yet inexplicably, ISE concludes that the stock trade-through exemption has no such requirement.

Unfortunately, the approval order spends little time discussing these serious policy issues. We are left only with an acknowledgement that the filing represents "a change in certain long-

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[27] *See, e.g.*, CBOE 6.45A(b)(ii) and ISE Rule 722(b)(2)).

[28] *See* Notice of ISE-2009-35, 74 FR at 30652, note 8. While the Complex Trade Exemption does not use the words "announced to exchange members as a single trade at a net price," it is understood as a fundamental feature of a complex order. The QCT Exemption is no different (in fact, the SIA letter requesting the exemption contains an example that involves a complex orders being represented on the floor of an options exchange at a net price before the components are executed).

held principles in the options market" and with a statement that the filing is necessary to allow "members to retain the flexibility needed to utilize the Commission's NMS QCT Exemption for qualified stock-option transactions that are not presented as a package on an options exchange, but instead where the options and stock components are executed on separate markets."[29] As we state above, we strongly disagree that legging-into a strategy is deserving of any special relief. Further, the Staff never explains why it is appropriate to replace a Block Trade Exemption with a process that eliminates exposure and priority. It appears that important and long-held regulatory policies were abandoned without sufficient scrutiny. Indeed, if the Commission wishes to alter its views on the role of crossing in the listed options market, it should not do so through an obscure rule change by delegated authority, but rather through a more thorough and deliberative process as it did in the 2004 Concept Release.

ISE Has Consistently Distorted the Issues

ISE has attempted to justify its proposal as a necessary part of its implementation of the New Linkage Plan. However, as we highlight in our comment letter, the ISE proposal has absolutely nothing to do with intermarket trade-throughs or order protection. Under the terms of the filing, the Qualified Contingent Cross execution would not violate the NBBO and therefore would not be in conflict with the New Plan, the Old Plan, or even Regulation NMS if it applied to options. In fact, the ISE proposal actually conflicts with options market exposure principles as well as 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.

[29] *See* Staff Approval Order, 74 FR at 45665, 45666.

ISE further obfuscates matters by constantly referring to the Old Plan's Block Order exemption. ISE stated that its proposal was necessary as a surrogate for the 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." [30] That characterization was very misleading and confused potential commenters. 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 or to trade unfettered without exposure of such orders to price improvement. The ISE proposal is completely different. It allows for trading ahead of the ISE BBO, but not through the NBBO. Thus, an ISE user who would rely on the Block 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's constant referral to the Block Exemption is a red herring. When the Block Exemption existed, users still needed to expose orders in the marketplace. ISE never justifies why eliminating exposure is necessary to replace what is lost with the expiration of the Block Exemption.

In its Response Letter ISE states that "while CBOE attempts to paint our proposal as creating a new and broad change to existing trading rules, in reality we are proposing a narrowing of what is available under the current rules and the linkage plan." That is flatly untrue. As noted above, the Old Plan provides trade-through relief for block sized trades, and the ISE proposal has nothing to do with trade-through relief. It terms of the scope of what the QCC allows versus what the Block exemption allowed, consider that ISE (and most options exchanges) are typically quoting at the NBBO. Thus, because ISE is frequently on the NBBO, the Block Exemption isn't nearly as useful for unfettered crossing as the QCC which allows for

[30] *See* Notice of ISE-2009-35, 74 FR at 30652.

absolute priority at that NBBO quote- and without exposure for price improvement. We can't stress strongly enough that the QCC hijacks the QCT Exemption for use as a vehicle to facilitate instantaneous crossing of option orders that are not disturbed by the possibility of price competition or the need to protect customer priority.

In its Response Letter, ISE also states that "because the equity component of a stock-option order can be executed at any price under the QCT exemption from Regulation NMS, the pricing of the options component can be flexible." If that is the case, then why does ISE need any special exposure and priority relief? ISE hints that when the option quote is one-tick wide, relief is necessary, yet the proposal is not limited to instances where the options quote is one-tick wide. Irrespective of whether a one-tick wide market warrants priority relief, ISE offers absolutely no justification as to why the option cross should not be exposed to a price-discovery process, and instead only offers distortions and misleading characterizations.

The Scope of the Approval is Far From Limiting

Language in the approval order suggests a belief by Staff that the QCC is narrowly tailored and a relatively limited exemption. Actually, around 30 percent of non-index option volume is comprised of trades involving 500 contracts or more. An overwhelming amount of those orders are tied to stock. Thus, a more-than-sizable percent of trades effected in listed options could go "dark" if the approval is allowed to stand.

Compounding that concern is an ambiguity relating to the applicable size threshold for QCC trades. The filing places a 500 contract minimum for use of the Qualified Contingent Cross feature. We assumed that meant that every single option leg seeking to avail itself of this new feature needed to be for at least 500 contracts. However, we have been told that ISE previously informed members that multiple option components need only add up to 500 contracts. We believe that is an inappropriate reading of the rule. Either way, that raises another

major issue that should have been clarified as part of the approval and evidences that the filing was defective from a Rule 19b-4, 17 CFR 240.19b-4, perspective. Still, this ambiguity (the minimum 500 contract size requirement) is dwarfed by the other significant options market structure policies and practices that will be voided unless ISE's QCC is not permitted to stand.

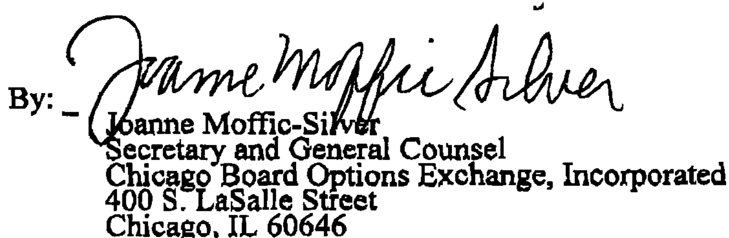
* * * * *

Conclusion

Our determination to file this petition was not made lightly, however we believe approval of the filing was a mistake, and in direct conflict with certain well-established principles in the options market, as well as completely inconsistent with recently stated Commission concerns. CBOE respectfully requests that the Commission grant our request for review of SR-ISE-2009-35. At a minimum, the SEC Staff's approval of the filing pursuant to delegated authority was an exercise of discretion or decision of law or policy that is vitally important to the options market and CBOE, and that the Commission should review and set aside the Staff's approval order.

DATED: September 14, 2009
Chicago, Illinois

Respectfully submitted,

By: 

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