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CHICAGO BOARD OPTIONS EXCHANGE

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OFFICE OF THE SECRETARY

January 13, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities & Exchange Commission
450 5th St NW
Washington, DC 20549

Re: Response to Citadel Comment Letter on SR-CBOE-2004-45

Dear Mr. Katz:

By letter dated December 15, 2004, Citadel Investment Group ("Citadel") submitted comments to the above-referenced CBOE rule filing, which proposes to automate the handling of complex orders trading on the CBOE Hybrid System.[1] The substance of Citadel's comments can be summarized in one sentence: Citadel believes that DPMs and Order Routers should have the authority to determine whether complex orders route either to the new Complex Order Book ("COB") or to PAR, and that this decision should not be made by the appropriate Exchange committees. The Exchange takes this opportunity to respond to the Citadel letter.

By way of background, currently, complex orders routed to the Exchange go to PAR, where they reside until they either are executed or cancelled. The Exchange's systems currently do not offer electronic interaction of resting complex orders. In other words, in today's world if a complex order rests on the DPM's PAR, an incoming order to trade against that resting order may only execute via manual intervention by the DPM. CBOE recognizes the limitations of this system and for this reason developed the COB. The COB allows these same complex orders to rest in an electronic format, which means they may be accessed electronically, without manual DPM intervention. This is a tremendous improvement over the current system. Citadel acknowledged that the proposed COB is an upgrade when it stated "We believe the COB will provide for more efficient executions for market participants whose complex orders are eligible for routing to COB."

Citadel asks that the Exchange cede to Order Routers[2] the ability to determine the location to where complex orders route, which raises numerous issues. From a historical perspective, the Exchange since its inception has always had the authority to determine the routing of all orders. In this regard, Exchange committees by rule and by charter have the responsibility to determine the location to where different types of orders route. For example, Rules 6.8 and 6.13 provide Exchange committees the authority to determine whether to allow orders from certain market professionals to auto-ex or whether such orders should route to PAR. Similarly, Rule 7.4 gives these Exchange committees the ability to determine

[1] Letter from Matthew Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, L.L.C., on behalf of Citadel Derivatives Group LLC.

[2] Citadel defines Order Routers as "designated primary market makers and participants who route their orders" to the CBOE.

whether orders from certain market professionals should be eligible for routing into the electronic order book.

These Exchange committees, which are comprised of a broad cross-section of CBOE members (including Market-Makers, DPMs, and order flow providing broker-dealers), weigh a host of competitive factors in making routing decisions. To arbitrarily provide to one contingent of our membership (DPMs) the unilateral ability to determine the routing parameters of certain types of orders not only usurps the right of our other member contingents to be heard, but also undermines the operating structure (i.e., the committee process) that has governed CBOE for the past 30 years. For this reason, the Committee process, where all membership factions are represented, continues to be the forum for determining CBOE routing decisions.

Practically speaking, Citadel's request for the Exchange to cede routing decisions to "Order Routers" threatens to impede any chance for the Exchange to develop a uniform routing policy. There are more than 20 firms that function as DPMs on the trading floor in more than 1,800 classes. If each DPM established its own routing parameters, CBOE's order flow providers would have to keep track of the different routing destinations for all 1,800 classes.[3] For this reason, CBOE committees adopt a much more uniform policy with respect to the classes under their jurisdiction. For example, the Equity Options Procedure Committee may determine that all order will route to PAR or that all orders will route directly to the COB. Alternatively, it may determine that for the Top 250 classes, orders will route to the COB while orders in other classes will route to PAR. This creates uniformity, which is sorely lacking in any scenario where every DPM decides on its own.

We also cannot help but think that perhaps Citadel is jumping the gun. Since the rule filing is not yet approved, CBOE committees have not even met to determine what the routing policies will be for complex orders. If they determine to route all orders to the COB, Citadel's letter is moot. Regardless of how they decide, though, committee members will continue to evaluate their decisions on an ongoing basis. Competitive forces and customer requests play a tremendous role in these decisions and if these forces tell us that the world prefers electronic complex order routing, then the Committee certainly takes this into account.

Citadel's definition of "Order Routers" is somewhat confusing in that we are not quite sure what they mean when they say that the definition should include "participants who route their orders." Would this refer to the individual customers or to the firms through whom the customers route orders? If the former, then somehow CBOE would need to monitor tens of thousands of order routing decisions everyday, one for every customer order. This onus likely would fall upon firms, who would have to collect order routing information every time a complex order is communicated to them. If the latter, then again Citadel is seeking to vest the order routing decision-making responsibility in only one contingent of our membership (order entry firms).

The Exchange is cognizant of a DPM's responsibility to manage its PAR stations and in this regard has taken steps in the past several months to reduce the number of orders that route to PAR and to enhance the DPM's ability to manage those orders more efficiently. Chief among these, several months ago the Exchange in all equity option classes reduced its Autobook timer to 5-seconds from 28-seconds.[4] This has had an impact on the number of orders that reside on a DPM's PAR station. Additionally, the

[3] Numerous order firms state a preference for marketable complex orders to route to PAR for immediate representation in the trading crowd, due to the potential for price improvement, as discussed infra.

[4] Autobook refers to the automated limit order display facility on each DPM's PAR that helps to ensure a DPM's compliance with the limit order display requirements by automatically displaying an order in the Exchange's limit order book after it resides on PAR for 5-seconds.

Exchange recently received approval to automate the handling of stop and stop-limit orders on CBOE's Hybrid trading system such that stop and stop limit orders now are handled automatically by the Hybrid system rather than by the DPM. This too has had an affect on reducing the number of orders residing on PAR. In this regard, the Exchange shares Citadel's concerns and has been proactive in addressing the issue.

Citadel neglects to mention in its letter the potential benefits associated with complex orders routing to PAR. An open outcry environment provides the ability for a trading crowd to offer price improvement, which is not possible with orders that remain in an electronic format, absent an auction, which the COB does not do. Because of their multi-legged composition, complex orders frequently may be executed at a price more favorable than that requested. The ability to offer price improvement on orders represented in the trading crowd is one of the linchpins of CBOE's Hybrid Trading System, which combines the best of both the electronic and open outcry trading worlds. A mandated electronic routing policy takes away an advantage that CBOE has enjoyed for the past 30 years.

Two of the last three main paragraphs of Citadel's letter contain some inaccuracies, which CBOE takes this opportunity to clarify. First, the letter states that ". . . routing orders to COB increases transparency in the marketplace because such orders would be disseminated to all market participants." We agree with Citadel's assertion that a COB increases transparency (that's why we built it), but not for the reason Citadel advances. Complex orders resting in any electronic book, whether CBOE's or ISE's, are not disseminated through OPRA as OPRA does not have the capability to disseminate complex orders. Rather, transparency increases because those members with an interface to the Exchange now have the ability to view, and interact with, those orders electronically.

The next inaccuracy is Citadel's belief "that such orders would have more opportunities for price improvement…." Complex orders in the COB, like non-complex orders in the electronic book, that are executed electronically will receive their stated price. As described above, our system does not currently incorporate an auction process, which negates the possibility for electronic price improvement. The potential for price improvement today comes from the liquidity pool in open outcry.

Finally, in the second to last paragraph we believe that Citadel has confused the rule filing process with the regulatory circular process when it notes "CBOE regulatory circulars require significant time to draft and receive approval from the Securities and Exchange Commission." Actually, compared to rule filings, the regulatory circular process can be a walk in the park. They are easy to draft and they rarely require SEC approval. In fact, CBOE staff on occasion have been known to procure same day turnaround in the regulatory circular process, which entails writing it, having it reviewed, assigning it an identification number, sending it to the copy center, and distributing it to the floor. We believe this efficient process should allay Citadel's fears that changes to the order routing process take too long to implement.

Finally, we ask you to consider the source of the letter. Citadel has built a very successful business model around technology. The more orders that go into an electronic format, the more Citadel stands to benefit by being able to trade with those orders by virtue of its faster systems. Citadel is a valued member of this Exchange however its business model is not necessarily the same as those of our other 930 members. For the past thirty years, and for as long as CBOE remains a member-owned Exchange, the decision-making process has been, and will remain, the purview of the Exchange or CBOE Committees, not individual members. In making order routing determinations, CBOE members will consider the preferences of all members, including our order flow providers, who may or may not prefer the opportunity to receive price improvement for orders they bring to the CBOE.

The fact of the matter is that Citadel's letter raises no legal or substantive issues to merit delaying approval of our complex order rule filing. Rather, the letter does nothing more than convey one member's desire to make decisions for all other members without regard for their input. We urge the Commission to approve the rule filing promptly.

Please contact me at (312) 786-7416 if you have any questions regarding our complex order filing.

Sincerely,

Stephen M. Youhn
Managing Senior Attorney

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