CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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<u>**Via Facsimile and Federal Express**</u>

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: ISE Comments on SR-CBOE-2004-71

Dear Mr. Katz:

As requested by the staff of the Securities and Exchange Commission ("Commission") Division of Market Regulation, this letter responds to comments submitted by the International Securities Exchange ("ISE") regarding Chicago Board Options Exchange, Incorporated ("CBOE") filing SR-CBOE-2004-71. The filing proposes to modify the distribution of the Designated Primary Market-Maker ("DPM") participation entitlement for orders specifying a preferred DPM. The ISE comments, while provocative, are not meaningful and do not merit delaying approval of the filing. We will attempt to respond to each of ISE's points below.

Specialist Guarantees

ISE postures that the proposal would "move the CBOE away from traditional exchange auction market principles" and that an entitlement based on a non-competitive status and simply due to a firm's designation as specialist would be inconsistent with the Commission's "longstanding polic[ies] with respect to specialist entitlements." Interestingly, the ISE's strong convictions in this regard did not stop it from implementing rules that allocate **100%** of orders for five or fewer contracts to the ISE Primary Market Maker (PMM) based solely on its status as PMM.[1] Further, we believe that the Commission's policies relating to specialist entitlements are centered around establishing a reasonable cap on the percentage of an order that can be allocated via a participation entitlement- we do not propose to increase our existing percentage.

ISE indicates that our proposal will have a negative impact on quote competition because non-Preferred e-DPMs would not receive any portion of the participation entitlement, implying they would not participate on any order executions. First, all e-DPMs quoting at the best price participate on orders based on the larger of the applicable participation right percentage or the allocation the e-DPM would receive under CBOE's matching algorithm.[2] Second, while e-DPM A may not receive a participation entitlement if e-DPM B is designated as the Preferred DPM on an order, e-DPM A will not receive a participation entitlement when *it* is the Preferred DPM unless it continues to quote at the NBBO. Thus, there will be no negative impact on quote competition.

[1] See ISE Rule 713.01(c).
[2] The Exchange's Hybrid matching algorithm is set forth in Rule 6.45A.

ISE also claims that "specialist guarantees should not be structured as ways for firms to attract or internalize order flow." To imply that existing specialist guarantee rules on the various options exchanges are not ways for firms to attract or internalize order flow is questionable at best. We believe it is constructive to look at ISE's assertions while keeping in mind certain existing options market realities:

- Payment for order flow (PFOF) exists in the options markets. Much to the dismay of CBOE (and apparently ISE), it is a reality that options exchanges and options specialists must deal with. ISE has a strong PFOF program, and ISE PMMs undoubtedly engage in PFOF just as do many specialists on other options exchanges.

- The Commission has allowed options exchanges to adopt specialist entitlements for up to 40% of an order. Commission focus has been on the size of the guarantee percentage, not how it is distributed. CBOE and ISE have chosen to cap their specialist entitlement rules at 30% (well below the accepted threshold).

Keeping those factors in mind while reviewing relevant rules, reveals that an ISE PMM that pays for order flow will receive a guaranteed minimum **30%** allocation (provided it is quoting at the NBBO) when those orders that it pays for are routed to ISE. On the other hand, under existing CBOE rules, a DPM that pays for order flow will receive a guaranteed minimum **15%** allocation (provided it is quoting at the NBBO) when those orders that it pays for are routed to CBOE, and an e-DPM that pays for order flow will receive a minimum guaranteed percentage in the neighborhood of **5%** (depending on the number of e-DPMs in that class and, of course, provided it is quoting at the NBBO) when those orders that it pays for are routed to CBOE. Under CBOE's proposal, the Preferred DPM would receive a guaranteed minimum **20%** allocation when it is designated as the Preferred DPM by the order sender (and provided it is quoting at the NBBO).

Thus, we fail to see how our proposal is any more of a burden on quote competition than the ISE's existing framework (in fact, we don't think it is a burden on quote competition). Both exchanges use specialist entitlements that can remove up to 30% of an order from other participants. We are not proposing to raise our specialist entitlement above 30%, we are merely redistributing the allocation of the entitlement within the DPM Complex to reward a DPM or e-DPM for bringing order flow to our market AND for quoting at the NBBO (as indicated above, our proposal still wouldn't match the 30% received by an ISE PMM[3]).

Indeed, our proposal *does* promote quote competition unlike proposals being submitted by the ISE. For example, unlike the ISE Directed Order proposal,[4] the Preferred DPM would not be afforded an opportunity to preview an order to determine if it wants to trade with the order. Further, the Preferred DPM would need to be quoting at the NBBO in order to participate in the execution and could not sit outside the NBBO with a less-than-competitive quote and still participate on orders. Thus, applying the ISE's logic, it is the ISE that is employing a specialist entitlement system, and pursuing initiatives, that are a burden on quote competition and "contrary to a free and open market and a national market system in that [they] perpetuate the routing of order flow not to the most competitive market, but to the market where the broker has a relationship with the market maker."

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[3] Of course, the 30% is in addition to the 100% ISE PMM lock-up for 5-lots.

[4] See SR-ISE-2004-16.

ISE also implies that attracting order flow to an exchange is not consistent with a specialist's obligations. We note that the various obligations of CBOE DPMs have always included duties such as to "promote the Exchange in a manner that is likely to enhance the ability of the Exchange to compete successfully for order flow" (see Rule 8.85) and to act "in ways reasonably designed to make the Exchange competitive with other markets" (see Rule 8.88).

In response to ISE's assertions that we provide no legal basis or analysis in support of our proposal, we feel that our legal analysis has been more than sufficient, however we would be happy to incorporate language that is more appealing to ISE such as the following statutory basis statements taken from two recent ISE filings:

- *The basis under the Securities Exchange Act of 1934 (the "Exchange Act") for this proposed rule change is the requirement under Section 6(b)(5) that an exchange have rules that are designed to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, this rule change will allow the Exchange to better compete with other options exchanges, while assuring the fair handling of Directed Orders.*

- *The basis under the Securities Exchange Act of 1934 (the "Exchange Act") for this proposed rule change is the requirement under Section 6(b)(5) that an exchange have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, the proposal will permit members to provide liquidity to customer orders in a more timely basis, thus providing investors with more speedy executions. At the same time, it will preserve a reasonable period for orders to interact in the auction market.*

Lastly, the ISE expressed that it fails to understand why attracting well capitalized firms to make markets on our exchange serves to protect investors and the public interest. We fail to understand how ISE fails to understand that well capitalized firms are capable of making more liquid, competitive and stable markets than poorly capitalized firms and how liquid, competitive, and stable markets benefit investors.

Restrictions on Internalization and Preferencing

In this section of the ISE letter, the ISE attempts to characterize our proposal as an internalization or facilitation program.[5] That is not the case. It is a proposal to redistribute (not increase) CBOE's DPM participation entitlement. To the extent a liquidity provider causes orders to be routed to CBOE in connection with our proposed rule and that order is automatically

[5] In doing so, ISE postures that CBOE's program should be limited to orders larger than 50 contracts, even though it acknowledges that actual internalization programs exist today (like its own PIM program or the BOX's PIP program) that effectively have no 50 contract minimum.

executed at the NBBO without exposure to an auction, it is no different than if a liquidity provider causes orders to be sent to ISE to take advantage of ISE's PMM participation entitlement (or the PMM 5-contract cartel) and those orders are automatically executed without an auction. Last we checked, ISE did not limit the application of its entitlement to only orders that are larger than 50 contracts. We do not believe that we are proposing any sort of new internalization mechanism.

ISE also expresses concern that we have no safeguards in place to protect against an order flow provider notifying a Preferred DPM of an incoming order. To the contrary, CBOE Rule 4.18 expressly prohibits this sort of misuse of material, non-public information. Ours rules already preclude the inappropriate conduct described by ISE. Of course, under ISE's proposed Directed Order process, no such notification is necessary because a directed order recipient need not be quoting at the best price in order to receive a directed order and internalize 40% of the order. In short, these "concerns" expressed by ISE are not meaningful.

We hope you agree that this letter sufficiently responds to the ISE's various contentions. We do not believe that the ISE's comments merit an amendment to our filing or any delay in approval of the filing. Please call me with any questions regarding this letter or the proposal at (312) 786-7464.

Sincerely,

Angelo Evangelou

cc: Elizabeth King
John Roeser
Joseph Morra
Theodore Venuti
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Joanne Moffic-Silver