CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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SR-CBOE-2005-60-3

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Via Federal Express

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Citadel and BSE Comments on SR-CBOE-2005-60

Dear Mr. Katz:

This letter responds to comments submitted by Citadel Derivatives Group LLC ("Citadel") and the Boston Stock Exchange ("BSE" or "BOX") regarding Chicago Board Options Exchange, Incorporated ("CBOE") filing SR-CBOE-2005-60. The filing proposes to adopt an automated improvement mechanism ("AIM") to allow a member representing an agency order to electronically execute that order against principal interest or a solicited order after the agency order is exposed to a brief electronic price-improvement auction. We do not believe the Citadel and BSE comments warrant delaying approval of the filing, nevertheless our responses to their points are provided below.

Citadel Comments

The focus of the Citadel letter is to express concern with mini-auctions and internalization in general, stating that such auctions hinder price discovery and discourage aggressive quoting. In its letter, Citadel acknowledges that other exchanges already operate mini-auctions that have been approved by the Securities and Exchange Commission ("Commission") and requests that the Commission evaluate and/or reconsider whether such auctions are beneficial to the marketplace. The letter does not comment on any unique aspect of the proposed AIM system.

CBOE believes that, for obvious competitive reasons, it should be allowed to adopt its own version of a "mini-auction" as long as other options exchange are allowed to operate such auctions. To the extent the Commission has determined that these mini-auctions are consistent with the securities laws, the AIM system should be allowed to compete with comparable programs offered by other exchanges. If the Commission determines to undertake the evaluation recommended by Citadel, we believe the AIM proposal should still be approved so that CBOE can compete for business that is currently being conducted through the mini-auctions and if any action is taken by the Commission with respect to mini-auctions, it should affect the exchanges equally and at the same time.

BSE Comments

On the opposite end of the spectrum from Citadel sits BSE/BOX. The BOX Price Improvement Period ("PIP") was the first "mini-auction" to operate in the options markets. BSE champions the positive impact of PIP on customer option orders, but predictably is "concerned" that the introduction of competing models like AIM could cause customers undo harm and "reduce liquidity on the CBOE".[1]

In its letter, BSE outlines six areas of concern. They are described below along with CBOE's responses to each.

1. Auto-Match Feature

In creating an auction program that would be unique, competitive, and offer customers the greatest value, CBOE believed a key component would involve a "blind" auction. That is, auction participants would not see other responses. This encourages a participant to put its best foot forward. If a participant does not know how other responses are priced and when the auction period will terminate, it creates a great incentive to submit its best price immediately. In contrast, if a participant is allowed to see other responses, it is encouraged to only submit the least amount of improvement it can get away with.

For example, a buy order is auctioned while the national best offer is 1.20. A participant's pricing model may dictate a willingness to sell the option at 1.16, but if that participant knows that it will have a chance to see all other responses it is competing with, it will naturally only submit a response of 1.19 and wait to see if that is improved upon by others before submitting a better price. There is no risk to that strategy. In a blind auction, there is great risk to submitting 1.19, and the participant is encouraged to submit its best price immediately instead of taking a wait and see approach.

BOX states that under the AIM structure "Members simply do not have enough information to make a fully-informed decision about how to compete for the agency order." We can't figure out what BOX means other than "traders won't be able to ascertain the highest/lowest possible sell/buy price that will be acceptable in order to participate in the execution of an agency buy/sell order". That seems like an odd thing to comment on, and if anything, BOX should consider how less robust the PIP auction is without a blind auction.[2] Of course, the PIP was built to provide order flow providers and liquidity providers that have purchased order flow a vehicle to receive a guaranteed participation against that "captive" order flow. Which leads us to the auto-match feature of AIM.

Because AIM is a blind auction (which we chose to pursue because of the superior pricing we believe it affords customers), we sought a method by which the submitting firm could still receive some sort of guaranteed participation. It is hard to argue that mini-auctions are not structured to allow firms to receive a guaranteed participation. On BOX, if the submitting firm

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[1] CBOE appreciates BSE's efforts to maintain liquidity levels on CBOE despite the fact that we are competitors.

[2] Unlike AIM, the PIP allows participants to see all responses.

matches the best auction price (which it can do because it sees the auction prices unfold), the submitting firm receives a guaranteed percentage of the agency order (generally 40%). Auto-match is an AIM feature the submitting firm can select *before* the auction starts that commits the firm to matching the price and size of every auction response. While this by default will always guarantee that the firm matches the best price and receives a participation, it also doubles the liquidity available at each auction response price point (which unlike BOX is available to unrelated orders), and, it also takes pricing control out of the firm's hands.[3] BOX's central contention about this feature is that it affords the submitting firm an advantage not available to other auction participants. BOX is worried that submitting firms would get a special break under our AIM program. There is a bit of hypocrisy to that contention. As far as we can tell, the PIP affords a 40% guarantee only to the submitting firm. Isn't that an advantage that is not available to other participants? That special break didn't seem to trouble BOX. Further, we do not expect that auto-match will be used by all submitting firms, but it was necessary to offer in order to use a blind auction and effectively compete with PIP for orders from firms that are trying to maximize participation.

In this section of the BOX letter BSE also claims that because auto-match is a feature within the AIM system, the submitting firm using auto-match will have the fastest auction response time (i.e. some sort of technological advantage). This complaint indicates that BSE does not really understand how auto-match will work. Auto-match is something you select before the auction. Once it is selected, *firms do not submit responses*, they must be good for whatever responses are received from other participants. There is no technological advantage.

2. Treatment of Opposite Side Unrelated non-Marketable Orders

Under AIM, if the CBOE Hybrid system receives an unrelated non-marketable limit order on the opposite side of the market from the agency order and the unrelated order improves any RFR response, the auction will end and the unrelated order and the agency order will trade at the midpoint of the best RFR response and the unrelated order's limit price. For example, a buy order is submitted for auction while the national best offer is 1.20. After 1 second, an unrelated limit order to sell at 1.15 is received while the best auction response is 1.17. The auction will end, and the unrelated order will trade with the agency order at *1.16* to the fullest extent possible. This affords price improvement to BOTH orders.

Amazingly, BSE has a problem with this. First, they claim that the unrelated order should just be treated as an auction response. Second, they claim someone could manipulate the auction by submitting a small non-marketable unrelated order on purpose to end the auction prematurely.

In response to the first point, we feel it is appropriate to provide both orders with price improvement, not just the order that was submitted by the order flow provider for a guaranteed participation. Further, if the BSE really wants to make the PIP auction responses more meaningful, they would allow unrelated orders on the same side as the agency order the benefit of the improvement prices offered during the auction. Instead, they allow those orders to skip price improvement and trade against the wider disseminated BOX market.

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[3] In crafting the AIM system, CBOE sought feedback from member firms that might be prospective AIM users and the feedback was far from unanimous on whether the auto-match feature would be widely used. In other words, many firms will not want to surrender the prices of their responses to forces outside of their control.

As to point number two, BOX is concerned that someone could inappropriately end the auction early in a manner that is "contrary to the basic tenet of the federal securities laws which purport to mitigate the likelihood of such manipulative conduct." We agree that terminating the auction for such purposes would be inappropriate, however we are concerned that BSE may not be aware that such conduct is also possible on BOX during a PIP. Section 18(h) of BOX rules provides that the PIP will conclude early if an unrelated order is received by BOX on the same side of the market as the agency order. Couldn't that unrelated order be a one-lot submitted by someone for the purpose of ending the auction prematurely? Of course it could. At CBOE, we added an interpretation to the proposed AIM rules (Interpretation and Policy .02) spelling out the regulatory consequences for a pattern or practice of submitting unrelated orders to end the AIM auction prematurely.

3. Lack of an Initial Price Improvement Increment for Certain Orders in an AIM Auction

Like PIP, the submitting firm in an AIM auction provides a stop for the agency order. However, the proposed AIM rules provide that for orders of 50 contracts or more, the stop price should equal the better of the NBBO or the agency order's limit price. BOX is unhappy with this because the PIP requires the stop price for all orders to be one penny better than the NBBO. BOX fails to understand that on virtually all of the options exchanges (in fact, all but BOX), a guaranteed facilitation participation is allowed at the NBBO for orders greater than 50 contracts. This is no different.

4. Definition of the Matching Algorithm

The AIM rules state that execution of an agency order will be allocated "pursuant to the matching algorithm in effect for the class." Thus, if we trade an equity option under our Hybrid Ultimate Matching Algorithm contained in Rules 6.45A for equity options (we use Rule 6.45B for index products), that is the algorithm we will use for an AIM allocation. What is confusing about that? If BOX is concerned that we do not actually reference Rule 6.45A and 6.45B in our AIM rules and that without such references we could use some undefined rogue matching algorithm that is not in our rules, then we will be happy to include the reference.

5. Ability and Process of Soliciting Potential RFRs

This is the strangest section of the BSE letter. The AIM rules allow a member that represents agency orders to submit an agency order along with principal interest (a facilitation order) *or* solicited interest (a solicitation order) into the AIM auction. As an initial matter, BOX believes the solicitation process should be described in greater detail. BOX then goes on to posture that it built its Directed Order process (which BOX characterizes as a solicitation mechanism) for investor protection purposes. Lastly and incredibly, BOX states that solicitation should only be allowed for orders of 300 contracts or more despite the fact that BOX's self-proclaimed solicitation mechanism- the Directed Order process- has no such limitation.

To the first point, AIM is not proposing to introduce the concept of solicitation to the options markets. Solicited orders are processed on the floor of all of the floor-based options exchanges. CBOE is proposing nothing new here. More relevant though, is the fact that the International Securities Exchange ("ISE") Price Improvement Mechanism ("PIM"), also a mini-auction, is identical to AIM in that it allows the submitting firm to "pair" the agency order with a facilitation order or a solicitation order. PIM rules do not contain elaborate procedures explaining the solicitation process, yet PIM was approved and is currently in operation. AIM rules should not require such elaboration either. Nevertheless, proposed Interpretation and Policy .04 provides that solicited orders submitted by the Initiating Member may not be for the account of a Market-Maker assigned to the option class.

Next, BOX states that the "BOX Directed Order rules allow any firm to solicit a willing market maker for price improvement, regardless of whether or not they have an established relationship." Our first response to that point is: so what? and what does it have to do with our AIM proposal? We are not proposing to emulate BOX's Directed Order process.[4] Second, we would like to note a few things about the Directed Order process that BOX fails to mention. For instance, while AIM affords all Market-Makers an equal chance to participate via the auction (and remember, they cannot be solicited) where they all receive the same information at the same time, the Directed Order process allows the market maker that has a relationship with the order provider to get a 3-second preview of the order to decide whether it is submitted to the PIP or discarded. No other market makers on BOX get that preview. As to BOX's boast that price improvement is achieved "whether or not they have an established relationship", we are skeptical. It is our understanding that BOX market makers will frequently categorically deny a PIP opportunity for orders they receive based on the identity of the order sender (i.e. discard directed orders from those they don't have relationships with). CBOE believes it is inappropriate to tout the Directed Order process as some sort of price improvement mechanism for all comers when in fact BOX provides the identity of the sender to the directed order recipient so that orders can be filtered based on the identity of the sender.

Lastly, BOX lobbies for a limit on solicitation based on order size. As a first step in addressing this concern, BOX should adopt size limits for its Directed Order process. Unless other exchanges are made to adopt such limits, it seems inappropriate to only impose such a limitation on CBOE.

6. Ability of Floor Brokers to Submit RFRs

In this section BOX complains that it would be cumbersome, if not impossible, for a CBOE Floor Broker to submit responses on behalf of customer order resting at the top of the CBOE book. We presume BOX contemplates an actual individual on the floor of CBOE when they make this assertion. We also presume that BOX is not aware of Amendment No. 2 to our AIM filing (submitted on October 11, 2005) that replaced the term "Floor Broker" with "Members acting as agent for orders resting at the top of the Exchange's book."

Like BOX, CBOE proposes to allow members representing customer orders to actually represent those customer orders during an AIM auction. It would be incumbent on the member to do that (we presume it would be contemplated with the customer at the time the customer order was submitted and electronically pre-programmed by the member) and we don't see how it is any different from the fact that BOX rules require *an OFP* to submit the CPO after the initiation of a PIP for which the customer CPO is eligible (See BOX Sec. 18(g)(v)). In both cases, the member has to act during the PIP based on instructions received from its customer.

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[4] ISE did choose to adopt a directed order process as well as a solicitation option within the PIM process.

We feel this letter sufficiently responds to the comments on our AIM proposal. Please call me with any questions regarding this letter or the proposal at (312) 786-7464.

Sincerely,

Angelo Evangelou

Angelo Evangelou

cc: Edward J. Joyce
Joanne Moffic-Silver
Deborah L. Flynn (SEC)