



INTERNATIONAL SECURITIES EXCHANGE®

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September 12, 2005

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

Re: File No. SR-CBOE-2005-71

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") appreciates the opportunity to comment on a recent proposal ("Proposal") by the Chicago Board Options Exchange, Inc. ("CBOE") to reduce certain transaction charges in options on the DIAMONDS® Trust ("DIA"). We are concerned that the proposed fee reduction does not apply to non-member market-makers, whether they send orders in DIA options to the CBOE directly or through the intermarket Linkage. As a result, non-member market makers will continue to pay the current fee, which, depending on the option's premium, could be almost twice as much as CBOE market makers for transactions in DIA options.

The Proposal is patently anti-competitive and goes well beyond what the Commission previously has permitted when distinguishing between member and non-member fees. Furthermore, the CBOE for the first time is proposing fees for Linkage transactions that are different – and far greater – than member market maker execution fees. Finally, we believe that the CBOE's filing does not comply with the procedural filing requirements of Rule 19b-4 under the Securities Exchange Act of 1934 ("Exchange Act") and, based on the sparse discussion in the filing, the Proposal does not meet the substantive requirements of the Exchange Act. We urge the Commission to reject the filing as not in compliance with Exchange Act filing requirements, or, alternatively, to institute proceedings to disapprove the Proposal.

The Exchange Act requires that the rules of an exchange provide "for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities."¹ Furthermore, an exchange's rules cannot be designed to permit "unfair discrimination between customers, . . . brokers, [or] dealers"² The Proposal is inconsistent with these requirements. Under the Proposal, for DIA options the CBOE seeks to charge:

- CBOE market makers \$0.24 a contract;
- CBOE members \$0.15 a contract for customer orders;
- CBOE members \$0.25 a contract for broker-dealer orders;

¹ Exchange Act Section 6(b)(4).

² Exchange Act Section 6(b)(5).

- CBOE members either \$0.27 a contract (if the premium is less \$1) or \$0.47 a contract (if the premium is greater than \$1) for the orders of non-member market makers; and
- Non-member market makers who access the CBOE through the intermarket Linkage either \$0.25 a contract (if the premium is less \$1) or \$0.45 a contract (if the premium is greater than \$1).

The filing does not even attempt to explain the statutory basis for charging non-member market makers up to \$0.23 more than CBOE market makers for the same service. Nor does the filing even mention that this is the first time that any exchange effectively is imposing a surcharge for Linkage transactions. Rather, the filing simply contains boilerplate language that the Proposal will provide for an equitable allocation of fees, without providing any substantiation for that conclusion.

This is not the first time the CBOE has proposed fees that discriminate against non-member broker-dealers. In 2003 the CBOE proposed to raise its transaction fees for non-member market makers by \$0.02 a contract.³ We objected to that proposal, arguing that the filing was discriminatory and anticompetitive.⁴ The Commission approved the 2003 Filing over our objections, noting that "while the fee distinguishes between member and non-member market makers . . . it does not do so in a manner that imposes a significant cost burden on the non-member market makers who send their orders to CBOE." The Commission further stated that the Exchange Act does not require that members, issuers, and others "pay the same fees for use of an exchange's facilities, but that the fees assessed these categories of users must be equitably allocated, *i.e.*, that they be allocated in a fair manner." The Commission then concluded that "the \$0.02 per contract fee differential for non-member market makers is reasonable under the circumstances and not unfairly discriminatory for the Exchange to charge non-member market makers a nominally higher fee than other non-members who submit orders to the Exchange."

We understand the Commission's conclusion that a \$0.02 per contract fee difference is nominal, and thus is not unreasonable or unfairly discriminatory. However, the same is not the case with the current Proposal, where the CBOE seeks to charge non-member market makers more than just a nominal fee, indeed up to \$0.23 a contract – or almost twice as much – as it charges its own market makers. Even in approving the 2003 Filing, the Commission specifically noted that "if such a fee were too large it possibly could have any adverse effect on competition." Certainly a fee nearly double the size of the fee on its own market makers is "too large."

In addition to the huge premium in fees for "front door" access, the Proposal is discriminatory and anticompetitive because it does not carve out an exception for trades executed through Linkage. Even the CBOE's \$0.02 away-market market premium in the 2003 Filing exempted Linkage trades. In approving that filing, the Commission specifically noted the exception for Linkage orders, recognizing that non-member market

³ See File No. SR-CBOE-2003-33; Exchange Act Release No. 34-50484 (October 1, 2004), 69 FR 60440 (October 8, 2004) ("2003 Filing").

⁴ See letter from Michael J. Simon, Senior Vice President and Secretary, ISE, to Jonathan G. Katz, Secretary, Commission, dated December 19, 2003 ("ISE Comment Letter").

makers would maintain access to CBOE's facilities via Linkage thus still being able to send orders that would fall outside of the proposed fee increase. This Proposal does not provide similar "back door" access to avoid the fee.

The disparity between fees charged to non-member market makers and CBOE market makers is large enough to create an economic disincentive for non-member market makers seeking to access the CBOE's market. This will decrease market efficiency and harm price discovery. Ultimately, the result will be harm to customers seeking to receive the best price for their orders. The CBOE's filing does not provide an adequate justification for this proposed discrimination against non-member market makers. Thus, we urge the Commission either to reject the CBOE's filing as not in compliance with Rule 19b-4 under the Exchange Act or to commence proceedings to disapprove the Proposal.

We thank the Commission for the opportunity to comment on the Proposal, and we are available to discuss this issue with either the Commission or its staff if you would find that useful.

Sincerely,

A handwritten signature in black ink, appearing to read "M. Simon", with a small flourish at the end.

Michael J. Simon
Secretary

cc: Robert Colby
Elizabeth King