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CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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Via Federal Express

Ms. Nancy Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Citadel and BSE Comments on SR-CBOE-2005-90

Dear Ms. Morris:

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-2005-90. The filing proposes to adopt a Simple Auction Liaison ("SAL") system. We do not believe the Citadel and BSE comments warrant delaying approval of the filing, nevertheless our responses to their points are provided below. We will first provide a brief explanation of SAL.

SAL Overview

SAL is merely a vehicle to provide price improvement over the NBBO. Today, option market quotations are expressed in nickel and dime increments. SAL will allow quoters to improve the pricing available to incoming orders by allowing trades to occur in penny increments that improve on the nickel/dime disseminated quotes without triggering full-fledged penny quoting through OPRA and all of the quote capacity issues that arise in a penny quoting environment. SAL does not have anything to do with internalization and does not guarantee any percentage of an inbound order to any market-maker or non-market-maker.

Here is how SAL will operate: When CBOE receives an order that would otherwise automatically execute against CBOE's NBBO quotation, CBOE will stop the order (i.e. guarantee its execution) at the NBBO against market-makers quoting at the NBBO and briefly auction the order for penny price improvement over the NBBO. This allows CBOE market-makers quoting at the NBBO, market-makers in that class not quoting at the NBBO, and customer orders resting at the NBBO to provide pricing that is even more aggressive than what is permissible through OPRA. To the extent multiple participants are on the best response price at the end of the auction period, preference is given to those participants that were quoting at the NBBO at the time the auction started. This is to create an incentive to quote aggressively at all times and not "lay in the weeds" away from the NBBO waiting for an auction to commence. In short, SAL promotes aggressive quoting and is pro-customer. Quite frankly, we were surprised critical comments were submitted.

Citadel Comments

We believe Citadel may have misunderstood the workings of the SAL proposal. The main thrust of the Citadel letter is that SAL is another "mini-auction" that will contribute to the erosion of the quality and competitiveness of options quotations over time. In essence, Citadel is lumping SAL in with the BOX's Primary Improvement Process ("PIP") auction. That is a mistake because unlike PIP or similar processes in place or proposed at various other exchanges, SAL does not guarantee any portion of an auctioned order to the member that introduced the order to the auction. Internalization does indeed take away a percentage of an order from liquidity providers, which in turn may impact a market-maker's incentive to quote aggressively. As pointed out by Citadel, CBOE has strong views on this matter, however SAL is not an internalization auction. If anything, by putting the whole order up for grabs, SAL encourages liquidity providers to quote even more aggressively both during an auction and throughout the trading day (to obtain better standing during an auction). Customers get true price improvement over the NBBO. Thus, Citadel's central assertion that SAL will hinder price discovery and harm investors is inaccurate.

Citadel also complains that the SAL auction is invisible and that this feature "is designed to reduce transparency and therefore will hinder price discovery and efficient and equitable trading." First, the SAL auction is invisible to OPRA because OPRA does not accept penny quoting at this time and the Exchange cannot disseminate quotations outside of OPRA that are superior to quotations provided to OPRA. It is a technical limitation and has nothing to do with an attempt to reduce transparency. Second, responses to the SAL auction are blind (i.e. auction participants cannot see each others responses) in order to *enhance* price discovery. We believe the blind auction feature encourages traders to submit the best possible prices they are willing to trade at as opposed to the least best possible prices that will get them on the trade (why improve on your competitor by three cents when you know you only need to improve by one cent?). We fail to see how it is more "efficient and equitable" to provide the least best possible price to the customer.

Citadel also expresses that SAL promotes discrimination because the proposal provides the Exchange with latitude to decide which order types qualify for a SAL auction. The options markets have a long history of providing enhanced executions to public customer orders over broker-dealer orders and market-maker orders. This is no different. The rule merely provides the flexibility to allow SAL auctions for public customer orders and not broker-dealer orders, or alternatively for public customer order and broker dealer orders that are not for the account of a market maker.

Lastly, Citadel is concerned that SAL will "freeze quotes". We believe they are referring to the stop feature of the SAL process. This feature is necessary in order to ensure compliance with firm quote obligations. If a buy order is represented to crowd members while Citadel is disseminating an NBBO 1.20 offer for 11 contracts, Citadel must be firm to that specific order for 11 contracts. This feature merely automates the fulfillment of that obligation while a brief auction is conducted to attempt to obtain price improvement for that order.

BSE Comments

The BSE/BOX letter is disturbing. It does not in any way purport to express concern that the SAL proposal is harmful to the options trading public, to the options markets in general, or even to BOX. Those would be legitimate reasons to comment on a rule filing (of course they do not apply to this filing). Instead, the BOX letter is a flat out attempt to delay approval of the proposal by raising beyond trivial concerns such as "should this requirement be written in the disjunctive versus the conjunctive?" The comment letter is heavy on quantity but light on quality or meaningfulness.

The overwhelming majority of the BOX comment letter is dedicated to asserting that the proposed SAL rules are ambiguous. This is interesting coming from the exchange that states in its rules that all trading on its market is anonymous when it fact it allows a directed order recipient to know the identity of the directed order sender in blatant violation of its rules (BOX has recently submitted a rule filing to clarify this "ambiguity"). BOX is also the exchange that continually submits rule filings to clarify the actual operation of the PIP process to address deficiencies in the PIP rules (for example, how various types of unrelated orders are handled when received during a PIP process[1]). We point this out in hopes that in the future BOX will channel energy used to critique our rules towards cleaning up their own rules. More importantly, we must stress that the proposed SAL rules are not ambiguous. We will not address the BOX letter point by point because it is full of unsupported assertions that our proposed rule is unclear and we would just be repeating ourselves to state over and over that the language is quite clear.

We will respond to the following BOX comments that are arguably more than superfluous:

BOX feels it will be unrealistic for floor brokers to manually process SAL auction information and respond on behalf of customer orders they are representing. First, we are proposing a process that is exactly the same as how the PIP was approved. Second, we agree it will be difficult for a floor broker to accomplish effective representation manually. We believe, however, that it will be entirely feasible for a brokerage firm to electronically represent orders within the prescribed time period based on prior instructions from the customer.

BOX worries that the blind aspect of the auction harms transparency. Please see our position on this in the Citadel section of this letter.

BOX wonders how allowing multiple auction responses from a participant facilitates price improvement. Well, lets try an example. A buy order for 100 is auctioned while the national best offer is 1.20. Market-Maker A is willing to trade 11 at 1.17, 11 at 1.18 and 11 at 1.19. If Market-Maker A is only allowed one response, it might not submit anything at 1.17 and it will likely not submit one response for 33 contracts. On the other hand, if Market-Maker A is allowed multiple responses all 33 contracts would be available at the price points described above. More liquidity is a good thing for the customer and facilitates price improvement.

BOX expresses that the lack of required price improvement suggests "that participants are merely required to match the Agency Order." Either this comment is attributable to a cut and paste error while extracting language from a previous BOX comment letter, or it suggests that BOX does not understand SAL. *There is no internalizer* to match in the SAL auction. Yes, all price improvement is voluntary.

BOX states that a market-maker could manipulate an early conclusion to the auction in order to assure a participation. This is true of any auction (including PIP), however the SAL rule has a provision prohibiting such conduct. It is important to note, however, that with SAL, unrelated orders ending the auction result in the auctioned orders getting healthy price

[1] For example, see SR-BSE-2004-51.

improvement over the NBBO without the presence of an internalizer. Today, non-auctioned orders get NBBO executions without price improvement.

BOX contemplates that SAL providing a stop to an order that is auctioned creates a firm quote dilemma for any subsequently received orders during the auction period. More specifically, BOX states "This would seem to present a firm quote issue." BOX does not go on to explain what that issue is. To be clear, we would execute the first order against the stopped interest (assuming no improvement pricing was received before the auction was cut short by the unrelated order) and we would trade the unrelated order against any interest in excess of the quantity that was used to honor the stop or at the next best price if it is the new NBBO.

BOX questions the manner in which SAL would trade a non-marketable opposite side limit order against an order being auctioned in SAL. By way of example, a buy order is auctioned for price improvement over the CBOE 1.20 NBBO offer. Auction responses are received at 1.17. A limit order to sell at 1.15 is received (CBOE's bid is 1.10). That order will trade against the SAL order to the fullest extent possible at 1.16 (the midpoint of the unrelated order's limit price and the best auction response price). BOX believes the 1.15 offer should be treated as an auction response and that the trade should occur at 1.15. We disagree. We have chosen to structure the auction this way to afford BOTH orders price improvement. We're not sure why BOX would not want to afford unrelated orders price improvement.

* * * * *

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

Sincerely,

Angelo Evangelou

Angelo Evangelou

cc: Deborah L. Flynn (SEC)