100 Franklin Street
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December 22, 2005

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

Re: File No. SR-CBOE-2005-90

Dear Mr. Katz:

The Boston Options Exchange ("BOX"), appreciates the opportunity to comment on the Chicago Board Options Exchange's ("CBOE") proposal to implement the Simple Auction Liaison system ("SAL"), a price improvement auction system for qualified inbound orders.

In reviewing the proposed rule filing it seems clear that there are numerous ambiguities relating to the operation and structure of SAL that are not directly addressed by the CBOE proposed rules. Because of these ambiguities it is difficult in some instances to discern the intent of certain aspects of the proposed rules. In addition, we believe that it would be difficult for market participants to understand and effectively utilize the mechanism while competing to provide price improvement as the rules are currently drafted in the proposal. As a result of these ambiguities, customer orders that participate in the SAL could be exposed to undue harm while perhaps other participants within SAL might be unfairly advantaged.

This letter discusses some of the more problematic elements of the rule proposal, including lack of clarity and specificity with respect to pivotal elements of the SAL and possible market integrity and investor protection concerns. This letter does not necessarily address all possible ambiguities or deficiencies with respect to the rule proposal. More generally, we believe the rule proposal lacks sufficient detail with respect to many fundamental elements of the SAL auction and is silent on some key issues, particularly with respect to the interaction of the proposed SAL auction with existing CBOE market mechanisms. The following areas will be addressed in this comment letter:

1. SAL Eligibility;

2. SAL Auction Process;

3. Definition of the "matching algorithm";

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4. Possible Firm Quote Violations;

5. Allocation of Agency Orders;[1] and

6. Termination of the Auction.

Below is a more comprehensive discussion of various short comings and ambiguities with respect to these elements of the SAL.

## 1. SAL Eligibility -- Need to Clarify Eligibility Rules

The SAL rule proposal fails to adequately define the universe of orders that are eligible to participate in a SAL auction. The rule proposal states "the appropriate Floor Procedures Committee" will be responsible for designating various elements of order eligibility ("Eligibility Criteria"). For example, order size, order type, order origin code and option class are not defined within the rule proposal, but rather are left to the sole discretion of the Floor Procedure Committee. The rule does not specify when the Eligibility Criteria are made and how CBOE intends to communicate the Eligibility Criteria to SAL participants. By failing to do so, SAL participants simply do not know what orders are eligible for a SAL auction. In addition, it appears that certain order types such as "all or nothing", "complex" or "strategy" or "immediate or cancel" orders would be incompatible with the SAL. This is not covered in CBOE's rule filing.

## 2. SAL Auction Process -- Lacks Clarity

Pivotal elements of the SAL auction process are at best ambiguous and at worst undefined. For example:

- ***Initiation of SAL Auction***: The rule proposal indicates that all marketable orders are eligible for the SAL auction. The rule proposal does not, however, define a "marketable order". Is marketable measured against the National Best Bid or Offer ("NBBO") or the CBOE BBO? What happens when there is a locked or crossed NBBO? What happens if CBOE quotes are locked?

  The rule proposal states that a SAL will not commence when there is a customer limit order **and** when there is insufficient MM quotes to fill the Agency Order. What do these conditions mean? Can the SAL start where there are sufficient MM quotes and there is a customer limit order? Should this requirement be written in the disjunctive versus the conjunctive?

  If the text of the rule proposal is intended to apply to situations where a SAL auction may commence if there is no customer limit order on the CBOE book **and** there is insufficient market maker depth to fill the Agency Order, then the Agency Order

[1] Terms not otherwise defined herein shall have the same meaning as defined in the rule proposal and applicable CBOE rules.

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should not be considered "stopped" at the initiation of the SAL auction. Under these circumstances, NBBO protection should be applied to the execution of the Agency Order at the termination of the SAL auction. Under the rule proposal as currently drafted, however, the Agency Order is considered to be "stopped" by the frozen quotes.

- ***Duration of the SAL Auction:*** The proposed rule filing provides that the SAL "auction will last for a period of time not to exceed two (2) seconds as determined by the Exchange on a class-by-class basis." The rule proposal does not specify when a shorter auction period will apply and how this is determined. In addition, the rule filing is unclear as to how the auction timeframe will be communicated to auction participants. In any case it seems unrealistic to expect that floor brokers would be able to process the information that a SAL is commencing, check the orders for which they are responsible and communicate an eventual SAL response order (*i.e.*, improvement order) within the two second maximum. Furthermore, even if the floor broker were able to enter an improvement order on time, there is nothing in the CBOE filing comparable to the BOX CPO rules that explain how this is communicated to the broker by the customer. BOX believes that the SAL auction as described in the CBOE filing provides very little possibility of significant competition due to the regulatory and practical limits on participation.

- ***Visibility of the Initiating SAL Order and SAL Response Information***: The rule proposal is silent as to what, if any, information is provided with respect to the initiating SAL order. In addition, the rule proposal provides "[r]esponses shall not be visible to other auction participants and shall not be disseminated to OPRA [(the Options Price Reporting Authority)]." Market transparency is a pivotal element of any securities market. Transparency facilitates investor protection concerns, market integrity issues and mitigates the potential for fraudulent conduct. The rule proposal does not articulate the underlying justification for this lack of transparency.

- ***Generation of Improvement Orders***: The rule proposal does not define the manner in which the improvement order is generated by floor brokers or OFPs.

- ***Multiple Response Feature***: The SAL auction process permits multiple responses from multiple participants in the auction. What is the justification for permitting multiple responses? How do multiple responses increase competition and facilitate price improvement for the Agency Order? Furthermore, in certain instances (*see* comments below regarding the crossing of the Hybrid System with response orders) this could make market manipulation easier for certain parties.

- ***One-Cent Increments***: According to the rule proposal, "[r]esponses *may* be submitted in one-cent increments." (emphasis added) The rule proposal does not require participants to offer any price improvement when responding in a SAL auction. This language suggests that participants are merely required to match the Agency Order. Improvement systems such as SAL, among other things, are

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intended to provide the market with increased opportunities for price improvement. It appears to be inconsistent with this underlying purpose for SAL not to require a minimum initial price improvement increment over the NBBO.

This issue with the SAL auction may not be problematic if the following three conditions are satisfied:

- Market maker quotes on the opposite of the Agency Order that are priced at the NBBO on CBOE are sufficient to fully fill the Agency Order;
- The market maker quotes are frozen at the initiation of the SAL auction in order to "stop" the Agency Order; and
- Where the Agency Order at the termination of the auction trades with the CBOE book (there being insufficient responses (*i.e.,* improvement orders) to fill the entire quantity of the Agency Order), allocation procedures are such that any trading account associated with the person acting as agent for the order cannot itself receive any of the allocation.

It is not clear in the rule proposal that these conditions have been met.

- ***Crossing a Hybrid Quote***: The rule proposal indicates that the SAL improvement orders may not cross the Hybrid quote on the opposite side of the SAL. The rule proposal provides that in this case, the SAL terminates. This presents an opportunity for manipulation by a market maker who is the first to submit an improvement order into the auction with one-cent improvement and then simply sends a one-lot improvement order that will cross the Hybrid market on the opposite side, thereby aborting the auction and ensuring no competition for his improvement order.

  Alternatively, any of the CBOE market makers already on the CBOE book at the NBBO and qualifying for an allocation privilege due to various preferencing mechanisms in the CBOE market may have an interest in prematurely terminating a SAL auction so that the Agency Order executes against the CBOE book (where the market maker has privileges) rather than letting the auction run its course. A one-lot improvement order to cross the Hybrid System on the opposite side could be a negligible price to pay in many circumstances for this advantage.

  Similarly, any party wishing to prematurely terminate the SAL auction for any reason could simply send a one-lot improvement order to cross the Hybrid limit on the opposite side.

- ***Cancellation of Market Maker Quotes***: The rule proposal suggests that the market maker quotes on the top of the book will be frozen for the duration of the SAL auction ("Frozen MM Quote"). The rules, however, do not address a cancellation of

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one or more Frozen MM Quotes. Is cancellation of the Frozen MM Quote even permitted? If so, will cancellation result in early termination of the SAL? Will this create firm quote issues? Are all the opposite side quotes frozen or just the quantity necessary to "stop" the order which goes into the SAL auction? Is the CBOE not concerned that this freezing of quotes may encourage CBOE market makers to reduce their quote size to avoid the risks implicit in such a freeze or perhaps reduce the probability of a SAL even commencing?

## 3. DEFINITION OF THE MATCHING ALGORITHM -- NEED TO DEFINE

The order allocation section of the proposed rule indicates that orders will be allocated according to an undefined "matching algorithm" in effect for the class subject to certain conditions. In addition, the proposed rule appears to indicate that this undefined matching algorithm is defined differently for different classes of options. Clearly, the "matching algorithm" is pivotal element of the SAL auction process and, therefore, must be fully and completely defined and discussed within the rule proposal. The lack of any disclosure with regards to the inner-workings of SAL and its "matching algorithm" will not permit the Securities and Exchange Commission and its Staff to meet its statutory obligation to ensure that the rules of a Self-Regulatory Organization comply with relevant requirements of the Securities Exchange Act of 1934 ("Exchange Act"). It also does not permit any meaningful comment by the public.

## 4. POSSIBLE FIRM QUOTE VIOLATION

In order to address firm quote issues around the SAL Agency Order, CBOE essentially proposes to initiate a SAL auction only when there are sufficient quotes on the opposite side of the market that are at a price equal to the NBBO and for an aggregate quantity that is greater than or equal to the size of the Agency Order. During the SAL auction period, these quotes are somehow frozen (the mechanism for which is not clear and is addressed elsewhere in this comment) to protect the Agency Order in the event the auction does not yield any improvement of the Agency Order. Any unimproved quantity of the Agency Order will then execute against the frozen quotes at the termination of the auction. In doing so, the Agency Order is assured of doing "no worse" than it would have had the order not gone through the SAL auction.

The broadcast of the frozen quotes is a potential "firm quote" issue. At the inception of the auction, quotes are "frozen" or held in reserve in the event they are "required" to satisfy the balance of the SAL Agency Order at the conclusion of the auction. Notwithstanding, it would seem that the frozen quotes are still included in the CBOE broadcast to OPRA. An unrelated order attempting to trade with the frozen quotes will simply be treated in accordance the early termination section of the rule proposal that addresses unrelated same side marketable orders (see later discussion). An unrelated same side order merely triggers the termination of the SAL auction and causes the Agency Order to trade with the frozen quotes. An unrelated same side marketable order will only be permitted to trade fully with the displayed quantity of the frozen quote if the SAL responses were sufficient to fully execute the SAL Agency Order at the time of the auction's termination.

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<u>For Example</u>:

Suppose there are three market makers on the CBOE bid, each for a quantity of 10 contracts at a limit equal to NBBid. An order to sell 30 at market is received in Hybrid which sets off a SAL. Prior to the receipt of any SAL improvement orders, another customer sends an order to CBOE to sell 30 at market. This second order will cause the auction to terminate early and the Agency Order to execute against the 3x10 market maker quotes. The second order will not receive an execution.

This would seem to present a firm quote issue.

## 5. ALLOCATION OF AGENCY ORDERS -- LACK OF CLARITY

The SAL utilizes a complex allocation method that occurs at different price points and in two different "rounds." The allocation mechanism is an important aspect of the SAL auction process but the rule proposal, as currently drafted, does not adequately describe how the allocation mechanism functions. The allocation mechanism is unclear with respect to market maker priority. The allocation process seems to offer priority to market makers on the top of the CBOE book at the inception of the SAL ("Market Maker Preference") and/or have a "participation entitlement". However, the rule proposal does not specify how the participation entitlement interacts with a Market Maker Preference. Could market makers have both the Market Maker Preference and the participation entitlement? Moreover, the rule proposal must define the parameters of the participation entitlement and when the participation entitlement (of the Market Maker Preference) is determined.

How do both the participation entitlement and the Market Maker Preference interact with customer orders submitted to the SAL? Because the rule proposal does not clearly answer this question, it is likely that customer order may not receive priority within the SAL Auction.

## 6. EARLY TERMINATION OF THE SAL -- LACK OF CLARITY

The SAL rule proposal identifies various situations that will cause the SAL auction to terminate prematurely. As discussed more fully below, these termination events are ill-defined and could potentially result in manipulative conduct and trade-through violations.

- ***Unrelated Same-Side Marketable Order***

  According to the SAL rule proposal, the auction will terminate in the event the "… Hybrid System receives an unrelated order on the same side of the market as the Agency Order that is marketable against the NBBO …." It is unclear, among other things, what "marketable" means and how the unrelated order will be allocated upon termination of the auction. Below is an example that illustrates this ambiguity:

  (i) <u>Example</u>:

  Prior to the initiation of a SAL auction, the CBOE's book is comprised of three (3) market-maker quotes each bidding ten (10) contracts at $2.00 which is

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equal to the NBBid. A SAL is initiated to sell 30 contracts. During the auction, the NBBid moves away from the original $2.00 quote to $2.05. Subsequently, an unrelated order to sell fifty (50) contracts at $2.05 is received by the Hybrid System.

(ii) Questions:

1. Is the "marketability" of the unrelated order determined in relation to the:

   a. NBBO at the time the SAL was initiated? If so, the unrelated order is not marketable and the SAL continues.

   b. NBBO at the time the unrelated order was received? If so, the unrelated order is marketable and the SAL aborts.

   c. What if there was a SAL response order at $2.06? Would the unrelated order be considered "marketable"?

2. Suppose the limit of the unrelated order was $2.00 rather than $2.05. What happens to the unrelated same side order? Does it:

   a. Execute against any "excess" of the SAL responses once the SAL order itself has been fully executed? (similar to the ISE Price Improvement Mechanism)

   b. Execute against the original market maker quotes at the time the SAL was initiated once the SAL order has been fully executed?

- ***Unrelated Opposite Side Marketable Order:***

  According to the SAL rule proposal, the auction will terminate in the event the "… Hybrid System receives an unrelated market or marketable limit order on the opposite side of the market from the Agency Order, such unrelated order will trade to the fullest extent possible at the midpoint of the best auction response and the NBBO on the opposite side of the market form the auction responses …." The CBOE rule filing does not specifically address how CBOE intends to ensure that the unrelated order does not trade-through the NBBO.

  If the quantity of the unrelated marketable opposite side order is less than the Agency Order, why is the auction terminated? In the BOX PIP, the auction is only terminated in this case when the inbound executable order is equal to or greater than the quantity of the SAL Agency Order.

  As previously discussed, the rule proposal does not address how and when an order is deemed to be "marketable." Is an order's marketability determined at the time the order is received or at the time the SAL auction was initiated, against the CBOE BBO or the NBBO?

- ***Unrelated Opposite Side Non-Marketable Order:***

  The SAL rule proposal specifies that the SAL auction will terminate when the "… Hybrid System receives an unrelated non-marketable limit order on the opposite side

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of the market from the Agency Order that improves any auction responses…." In such an instance, "… the unrelated order will trade (after any responses that were priced better than the unrelated order have traded) to the fullest extent possible at the midpoint of the best remaining auction responses and the unrelated order's limit price…." It is unclear why this type of order should terminate the SAL Auction. Why not treat this order as another response (*i.e.,* improvement order) to increase the number of responses and maximize the potential for price improvement by continuing the auction?

And even if an unrelated unmarketable opposite side limit order terminates the SAL, why not execute the order at the price specified by the limit order rather than offering it some sort of "price protection", to the detriment of the SAL Agency Order's interest?

In addition, this feature gives a person participating in a SAL auction another avenue to prematurely terminate the auction for purposes of manipulating the market, particularly given the fact that the rules allow for multiple responses. For example, a Market Maker could enter a response (i.e., improvement order) that is only one cent better than NBBO and immediately enter a one-contract, non-marketable, opposite side limit order five cents better than NBBO with the intent of prematurely terminating the auction so as to secure the execution of the bulk of the first order within the auction. Market Makers wishing to simply block a SAL auction from even starting could do the same with a one contract order on the opposite side. This is contrary to the basic tenet of the federal securities laws which purport to mitigate the likelihood of such manipulative conduct (*see, e.g.,* Sections 9 and 10 of the Exchange Act).

The rule proposal does not address the instance of an unrelated opposite-side non-marketable order which is *not* better than the best improvement order? Would such an order stop the SAL? Regardless of whether such an order stopped the auction early or not, there is an allocation priority issue. Given that the first round of the allocation at the termination of the auction is allocated to the CBOE market makers who were at the top of the book prior to the start of the auction, how could this unrelated limit order on behalf of a customer participate in the allocation? This would appear to create a violation of customer priority requirements.

- ***Locked Market***

  The rules provide for early termination of the SAL when there is a "quote lock" pursuant to CBOE Rule 6.45A(d). What is the rationale for terminating the SAL early? Why not treat the order that is creating the lock as an unrelated order and permit it to interact with the SAL auction?

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**CONCLUSION**

Due to the issues discussed in this comment letter, as well as any other comments which we and others may provide at a later date, BOX urges the Commission not to approve the proposal in its current form. In light of the absence of basic details regarding the SAL Auction and its related processes, it is virtually impossible for the Securities and Exchange Commission and its Staff, as well as commenters, to adequately understand and assess the functionality of the SAL Auction and its overall compliance with the requirements of the Exchange Act.

If there are any questions or comments regarding the issue raised herein, please do not hesitate to contact me.

Sincerely,

Will Easley
Senior Managing Director
Boston Options Exchange Group LLC