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Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Attn: Nancy M. Morris, Secretary

Re: File Number: SR-CBOE-2006-106

Ladies and Gentlemen:

This letter responds to the Chicago Board Options Exchange, Inc.'s ("CBOE") January 12, 2007 letter to the Securities and Exchange Commission ("Commission"), in which CBOE attempts to refute the objections to CBOE's proposed rule change (SR-CBOE-2006-106) (the "Proposed Rule Change")[1] that we raised in our December 12, 2006 letter. As explained below, CBOE's arguments are without merit.[2] Accordingly, we renew our prior request that the SEC defer consideration of the Proposed Rule Change pending an adjudication of the state law claims currently before the Delaware Court of Chancery ("the Delaware Court").

The Proposed Rule Change reflects a remarkable attempt by CBOE and its directors to misuse CBOE's rulemaking authority as a self-regulatory organization to wrongfully expropriate, for no consideration, the property of hundreds of CBOT members. The Proposed Rule Change has no legitimate securities regulatory or self-regulatory purpose. Instead, it is designed to enrich a select group of CBOE member insiders, including some members of the CBOE Board of Directors who authorized its filing with the Commission. At its core, it represents an improper attempt to induce the Commission to take sides in a private contractual dispute over state law issues.

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[1] On January 16, 2007, CBOE amended the Proposed Rule Change to, among other things, consent to an extension of the time within which the Commission must review the filing and to add certain exhibits, one of which is discussed in more detail below.

[2] As in our December 12 letter, we are writing on behalf of CBOT Holdings, Inc. ("CBOT Holdings") and its wholly-owned subsidiary, the Board of Trade of the City of Chicago, Inc. (collectively referred to herein as "CBOT").

An action to resolve this dispute is pending before the Delaware Court,[3] which is the proper forum for the resolution of the core state law contract, corporate, and fiduciary questions at issue in this matter. We respectfully urge the Commission to await resolution of this dispute by the Delaware Court before acting on the Proposed Rule Change. To do otherwise would waste the Commission's scarce resources, without serving any investor protection, market regulation, or public interest purpose, and facilitate CBOE's improper attempt to use the SRO rulemaking process to avoid a proper adjudication of CBOT's state law claims.

The Subject Matter of the Proposed Rule Change Is In Litigation in the Delaware Action.

In support of its effort to decide unilaterally the issues related to the Exercise Right,[4] CBOE asserts that the matters addressed by the Proposed Rule Change were not originally in controversy in the Delaware Action. This assertion is meritless. The Delaware Action, as originally filed, raised broad issues arising under state law about the meaning of the Exercise Right and the ownership of CBOE.[5] The central issue raised by the Proposed Rule Change – whether the consummation of the proposed CME Holdings-CBOT Holdings merger would extinguish the Exercise Right – plainly is a state law question and an integral part of the dispute between the parties concerning ownership of CBOE. Indeed, the state law issues raised by the Proposed Rule Change are expressly part of the Delaware Action, pursuant to an amended complaint. In light of these facts, CBOE's argument about what was in the original Delaware complaint is irrelevant. The important state law issues separating the parties are now all presented in the Delaware Action, and should be decided by the Delaware Court.[6]

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[3] *CBOT Holdings, Inc., et al. v. Chicago Board of Options Exchange, Inc., et al.*, C.A. No. 2369-N ("the Delaware Action").

[4] The term "Exercise Right" was defined and explained in our December 22, 2006 letter to the Commission and has the same meaning here.

[5] CBOE is a non-stock Delaware corporation. CBOT Holdings and the Board of Trade of the City of Chicago, Inc. are also Delaware corporations.

[6] CBOE states in its January 12, 2007 letter that the subject of the Proposed Rule Change had not been raised in the Delaware Action at the time of CBOT's December 22, 2006 letter. This statement is not correct. On December 22, 2006, the same day that CBOT sent its letter to the Commission, CBOT and the plaintiff class filed a motion for leave to amend their complaint in Delaware, attaching the amended complaint. The amended complaint includes a specific request that the Delaware Court declare that CBOT's pending merger will not terminate the exercise right. Thus, that issue was raised as of December 22, 2006. Moreover, it is misleading for CBOE to suggest that the subject matter of the Proposed Rule Change was a new issue in the Delaware Action. CBOT's objective from the beginning of the Delaware Action has been to protect the contractual rights of its members to participate on an equal basis with the other owners of CBOE in its demutualization. From at least 2005 through November 2006, CBOE took the position that exercise right holders were entitled to receive *some* level of ownership in CBOE, but at a level *less* than other CBOE members, and that position was reflected in the original complaint. In December 2006, with no notice whatsoever and almost two months after the announcement of CBOT's proposed merger, CBOE suddenly took the position that as a result of the merger, exercise right holders would receive *nothing* in CBOE's demutualization. CBOT thus amended its complaint to reflect CBOE's new position, but the substance of the controversy has remained the same throughout the Delaware Action. In short,

CBOE is Attempting to Exploit the Commission's SRO Oversight Process to Legitimatize Its Breaches of Contract and Fiduciary Duty and Justify its Expropriation of CBOT Member Property Rights.

The Proposed Rule Change – unlike *any* prior rulemaking or interpretive actions taken to date by CBOE[7] – is nothing more than an attempt to manipulate the SRO rulemaking process under the Securities Exchange Act to effect an outright taking of a property interest that belongs to many of CBOT's members, in plain violation of CBOE's charter[8] and its contractual commitments to CBOT and its members, in gross dereliction of its fiduciary duties to those CBOT members who are, or have the legal right to be, members of CBOE, and in violation of applicable state law. We are not asking the Commission to accept our view on the state law issues discussed in this letter, inasmuch as the Commission does not have the legal responsibility to adjudicate these issues. We *are* asking the Commission to rebuff CBOE's ploy to circumvent having these issues properly decided by a neutral court in the Delaware Action.

CBOE seeks to "paper over" the deficiencies in its position, and persuade the Commission that its actions are consistent with Delaware corporate law, by submitting as an exhibit to its January 16, 2007 amendment to the Proposed Rule Change an "opinion" of counsel. This document purports to demonstrate that as a matter of Delaware corporate law, the CBOE Board of Directors has the corporate authority to interpret terms in CBOE's corporate charter, and that the charter interpretation reflected in the Proposed Rule Change is a proper exercise of that authority. *See* Letter of Wendell Felton to Joanne Moffic-Silver, General Counsel, CBOE, dated January 16, 2007, attached as Exhibit 3f to CBOE's amended Proposed Rule Change. However, as the letter itself makes clear, the CBOE Board's interpretive authority with respect to CBOE's charter is conditioned on the board acting "in good faith, in a manner consistent with the terms of [Article Fifth(b)] and not for inequitable purposes." It is precisely for that reason that the letter, far from supporting CBOE's position here, confirms that the Commission should defer any consideration of the Proposed Rule Change.

CBOE's rationalization for shortchanging the exercise right holders changed, so CBOT's specific claims had to be amended in response, but the Delaware Action is and has always been about CBOT's attempt to protect the property and contract rights of its members.

[7] The possible lone exception, CBOE's original proposed rule to extinguish the CBOT's exercise right upon the CBOT's demutualization [SR – CBOE-00-44], was published for comment but was never acted upon by the Commission. In any event, that rule change was substantively superseded by a subsequent CBOE proposed rule [SR-CBOE-2005-19] filed after CBOT and CBOE reached a settlement of their underlying state law dispute.

[8] Under Delaware law, CBOE's charter is treated as a contract between CBOE and CBOT members given the right under the charter to be or become members of CBOE pursuant to the Exercise Right. *See Morris v. American Public Util. Co.*, 122 A. 696 (Del. Ch. 1923); *State ex rel. Southerland v. U.S. Realty Improvement Co.*, 132 A. 138 (Del. Ch. 1926); *Lawson v. Household Finance Corp.*, 147 A. 312 (Del. Ch. 1929), *aff'd*, 152 A. 723 (Del. 1930); *Voege v. Am. Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965). Delaware law does not permit CBOE to unilaterally "interpret" its charter to eliminate these contractual rights.

Whether the CBOE Board acted in good faith and not for inequitable purposes are issues of Delaware law pending before the Delaware Court. CBOT's Delaware lawsuit alleges that the CBOE Board did *not* act in good faith, but rather acted for inequitable purposes, in violation of the board's fiduciary duties under Delaware law and in violation of CBOE's charter and its contracts with CBOT. Among other things, CBOT asserts that the CBOE Board's inside members who voted to "interpret" Article Fifth(b) to expropriate the Exercise Rights of CBOT members were riddled with conflicts of interest that not only precluded a fair and objective consideration of the Proposed Rule Change, but also acted in dereliction of their fiduciary duties towards a class of CBOE members and prospective members. Consequently, the CBOE Board's actions in this case fail to even approach the standard of good faith necessary for the board to be acting within its authority under Delaware corporate law. The CBOE Board's actions were also taken for inequitable purposes: the Proposed Rule Change is an effort to railroad an *ex parte* extinguishment of a valid property interest of a large class of CBOE members and prospective members in breach of numerous contractual and state requirements and legal standards.[9]

The tenuousness of CBOE's position under state law is what has led CBOE to devise the strategy of using the SRO rulemaking process as a means of seeking to legitimatize its indefensible actions. Given that there is no inconsistency between the positions taken by CBOT in the Delaware Action and either the language or policies of the Securities Exchange Act of 1934 ("Securities Exchange Act"), CBOT strongly urges the Commission not to take action until CBOT's and its members' contractual and fiduciary claims are resolved in the Delaware Action. In filing for Commission approval of a rule change that would violate state law by depriving certain owners of CBOE of their property rights, CBOE is attempting to make the Commission a participant in CBOE's illegal conduct. The Commission should reject this effort to abuse the Commission's SRO oversight process.

In short, as CBOE counsel's letter acknowledges, the propriety of the CBOE Board's actions turns upon issues of Delaware law already pending before the Delaware Court, the resolution of which falls outside the Commission's statutory responsibilities under the Securities Exchange Act. Accordingly, we respectfully urge the Commission to defer action on CBOE's Proposed Rule Change pending resolution of the dispute by the Delaware Court.

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[9] CBOE's reliance on this letter is misplaced for additional reasons. The letter is dated *five weeks* after CBOE's filing of the Proposed Rule Change and is not the sort of timely contemporaneous advice that a responsible board of directors would expect to seek and receive before taking action on such an important issue. In addition, the letter was written by CBOE's principal *litigation* counsel in the Delaware Action, raising fundamental questions about its impartiality and reliability. And even if the letter were impartial and reliable, it merely asserts that the board of a Delaware corporation generally has authority to interpret charter provisions. The letter does not purport to opine on whether, in the particular circumstances here, the CBOE Board acted in good faith and not for inequitable purposes, nor does it address the conflict of interest issues arising from the board's actions, or whether the board has the authority to unilaterally "interpret" contracts in a manner that violates those contracts.

The Commission's Authority Over the Subject Matter of the Proposed Rule Change Does Not Preempt State Law.

In an effort to overcome what are significant, if not fatal, flaws in its state law defenses, CBOE next contends that the Commission has exclusive jurisdiction under the Securities Exchange Act to consider the Proposed Rule Change, and that any interpretations of CBOE rules, including Article Fifth(b), are a matter exclusively of federal law for the Commission to resolve. CBOE's argument, however, masks a critical distinction between the responsibility of the Commission to decide whether a CBOE rule change *is consistent with the requirements of the Securities Exchange Act*,[10] and the responsibility of state courts to determine the consistency of CBOE's actions with applicable state corporate, fiduciary, and contract law.

The Commission's authority to determine whether a proposed SRO rule change is consistent with the Securities Exchange Act does not preempt the right and obligation of the Delaware Court to determine whether the corporate actions taken by the SRO or its board in adopting the proposal complied with applicable state laws. Nothing in the Securities Exchange Act preempts state law governing the conduct of corporations and their directors, state contract law, or other applicable state law when a SRO considers and adopts a proposed rule change, nor can any such preemption be implied from the language of the Securities Exchange Act or its legislative and administrative history.

Any preemption analysis must begin with "the presumption against finding pre-emption of state law in areas traditionally regulated by the States." *California v. ARC America Corp.*, 490 U.S. 93, 101 (1989). That is because "[w]hen Congress legislates in a field traditionally occupied by the States, 'we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'" *Id.* (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)). The regulation of corporations is one such field traditionally occupied by the States. *Air Line Pilots Ass'n, Int'l v. UAL Corp.*, 784 F.2d 439, 447 (7th Cir. 1989) ("[T]he regulation of corporations is . . . a matter of primary state responsibility," and thus is one of the "areas [where] the presumption is against federal preemption."). This presumption against preemption also extends to "'common law . . . contract remedies in business relationships.'" *G.S. Rasmussen & Assoc. v.*

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[10] CBOT agrees that the Commission has exclusive authority under the Securities Exchange Act to determine if the Proposed Rule Change is consistent with the language and purposes of that Act. In its current form, and with no resolution of the underlying state law issues, the Commission cannot make the findings required by the Securities Exchange Act for approval of the Proposed Rule Change. This means that, if the Proposed Rule Change is published for comment, the Commission will be forced to commence disapproval proceedings that will be both time consuming and an unfortunate drain on the Commission's resources. It would make far better sense for the Commission either to delay action on the filing or to ask CBOE to withdraw it. Of course, should the Commission nevertheless decide to publish the Proposed Rule Change in its current form, CBOT will demonstrate why the Commission must *disapprove* the Proposed Rule Change as being wholly inconsistent with the requirements of the Securities Exchange Act. At this time, however, consideration of this substantive issue is premature for the reasons stated in our December 22, 2006 letter and this reply letter.

Kalitta Flying Service, Inc., 958 F.2d 896, 906 (9th Cir. 1992) (quoting *West v. Northwest Airlines, Inc.*, 923 F.2d 657, 659 (9th Cir. 1990)).

CBOT's state law claims in the Delaware lawsuit are not preempted by the Securities Exchange Act. While federal law requires a SRO to comply with the Securities Exchange Act, this is in addition to and not in lieu of the SRO's obligations to comply with state law requirements, such as the fiduciary duties imposed on the board of a SRO organized as a corporation or the obligation to honor binding contracts. Holding CBOE to its prior contracts and imposing fiduciary duties on its board in no way "conflicts" with federal law or "stands as an obstacle to the accomplishment of the objectives of Congress." *Credit Suisse First Boston Corp. v. Grunwald,* 400 F.3d 1119, 1132 (9th Cir. 2005). CBOE does not and cannot assert that it is impossible for CBOE to comply with the Securities Exchange Act while simultaneously adhering to its contractual commitments and the fiduciary duties imposed by state law. Nor could CBOE plausibly assert that enforcing contracts voluntarily entered into by a SRO, and imposing the same fiduciary duties on a SRO's board that apply to other corporate boards of directors, somehow thwarts the objectives of the Securities Exchange Act, such that the SRO must be authorized by the Commission to disregard its contracts and its directors to ignore their fiduciary duties if Congress's objectives are to be achieved.

CBOE attempts to bootstrap its erroneous assertion of exclusive federal jurisdiction by claiming that, because Section 6 of the Securities Exchange Act requires a national securities exchange to comply with its own rules, the question of whether CBOE's Proposed Rule Change complies with CBOE's charter likewise is subject to the Commission's exclusive jurisdiction under the Securities Exchange Act. That argument is beside the point and mischaracterizes the Commission's authority under the Securities Exchange Act. CBOT does contend that CBOE has not complied with its charter, which is itself a contract under Delaware law.[11] But CBOT's Delaware lawsuit also raises wholly separate state law issues – namely, whether CBOE has committed a breach of contract with respect to the agreements with CBOT, and whether the CBOE Board has breached its fiduciary duties. Again, as noted above, the Delaware Court's enforcement of these state law matters will not conflict with, or frustrate the purposes of, the Securities Exchange Act.

A careful reading of the case on which CBOE primarily relies, *Buckley v. CBOE,* 440 N.E.2d 914 (Ill. App. 1982), actually refutes CBOE's exclusive jurisdiction argument. In *Buckley*, the court *rejected* CBOE's assertion that the state court lacked jurisdiction over plaintiffs' state law claims because CBOE's "Certificate of Incorporation is an exchange rule . . . and the Act requires CBOE to comply with its own rules." *Id.* at 917. The court held that the Act "does not bar plaintiff from pursuing at his option remedies based solely on state law, even though the action may be based on the same factual circumstances" that establish a violation of the exchange's rules. *Id.* In other words, while the factual circumstances supporting CBOT's

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[11] *See* n. 8, *supra.*

state law breach of contract and breach of fiduciary duty claims may *also* show that CBOE has breached its own rules in violation of the Securities Exchange Act, those state law claims provide an independent basis for state court jurisdiction.[12] *See id.*

In addition, the 1992 agreement between CBOT and CBOE ("the 1992 Agreement") expressly provides that "either party . . . may bring suit (on its own behalf or on behalf of its members, or both) to enforce the terms of this Agreement and to recover damages for any breach of this Agreement." That, of course, is precisely what CBOT has done. For CBOE to assert that CBOT's right to enforce the 1992 Agreement is limited to matters such as "confidentiality and information-sharing" (CBOE January 12 letter at 5) is absurd. Nothing in the 1992 Agreement supports CBOE's suggestion that CBOT's contractual right to bring suit "to enforce the terms of this Agreement" is limited to some subset of the Agreement's terms.

The Commission, in approving SRO rule changes (including those of CBOE), has rightfully acknowledged the applicability of state laws to such rules, and has never suggested that its rulemaking authority extends beyond the determination of whether a SRO rule is consistent with the requirements of the Securities Exchange Act.[13] That is because the Commission has recognized that jurisdiction to enforce matters of state law resides in state courts. Unfortunately, we expect that CBOE will mischaracterize the mere publication of the Proposed Rule Change by the Commission as indicating that the Commission believes that it has exclusive jurisdiction over the state law claims pending in Delaware.

CBOE cannot be allowed to place CBOT's state law claims beyond the reach of state courts simply by inserting its desired resolution of those claims into a proposed change to one of its rules and filing it with the Commission. The Delaware Court's adjudication of the contractual rights of CBOT and its members and the fiduciary duties of the CBOE Board under applicable state law will do no violence to the Congressional purposes underlying the Securities Exchange

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[12] Contrary to CBOE's characterization, the only matter the court found preempted in *Buckley* was the specific relief sought by plaintiffs – the "equitable remedy of specific performance." 440 N.E.2d at 917. The court concluded that granting that particular form of relief in that particular case would conflict with (and was thus preempted by) the procedural provisions of the Securities Exchange Act governing SRO member discipline, because granting Buckley's requested relief would have resulted in CBOE's expulsion of an existing member (named Hard), "Hard could then appeal to the Commission through the review procedures set forth in the Act," and "[a]n obvious conflict would result if the Commission determines that Hard and not Buckley is the proper member for purposes of the Act." 440 N.E.2d at 919. Here, in contrast, CBOT seeks relief other than specific performance (including injunctive and declaratory relief); CBOT's lawsuit does not challenge any disciplinary action undertaken by CBOE (and thus does not conflict with any of the disciplinary provisions of the Act); and granting the relief sought by CBOT in its lawsuit would not result in the expulsion of any existing member of CBOE. The *Buckley* case is easily distinguishable from the present dispute for yet another important reason: it predated the execution of the separate contracts between CBOT and CBOE, such as the 1992 Agreement that forms the primary basis for CBOT's Delaware claims.

[13] *See, e.g.*, Securities Exchange Act Release No. 34-51252 (Feb. 25, 2005), 70 Fed.Reg. 10442, 10444 (Mar. 3, 2005).

Act or to its express language. There is no basis on which the Commission can make the findings necessary to approve the Proposed Rule Change in its present form. Therefore, it makes the most sense for the Commission to wait until CBOT's contractual and fiduciary claims are resolved in the Delaware Court before taking any action on the Proposed Rule Change.

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In conclusion, CBOE's January 12, 2007 letter fails to state any reason why the Commission should not defer action on the Proposed Rule Change, and CBOT respectfully reiterates its request for deferral until such time that the core state law contract, corporate, and fiduciary controversies underlying the Proposed Rule Change have been resolved in the Delaware Action. Once the Delaware Court has decided the state law issues, the Commission could proceed to consider any proposed rule change necessitated by the Delaware decision in the context of any federal regulatory issues or policies that may then be implicated.

Thank you for your consideration of the foregoing. If you have any questions, please contact the undersigned at (202) 263-3219 or Kathryn McGrath at (202) 263-3374.

Sincerely,

Charles M. Horn

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