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Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: SR-ISE-2010-73 (The "New" Qualified Contingent Cross)

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated ("CBOE") submits this letter commenting on the captioned rule filing by the International Securities Exchange ("ISE"). The filing proposes to adopt a modified version of the Qualified Contingent Cross ("QCC"). In the filing, ISE claims to address "the two primary concerns raised by commenters" with the original QCC proposal. This is an astonishing assertion given that the new QCC proposal remains completely unchanged with respect to the central objection raised by every QCC commenter opposed to the proposal: that the proposal allows option crosses to occur without prior exposure to the marketplace. CBOE believes that approval of the new QCC and its non-exposure feature would be harmful to the options market in that it would remove a valuable incentive for dedicated liquidity provider participation – something that is increasingly viewed by most as critical in light of market events on May 6, 2010. Further, as with the original proposal, ISE has totally failed to demonstrate how allowing unimpeded options crossing via QCC in any way benefits investors.

As an initial matter, we refer the Commission to our numerous previous submissions related to QCC. With the exception of the recent modification to provide for resting public customer priority over a QCC cross, all of CBOE's other objections, questions, and concerns remain unaddressed and should be reexamined (See Appendix A for more information regarding some of these continuing deficiencies).

Description of QCC

The revised QCC would allow an ISE user to cross/print an options trade without auction or exposure on the ISE market, provided: the cross was for at least 1000 contracts (the original QCC had a 500 contract threshold), the cross is not at the same price as a resting ISE Priority Customer Order (this is the other change from the original proposal), the cross price is at or between the National Best Bid and Offer ("NBBO"), and the cross is identified to ISE as being part of a "qualified contingent trade" or "QCT" (as that term is defined in a known exception to the Commission's Order Protection Rule for stock trading).

CBOE believes that allowing option orders to cross without exposure to the marketplace will be incredibly damaging to options market structure and that the Commission should take great care before engaging in rulemaking, or approving proposed rules, that could have unintended adverse consequences. CBOE also believes that providing QCC trades with "benefits" that exceed those available to bona-fide stock-option orders is ill-advised. These concerns are expanded upon below.

Order Exposure is Critical

Two central distinctions between the option and stock markets are that all option trades must occur on an exchange (stock trades may take place off exchange and are increasingly occurring on dark pool venues), and option crosses must be exposed to the market for potential price improvement and market interaction before such cross trades can be consummated[1] (stock crosses can generally print without market interaction).

The exposure requirement is a long-standing tenet of the options marketplace. It recognizes that the options market is quote driven and relies on dedicated liquidity providers (i.e. market makers) to ensure that two-sided quotations are available across hundreds of thousands of option series for interested investors. As highlighted in the CBOE Petition regarding QCC, for every stock listed on a stock exchange, there are usually hundreds of individual series listed in the options market, with each such series requiring its own bid/ask market. On CBOE, over 75% of trades consist of market-makers on at least one side of the transaction. Option market-makers provide liquidity where it otherwise would not exist. This function can only be performed, however, if market-makers have an opportunity to interact with order-flow. Order exposure requirements provide that opportunity and create incentives for market makers to provide two-sided markets.

Options exchanges' crossing rules contain well-established percentage limitations (generally 40%) on how much of an order a broker can cross with another order in that broker's custody ahead of other interest at the execution price. Importantly, those percentage limitations *only apply after a price-discovery exposure period or auction has allowed other market participants (including market-makers) an opportunity to provide price improvement and participate*. Thus, for over 35 years a larger group of option market participants have had a chance to engage in the price discovery process before any options cross could take place. This construct applies equally to electronic marketplaces

[1] The only exception involves a public customer to public customer cross - since public customers have traditionally maintained order priority over all other market participants, there is a justification to not expose the cross to other participants who would not have priority over public customers anyway. Importantly, these customer crosses cannot be executed ahead of resting public customer interest.

and open-outcry marketplaces. In addition to allowing for price improvement for the orders being crossed, this structure also affords other market participants an opportunity to participate on trades. That participation provides an incentive for a market-maker to aggressively quote, which, in turn, benefits the marketplace as a whole.

Order exposure and the opportunity for market participant interaction has long been one of the SEC's hallmarks for what constitutes an exchange. Rule 3b-16 under the Exchange Act, which defines the terms used in the definition of an "exchange" under the Exchange Act, stresses that an exchange must use non-discretionary methods by which *orders interact with each other*. The Commission has been consistent and stringent in not permitting options exchanges to become mere "print" mechanisms for listed options by enabling an exchange to bypass order exposure and interaction. Only in extremely rare and very limited circumstances has the Commission deviated from this precept. The ISE proposal in no way justifies the Commission abandoning its long held standards for order exposure and interaction on an exchange.

May 6, 2010

In the Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues concerning Preliminary Findings Regarding the Market Events of May 6, 2010 (the "Report"), the staff noted that the SEC seeks to develop regulatory initiatives to help prevent a recurrence of the events of May 6th. Prominent among the initiatives under consideration is to require all market makers to maintain bona-fide quotes that are reasonably related to the market. This tightening of market maker obligations can only be successful if corresponding benefits accrue to liquidity providing market makers. Yet, there is no doubt that in the stock market, and increasingly in the options market, the presence of dedicated liquidity providers is in decline. Indeed, the Report references the Market Structure Concept Release's observation that specialists and market makers with affirmative and negative obligations for market liquidity and market quality have been largely replaced by high frequency trading firms with no such obligations. Of particular interest, the Concept Release requests comment on whether certain high frequency traders should be subject to market maker obligations. We believe these concerns require, from a public policy point of view, that the ISE QCC proposal be rejected.

QCC eliminates exposure of a prominent segment of large option crosses. Users will have every incentive to try to characterize option trades as QCC-eligible in order to avoid order exposure requirements. In May 2010, CBOE calculated that 36% of CBOE order volume came from orders of 1000 contracts or greater. Even a fragment of this volume would greatly impact the order interaction opportunities available to option market makers. At a time when bolstering market maker obligations is under a great deal of scrutiny, CBOE questions the advisability of approving a rule filing that withdraws significant options order flow (and the market maker "opportunity" attendant to that order flow) from the marketplace's price discovery process. ISE will use terms like "narrowly tailored" in an attempt to minimize the significance of this non-exposure exemption, but such efforts are insincere. The numbers speak for themselves.

ISE also claims that it needs QCC to compete with trading floors. That claim is erroneous and disingenuous, and it ignores the broader ramifications of QCC approval. Trading floors *require* representation and exposure of orders before executions can take place. Indeed, data provided by CBOE and data compiled by the SEC's RiskFin Division[2] illustrate that market participation on orders is no less prevalent on trading floors than on ISE's existing market. *QCC, on the other hand, eliminates exposure altogether!* Approval of QCC will make certain that a huge segment of options order flow will never be exposed to the marketplace again. What was handled on trading floors and certain electronic stock-option mechanisms would migrate to ISE's QCC or another exchange's version of QCC. Equally troubling is that, as discussed below, orders that would be handled pursuant to QCC are not bona-fide stock-option orders and not deserving of special treatment.

Stock-Option Orders

A stock-option order is a single order that contains stock and option components. The components are represented (exposed) on an exchange as a package so all terms of the complete order are transparent to the marketplace. Once the price discovery process has achieved acceptable pricing, the stock and option components are broken up for execution in their respective markets. The stock and option executions are understandably and necessarily contingent on one-another since the original order cannot be completely executed without successful execution of the various components. The Commission has acknowledged the value of stock-option orders and has granted certain intermarket trade-through relief for the stock and option component executions.

QCC trades, on the other hand, are never represented as a package. Instead, only the upstairs parties to these trades are aware of the complete terms of the total "transaction". Transparency to the marketplace regarding the terms of the trade are completely lacking. Further, ISE does not even propose to allow QCC trades to obtain the *same* intermarket trade-through relief that is applicable to stock-option trades, instead it proposes to allow QCC trades to be printed on an exchange without ever being represented or auctioned on an exchange. Thus, effecting QCC trades would be easier and more frictionless than effecting bona-fide stock-option trades. CBOE sees no reason why QCC trades should receive such special consideration and believes that this unique treatment is not warranted for what are essentially distinct and unrelated stock and option crosses in the eyes of the entire marketplace, other than the upstairs parties involved in the trade. The example below attempts to highlight this point.

An investor trading from home seeks to buy 100 shares of XYZ for $50 a share and to sell an XYZ call for $2 (a buy-write *strategy*). He uses his online broker to transmit a stock buy order into the stock market and an option sell order into the option market. Seconds later he receives a fill notification on the stock, but his option order remains unfilled because the limit price on the call was not marketable. In fact his sell

[2] Admittedly, as pointed out in CBOE's April 7, 2010 letter, the RiskFin data is imperfect in that it includes one-lots and also assumes that executions at multiple price points must involve different contra parties.

order was booked and the market is now moving away from its limit price. Disappointed that his stock-option strategy could not be fulfilled, he calls his brokerage firm and requests that it contact the venue where the stock was executed to cancel the stock execution because in his mind it was contingent on the execution of his option order. The representative informs him that nullifying the stock execution is not feasible under the circumstances and that "legging" into a strategy, as he attempted to do, does not come with the same safeguards and execution benefits as utilizing a bona-fide stock-option order. The example illustrates that it is not sensible to allow something that is not really a stock-option order, and that has not been fully disclosed to the market as such, to receive certain market benefits preserved for true stock-option orders (which the Commission has historically recognized as being beneficial to investors). Yet, ISE's QCC proposal seeks to do just that.

In a QCC transaction, two upstairs parties agree to trade stock and options. They then effect a stock cross on a stock venue (maybe a dark pool) without any exposure to the market pursuant to existing stock crossing rules. They also effect an option cross on an options exchange without any exposure. This guaranteed frictionless cross is a major deviation from existing option market principles. Why such special treatment for something that isn't even a real stock-option order? Indeed, the QCC provides this option cross with more specialized treatment than bona-fide stock-option orders. Real stock-option orders receive certain *trade-through* exemptive relief, but they must always be *exposed* to the market for potential price improvement and market participation. The proposed QCC trade prints without exposure thereby avoiding potential participation (break-up) from the marketplace. CBOE questions why this special treatment is warranted? Because the upstairs parties involved want the executions to be contingent on one-another (like the investor in the example above)? ISE has had ample opportunity to explain why this special treatment is beneficial to investors, but has offered nothing to validate the usefulness of QCC. That is because it is not useful to anyone other than the parties seeking to effect frictionless option trades.

It is clear that the ISE proposal remains what it originally intended to accomplish: a means to enable the ISE to act as a print mechanism for the options component of a QCC trade. All the justifications posited by the ISE for the proposal do not alter the true effect of the proposal. If the SEC were to approve the proposal, it would represent an unjustifiable and unique deviation from the SEC's standards for exchange trading for "regular-way" options and the significant opening of a slippery slope toward loosening of the SEC requirements for exchange order exposure and interaction.

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In CBOE's April 7, 2010 letter to the Commission regarding QCC, we stated that "the simple policy question before the Commission is whether crossing without any exposure is appropriate and beneficial for investors, and whether such unfettered crossing would adversely impact the options markets." That central policy issue was not addressed in the revised QCC proposal. *QCC creates a disincentive to competitively* *quote* and dampens transparency in the options markets. ISE's recent decline in market share has nothing to do with QCC (as it alleges) and it should not warrant the establishment of harmful market structure changes to the whole options industry as proposed with QCC.

We respectfully request that the Commission not approve the revised QCC filing and also disapprove the original QCC filing. At a time when significant market structure matters are under review, approval of a rule filing that would accelerate the decline in dedicated liquidity provision could have long lasting damaging effects on the options market. If you have any questions regarding this letter or if you would like additional information, please contact me at 312-786-7001, Joanne Moffic-Silver, General Counsel and Corporate Secretary, at 312-786-7462, or Angelo Evangelou, Assistant General Counsel, at 312-786-7464.

Sincerely,

William J. Brodsky

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Robert W. Cook, Division of Trading and Markets
James A. Brigagliano, Division of Trading and Markets
Heather Seidel, Division of Trading and Markets
David Liu, Division of Trading and Markets

Appendix A

Additional Deficiencies, Inconsistencies, and Ambiguities with the ISE QCC Proposal

ISE's Flawed Justifications. ISE has repeatedly stated that it needs the QCC exemption to account for the loss of the old linkage plan's block order exemption. That is false. First, the ISE actually drafted the new plan which did not contain the block exemption. Thus, the ISE affirmatively omitted the block exemption from the new plan. It was never part of any draft of the new plan and ISE only sought its inclusion around the time ISE invested in an options "grey pool". If ISE needed the block exemption so badly, why didn't they include it in the plan that they drafted? Second, the old block exemption allowed qualifying trades to be exempt from *trade-through liability.* QCC trades are not exempt from trade-through liability, instead they bypass the *exposure process* that was always required for block trades. Exemptive relief from trade through liability and from exposure have nothing to do with one another. ISE has never explained how replacing a trade-through exemption with a market structure changing non-exposure exemption is appropriate. Third, an exemption already exists in the new plan for stock-option trades -- it is called the complex order exemption and it is fully available to ISE.

Ballista Securities. We find it telling that after numerous letters from CBOE detailing the ISE investment in Ballista Securities (the self proclaimed "Options ATS") and the ease with which Ballista is able to cross options on ISE without QCC, that ISE has never offered a single sentence refuting our claims. You will recall that Ballista posted statistics on its website showing that crosses executed on ISE rarely get broken-up (in fact, CBOE's trading floor offers greater market maker participation than what Ballista experiences on ISE *without* QCC or the block exemption). After several CBOE letters highlighted the Ballista statistics, Ballista ceased posting them. In any event, we question why the Commission would approve a filing that only benefits off-exchange order interaction and that could lead to a proliferation of dark and/or grey pools in the options market.

Where are the firms defending QCC? Many commenters have submitted letters imploring the Commission to disapprove the QCC filing stating, among other things, that QCC trades are not bona-fide stock option trades, and that stock-option trades were always meant to be exposed as a package on an options exchange. Indeed, we believe that to claim that a stock trade tied to options qualifies for the SEC's QCT Exemption without exposing the entire stock-option package on an options exchange would be inappropriate. Why have no firms come forward in support of QCC explaining that they currently utilize the QCT Exemption in such a manner (*i.e.* without exposing the entire stock-option order as package on an exchange)?

Customer Harm. ISE claims that QCC will have no impact on customers because a resting customer option order could not interact with a QCC trade since the resting option order does not have a corresponding stock component. Actually, the QCC cross does not have a stock component, it is only presented to the market as an option trade.

Additionally, there could be customers willing and eager to trade with the entire stock-option order if it were exposed as such. The fact is, because QCC trades are not exposed anywhere, no customers or market participants have a chance to interact with them. Further, QCC will create yet another disincentive for market makers to provide liquidity and this will have a harmful impact on the customer options experience.

ISE is Unwilling to Compete. ISE asserts that trading floor crowds are less competitive than the ISE electronic "crowd", and therefore ISE is at a disadvantage to exchanges with trading floors when it comes to users seeking to maximize order facilitation/solicitation. CBOE for years has lived with the fact that other option exchange trading floors had fewer market makers than our trading floor, however we consider the fact that our floor is vibrant and competitive to be a positive, and to the extent we are at a "disadvantage" to other markets for certain crossing business, we view that as the price we pay for success and deem it a good problem to have. On the other hand, ISE would rather pursue a regulatory reengineering than to compete for business. If floor-based markets were as "frictionless" as ISE claims they are, they would not file rule changes such as recently filed SR-NYSEArca-2010-69 regarding refining processes for floor executions of solicitation trades.

QCC is Ill-Defined Part I. The non-exposure requirements would certainly draw market participants to explore maximizing as many trades as possible under the auspices of QCC. For example, market maker option trades are almost always combined with corresponding hedging stock trades. Would market maker's begin utilizing QCC thereby extracting yet more order flow from the options markets?

QCC is Ill-Defined Part II. The proposal is unclear with respect to how the 1000 contract minimum is achieved. If the QCC order has multiple option legs, do they need to cumulatively add up to 1000 contracts (making the proposal even more suspect than it already is)? Or must each leg be for a minimum of 1000 contracts to qualify? Further, since QCC trades cannot occur at a price where public customers are resting, how does the ISE define whether customers are resting for purposes of QCC? For example, what if a public customer is resting with a complex order for the same strategy, or in one or all of the legs of the strategy?