December 13, 2013

Re: SR-Phlx-2013-106 (Proposed Rule Change to Amend Minimum Number and Size of Counterparties to Qualified Contingent Cross ("QCC") Trades

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated ("CBOE") submits this letter on the captioned rule filing by the NASDAQ OMX PHLX ("Phlx").[1] The Proposal would effectively eliminate the QCC minimum size/single order requirement by permitting multiple smaller orders, entered by multiple counterparties, to constitute one side of a QCC transaction. CBOE believes that the Proposal is not consistent with the protection of investors and the public interest, nor is it otherwise consistent with the Securities Exchange Act of 1934 ("Exchange Act") and Commission rules thereunder. Accordingly, because the Proposal would facilitate trades that are designed to avoid exposure to the auction market and expand the universe of orders that are denied price discovery opportunities, we respectfully request that the Commission disapprove the proposed rule change.

I. Description of the Proposal

The Proposal would eliminate the current requirement that a QCC transaction have a *single* option order on each side of the cross. Under current Phlx rules, QCC orders may be filled in one of two ways. Under Phlx Rule 1064(e), a floor QCC Order ("Floor QCC Order") is comprised of an order to buy or sell at least 1,000 contracts (or 10,000 mini options

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[1] See Securities Exchange Act Release No. 70821 (November 6, 2013), 78 FR 68126 (November 13, 2013) (SR-Phlx-2013-106) (the "Proposal").

contracts) that is identified as being part of a qualified contingent trade ("QCT"),[2] coupled with a contra-side order to buy or sell an equal number of contracts. Floor QCC Orders are immediately executed upon entry in the Phlx Floor Broker Management System by an option floor broker, provided that (i) no customer orders are at the same price on the Phlx's limit order book, and (ii) the price is at or between the national best bid or offer ("NBBO"). Floor QCC Orders are automatically rejected if they cannot be executed.

In addition to Floor QCC Orders, Phlx permits automated QCC Orders ("Automated QCC Orders") to be effected, pursuant to Phlx Rule 1080(o). Under Rule 1080(o), an Automated QCC Order must be comprised of an order to buy or sell at least 1,000 contracts (or 10,000 mini options contracts) that is identified as being part of a QCT, coupled with a contra-side order to buy or sell an equal number of contracts. Automated QCC Orders are submitted electronically from off of the exchange floor to the Phlx system. Automated QCC Orders are immediately executed upon entry into the Phlx system by an order entry firm, provided that (i) no customer orders are at the same price on the Exchange's limit order book, and (ii) the price is at or between the NBBO. Automated QCC Orders are automatically rejected if they cannot be executed.

Phlx is proposing to permit members to submit both Floor and Automated QCC Orders involving multiple counterparties on one side of the trade where the orders submitted total at least 1,000 contracts. To do so, Phlx proposes to amend the definition of both Floor and Automated QCC Orders to permit members to execute with multiple counterparties, as compared with the current definition which contemplates a single counterparty to each QCC trade. The result would permit a member to execute a single order against multiple counterparties, provided that the single order side of the trade was for a minimum of 1,000 contracts (or 10,000 mini options contracts).

II.   The Proposal Would Facilitate Trades That Avoid Exposure to the Auction Market and Deprive Orders of Price Improvement Opportunities

As CBOE has discussed previously,[3] QCC trades, by their nature, harm options markets by enabling market participants to effect listed options transactions without exposing their

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[2]   Phlx defines a QCT as a transaction consisting of two or more component orders, executed as agent or principal, where: (a) At least one component is an NMS stock, as defined in Rule 600 of Regulation NMS under the Exchange Act; (b) all components are effected with a product or price contingency that either has been agreed to by all the respective counterparties or arranged for by a broker-dealer as principal or agent; (c) the execution of one component is contingent upon the execution of all other components at or near the same time; (d) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined by the time the contingent order is placed; (e) the component orders bear a derivative relationship to one another, represent different classes or shares of the same issuer, or involve the securities of participants in or with the intentions to merge that have been announced or cancelled; and (f) the transaction is fully hedged (without regard to any prior existing position) as a result of other components of the contingent trade.

[3]   See, e.g., letter from Joanne Moffic-Silver, General Counsel and Corporate Secretary, CBOE to Elizabeth M. Murphy, Secretary, Commission (September 14, 2009) (CBOE petition for review of original QCC approval order "CBOE Petition for Review"); Statement of CBOE in Opposition to the

orders to the auction market. This hampers market liquidity and eliminates the possibility of price improvement. The Proposal would exacerbate the harm to the options markets resulting from QCC trades by reducing the minimum size to participate in a QCC trade. As discussed below, the understanding that QCC trades would always involve large orders from sophisticated, institutional investors was fundamental to the Commission's approval of the ISE modified QCC rules,[4] after CBOE requested review of the Commission's approval of the original ISE QCC rules proposal,[5] which required a minimum of 500 contracts for a QCC trade.[6] After CBOE petitioned for review of the original approval order, and after providing ISE the chance to object, the Commission stayed its original approval order.[7] ISE ultimately responded by amending its proposal to require a minimum of 1,000 contracts (to ensure QCC trades are used only by sophisticated institutional investors, and even then, only in large size orders).

In prior filings pertaining to QCC,[8] we have pointed out two central distinctions between the stock and options markets. The first distinction was that all options trades had to occur on an exchange (stock trades may take place off an exchange and are increasingly occurring on dark pool venues); the second distinction was that option orders, with limited exception, had to be exposed to the auction market for potential price improvement and price interaction before execution (stock crosses can generally print without market interaction). The ISE's QCC rules eroded those distinctions, under the circumstances described in the Commission's approval order.[9]

As we stated, 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 two-sided quotations are available for interested investors across hundreds of thousands of options series. Options market-makers provide liquidity where it otherwise would not exist. This function can only be performed,

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Division of Trading and Markets Approval of Rule Under Delegated Authority (December 3, 2009) ("CBOE Statement"); and letter from William J. Brodsky, Chairman and Chief Executive Officer, CBOE to Elizabeth M. Murphy, Secretary, Commission (August 9, 2010) (CBOE comment letter on modified International Securities Exchange ("ISE") QCC rule in SR-ISE-2010-73, "CBOE Comment Letter").

[4] See Securities Exchange Act Release No. 63955 (February 24, 2011), 76 FR 11533 (March 2, 2011) (SR-ISE-2010-73) (order approving ISE proposal to modify its requirements for QCC trades to require the cross to be cancelled if there are any "Priority Customer" (as defined in ISE rules) orders on ISE's limit order book and to increase the minimum size requirement for QCC orders to 1,000 contracts).

[5] See Petition for Review, note 3, supra.

[6] See Securities Exchange Act Release No. 60584 (August 28, 2009), 74 FR 45663 (September 3, 2009) (SR-ISE-2009-35) (order approving original ISE QCC rules).

[7] See Commission Order Granting Petition for Review and Scheduling Filing of Statements (November 12, 2009).

[8] See note 3, supra.

[9] See note 4, supra.

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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, which in turn, benefits the marketplace as a whole. Importantly, exposure requirements also provide critical price improvement opportunities for orders. QCC trades deny the marketplace of these essential benefits, and the Proposal would only compound this problem.

III.   Phlx's Primary Justification for the Proposal is Flawed

The primary justification for the Proposal is that a competing exchange (ISE) currently interprets its QCC rules in the manner that Phlx is proposing to adopt. Because Phlx essentially admits it believes ISE is currently interpreting its QCC rules incorrectly, CBOE asserts that Phlx's justification is insufficient.

In its Proposal, Phlx states that it "understands that the [ISE] permits multiple counterparties on one side of a QCC to facilitate the 1,000 contract minimum. Although ISE and Phlx rules governing QCC trades are identically worded in relevant respects, Phlx has taken the opposite approach and required both sides of a QCC trade be a single order of at least 1,000 contracts." CBOE infers from this statement that Phlx believes that each of ISE's and Phlx's QCC rules limit QCC trades to crosses of single orders of at least 1,000 contracts. Despite the Commission's explicit statement that QCC trades are intended for crosses of orders of 1,000 or more contracts by sophisticated investors, Phlx points to ISE's interpretation as a justification for the proposed rule change.[10] In fact, Phlx even acknowledges in its Proposal that ISE appears to contradict both the Commission's approval order and its own statements to the Commission in support of ISE's modified proposal that limited QCC Orders to not less than 1,000 contracts. In its Proposal, Phlx quotes the ISE as follows:[11]

> ...CBOE questions how we calculate the 1,000 contract minimum for the QCC. Nothing could be clearer in our proposed rule: proposed ISE Rule 715(j) defines QCC as 'an order to buy or sell at least 1,000 contracts that is identified as being part of a qualified contingent trade....' This means what it says, that there must be an order to buy or sell 1,000 contracts that is part of a QCC - not two 500 orders not two 500 legs, not anything but an order to buy or sell at least 1,000 contracts.

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[10]   CBOE notes that although this letter specifically addresses a proposed rule change by Phlx to re-interpret Phlx's QCC rules, the Proposal implies to us that ISE is currently interpreting ISE's own rules improperly. CBOE therefore urges the Commission to examine ISE's administration of its QCC rules and require ISE to enforce those rules consistent with their terms and as approved and contemplated by the Commission.

[11]   See letter from Michael J. Simon, Secretary, ISE to Elizabeth M. Murphy, Secretary, Commission (August 25, 2010) (letter responding to CBOE comment on SR-ISE-2010-73).
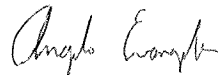
Phlx goes on to state that "despite this seemingly clear statement requiring a single order of at least 1,000 contracts on each side of a QCC Order, ISE currently permits members to satisfy the 1,000-contract requirements through a combination of multiple orders."[12] If Phlx were to continue by stating that the ISE is administering its own rules incorrectly, we would agree. Instead, Phlx bypasses commenting on the legality of the ISE interpretation and, presumably for competitive purposes, merely seeks to codify the ISE interpretation in its rules.

In its Proposal, Phlx also fails to mention the Commission's stated inference from ISE's proposal to increase the minimum contract size of QCC Orders. In its order approving that proposal, the Commission stated: "in SR-ISE-2010-73, the ISE proposes to increase the minimum requirement for a QCC Order from 500 contracts to 1,000 contracts. ISE contends that such an increase supports the [ISE's] intention to permit crossing of only large-sized institutional stock-option orders."[13] The Commission therefore intended that each counterparty to a QCC trade must enter orders for at least 1,000 contracts. Any other reading is implausible to us and undermines the express limits that the Commission intended to attach to QCC trades. CBOE concludes from these materials that, if anything, ISE is currently not administering its own QCC rules properly.

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We respectfully request that the Commission disapprove the Proposal. At a time when significant market structure matters are under review, approval of a rule filing that would accelerate the decline in dedicated market liquidity and preclude additional price improvement opportunities 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 312-786-7464.

Sincerely,

Angelo Evangelou
Associate General Counsel

cc: Heather Seidel (SEC)
       Richard Holley III (SEC)
       David Liu (SEC)
       Jennifer Colihan (SEC)
       Arisa Tinaves (SEC)

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[12]   See the Proposal, note 1, supra, at 68127.

[13]   See note 4, supra.