CBOE EXECUTE SUCCESS™

Angelo Evangelou
Associate General Counsel
Legal Division

Phone: 312-786-7464
Fax: 312-786-7919
evangelou@cboe.com

December 20, 2013

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: Release No. 34- 70940; File No. SR-Phlx-2013-113

Dear Ms. Murphy:

The Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") appreciates the opportunity to comment in response to the Commission's Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove A Proposed Rule Change to Offer a Customer Rebate ("Suspension Release"),[1] issued with respect to the recent rule filing submitted by NASDAQ OMX PHLX LLC ("Phlx") contemplating customer rebates based on aggregated order flow sent to the Phlx and its affiliated options exchanges.[2] As discussed below, the Commission should disapprove the Proposal as inconsistent with various provisions of Section 6 of the Securities Exchange Act of 1934 ("Exchange Act").

I. Background

The Phlx Rebate Proposal was filed inappropriately under Section 19(b)(3)(A) of the Securities Exchange Act of 1934 ("Exchange Act") for immediate effectiveness – inappropriate because the Proposal contemplates a novel method of determining how a member will qualify for the rebates that raises significant legal and policy issues, examined below. Under these

[1] Securities Exchange Act Release No. 70940 (November 25, 2013), 78 FR 71700 (November 29, 2013) (SR-Phlx-2013-113).

[2] See Securities Exchange Act Release No. 70866 (November 13, 2013), 78 FR 69472 (November 19, 2013) (SR-Phlx-2013-113) ("Phlx Rebate Proposal" or "Proposal").

circumstances, issuance of the Suspension Release was necessary and proper as an initial response to the Proposal, affording commenters and the Commission additional time to review and analyze it. After considering the Proposal and its implications, CBOE believes that it should be disapproved and urges the Commission to do so.

Under the Phlx's Customer Rebate Program, the Phlx pays tiered rebates to Phlx members for certain customer orders in multiply traded options executed on the Phlx. The Phlx Rebate Proposal, however, would modify the current method of determining how such rebates are earned in an unprecedented way. In particular, the Proposal would calculate additional rebates by reference not only to the number of such orders effected by the member and its affiliates on the Phlx, but also on the aggregate of those effected by the member and any of its affiliates on either or both of the other national securities exchanges affiliated with the Phlx – i.e., The NASDAQ Options Market LLC ("NOM") and/or NASDAQ OMX BX, Inc. ("BX Options") (collectively, "NASDAQ OMX Exchanges").

II. Stated Purpose and Likely Effects of Phlx Rebate Proposal

The Phlx explains in its filing that the purpose of the Proposal is "to incentivize its members to achieve [the] volume [needed to earn the new Phlx rebate] by . . . aggregate[ing] Customer volume transacted on NOM and/or BX Options for the . . . purpose of measuring the volume criteria."

As discussed below, the purpose and the predictable effects of the Phlx Rebate Proposal are inconsistent with the requirements of Sections 6(b)(4), (b)(5), and (b)(8) of the Exchange Act and we urge the Commission to disapprove it.

A. The Proposal is Inconsistent with Section 6(b)(4).

Section 6(b)(4) of the Exchange Act requires that the rules of a registered national securities exchange provide for "the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using *its* facilities." [emphasis added][3] That section contemplates that such "dues, fees, and other charges" shall be allocated only in respect of use of the facilities of the exchange imposing such charges, not the facilities of some other exchange – or, for that matter, on the basis of anything except use of the facilities of the charge-imposing exchange. The proposal is therefore inconsistent with the statutory language of that section.

---

[3] See NetCoalition v. Securities and Exchange Commission, 615 F.3d 525 (DC Cir. 2010) ("NetCoalition I") at 534 (Under Section 6(b)(3) of the Exchange Act, the rules of an exchange "must also 'provide for the equitable allocation of reasonable dues fees and other charges among . . . persons using its facilities'. " [intervening words omitted in original]).

Moreover, to conform to Section 6(b)(4) a fee, due or other charge imposed by an exchange must also be allocated in an "equitable" manner and "reasonable." Imposition of a fee or charge by an exchange based on some activity other than use of the fee-imposing exchange's own facilities necessarily would be impossible to allocate in an "equitable" way and could never be "reasonable."[4] For the reasons stated above, the Proposal is inconsistent with Section 6(b)(4) of the Exchange Act.

B. The Proposal is Inconsistent with Section 6(b)(5)

Section 6(b)(5) of the Exchange Act requires that exchange rules be designed to "protect investors and the public interest" and that they not "permit unfair discrimination between customers, . . . brokers, or dealers."

It has long been recognized that exchange rebates can and do serve legitimate policy purposes, consistent with the Exchange Act, including lowering order routing costs to broker-dealers seeking best execution of customer orders, attracting liquidity, facilitating technological advancements in retail customer order handling practices, and facilitating competition amongst broker-dealers and exchanges.[5] Thus, rebate practices of exchanges have been allowed by the Commission in the past as an acceptable means of seeking to attract additional order flow.

The Phlx Rebate Proposal, however, is significantly different from those allowed rebates proposals. By its nature, the Phlx Rebate Proposal would change the relative costs of members of the Phlx who submit orders to that exchange. It would advantage members that are also members of NOM and/or BX that direct orders to those exchanges, while disadvantaging Phlx members who do not have such memberships. Similarly, the Proposal would increase the relative costs of trading for customers of the latter group, while lowering those costs for customers of the former. No useful or proper purpose under the Exchange Act is served by an exchange rule that discriminates among exchange members and their customers, solely by reason of being members, or being affiliated with members, of other affiliated exchanges and effecting trades on those exchanges. For that reason, the Proposal is inconsistent Section 6(b)(5) of the Exchange Act.

Moreover, up until now, disclosure by brokers accepting rebates or other inducements for order flow, coupled with continued insistence by the Commission that broker-dealers must take appropriate steps to be sure they are fulfilling their best execution responsibilities notwithstanding acceptance of rebates and other such inducements to direct order flow, have

---

[4] See, also, Section 6(b)(5) of the Exchange Act, which precludes rules of an exchange from being designed "to regulate . . . matters not related to the purposes of this chapter or the administration of the exchange."

[5] See Securities Exchange Act Release Nos. 34902 (October 27, 1994), 59 FR 55006 (October 27, 1994) (S7-29-93).

been thought adequate to ensure that the payment of inducements for order flow do not distort brokers' basic duty to secure the best prices obtainable for their customers opportunities. The discriminatory nature of the Phlx Rebate Proposal could alter this balance and present a new threat to public confidence in brokerage services and market integrity generally. This would be contrary to the public interest and inconsistent with the protection of investors. If such a reconsideration of policy must be undertaken, it should be conducted searchingly on a market-wide basis and not in the context of a single outlier rule proposal such as the Phlx Rebate Proposal.

C. The Proposal is Inconsistent with Section 6(b)(8)

Section 6(b)(8) of the Exchange Act prohibits exchanges from adopting rules that impose burdens on competition that are not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Phlx Rebate Proposal is such a rule because, by allowing Phlx to aggregate volume across three distinct exchanges for purposes of rewarding trading by certain of its members on Phlx, the competitive positions of all other options exchanges – reliant on only their own volumes for the purpose of rebate structures and calculations – are adversely affected. The proposal also would unfairly and inappropriately burden Phlx members whose businesses and affiliations will not entitle them to the new, lowered costs of doing business to be enjoyed by their larger, better-situated fellow members (and correspondingly adversely affecting their customers compared to customers of better-positioned members). For the reasons stated above, the Proposal is inconsistent with Section 6(b)(8) of the Exchange Act.

III. The Phlx's Statutory Basis for the Proposal is Flawed

To support its Proposal, the Phlx relies on the competitive market forces arguments marshaled by the Commission in 2008 when it approved a rule filing by the NYSE Arca, Inc. ("NYSE Arca") proposing imposition of a new fee for real-time access to market information with respect to all limit orders resident in the NYSE Arca limit order book, formerly disseminated by NYSE Arca free of charge, and new professional and non-professional device fees with respect to display of such information by subscribers ("NYSE Arca Fee Filing").[6] Certain commenters protested that the NYSE Arca Approval Order was defective for various reasons, including the absence of a cost-based analysis of the proposed fees.[7] In relying on the Commission's responses to those arguments, the Phlx ignores the key differences between the issues presented by the NYSE Arca Fee Filing and those presented by its novel Proposal.

---

[6] See Securities Exchange Act Release 59039 (December 2, 2008), 73 FR 74770 (December 9, 2008) ("NYSE Arca Approval Order").

[7] The matter was litigated in NetCoalition I, supra, note 3.

In resolving the issues presented by the NYSE Arca Fee Filing, the Commission concluded that it was unnecessary to engage in a cost-based analysis of the proposed fees because its own market-based, competitive forces analysis sufficed to support the reasonableness of the proposed fees without having to resort to a cost-based analysis. That is, the Commission concluded that competitive market forces were sufficient to control the level of the fees NYSE Arca proposed to charge and to ensure that such fees were equitable, fair, reasonable, and not unreasonably discriminatory.[8] At issue in this case is not whether competitive forces suffice to control the level of a fee to be charged by Phlx for market information, but something quite different. The issues presented by the Phlx Rebate Proposal are whether competitive market forces are sufficient to:

> (i) justify misuse of the Phlx's authority to set fees, dues and other charges (basing use of that authority in significant part on use of the facilities of other, affiliated exchanges rather than exclusively on use of its own facilities);
>
> (ii) overcome or remedy the unfair discrimination between various of its own exchange members and their customers that will result as a predictable consequence of the rebate scheme contemplated by the Proposal;
>
> (iii) counteract and mitigate the negative effects of its Proposal on existing protections for investors in the routing of their orders in multiply-traded options by members of the Phlx and their affiliates; and
>
> (iv) outweigh the burdens on competition that the Proposal, if implemented, would impose on differently-situated Phlx members and their customers.

CBOE is of the view that competitive forces do not suffice for any of these purposes.

The NYSE Arca Approval Order, on which the Phlx has placed such considerable reliance, points out directly why the Proposal is unsound:

> ". . . the Exchange Act precludes anti-competitive tying of the liquidity pools of separately registered securities exchanges even if they are under common control."[9]

Indeed, the NYSE Arca Approval Order states this principle more fully as follows:

---

[8] NYSE Arca Approval Order at 7481-2.

[9] NYSE Arca Approval Order at 74790. There can be no question but that the Commission used the term "tying" in this context in the loose sense of "connecting" or "putting together," and not in any technical way alluding to the anti-trust concept of "tying."

> "Exchanges under common control clearly have incentives to avoid competing with each other. Each national securities exchange, however, is subject to a comprehensive regulatory structure that is designed to address anti-competitive practices. This regulatory structure limits the potential for related exchanges to act jointly in ways that would inappropriately inhibit competition by other exchanges and trading centers with each related exchange. [After referring to Section 6 of the Exchange Act] ... a proposed exchange rule must stand or fall based, among other things, on the interests of customers, . . . broker-dealers, and other persons using the facilities of that exchange." [10]

The Phlx argues that its Proposal does no more than respond to competitive imperatives and that, if its fee rebate concept causes some to pause in directing orders to the Phlx, there are many alternative markets besides the Phlx (or NOM or BX Options) to which they can turn – that is, that its Proposal does no real harm to any participant in the markets for multiply-traded options and affects other options exchanges only by taking from them some portion of the order flow they now enjoy and that Phlx seeks, through this "competitive" means, to capture. This argument, however, fails to address any of the Section 6(b) inconsistencies described above, factors not implicated by the NYSE Arca Fee Filing.

For the reasons stated above, the Phlx analysis falls far short of demonstrating that the Phlx Rebate Proposal is consistent with the Exchange Act.

* * * * *

We respectfully request that the Commission disapprove the Proposal. We would be pleased to discuss the concerns expressed above with any member of the Commission or its staff. 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: John Ramsey, Acting Director, Division of Trading & Markets
James Burns, Deputy Director, Division of Trading & Markets
Heather Seidel, Associate Director, Division of Trading & Markets
Richard Holley III, Assistant Director, Division of Trading & Markets

---

[10] Id. at 74793