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CHICAGO BOARD OPTIONS EXCHANGE

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February 14, 2005

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Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. S7-10-04 – Regulation NMS

Dear Mr. Katz:

The Chicago Board Options Exchange, Incorporated ("CBOE") submits this letter in response to the Securities and Exchange Commission's ("Commission") re-proposal of Regulation NMS. CBOE previously submitted extensive comments on Regulation NMS in a letter dated July 1, 2004. The purpose of this submission is to supplement our July 1st letter by: (1) commenting on the locked/crossed market provisions of the proposal; and (2) stating a preference regarding the trade-through protection alternatives proposed by the Commission in the re-proposal. In short, we believe that the locked/crossed provisions are unnecessary and counter-productive; and, we support the market BBO (Top of Book) alternative over the Depth of Book alternative.

Locked/Crossed Markets

Regulation NMS proposes to codify the notion that locked/crossed markets are inherently wrong or, at least, that they do not contribute to fair and orderly markets. To that end, proposed Rule 610(d) states the following:

> (d) *Locking or crossing quotations.* Each national securities exchange and national securities association shall establish and enforce rules that:
>
> (1) Require its members reasonably to avoid displaying quotations that lock or cross any protected quotation in an NMS stock, and to avoid displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an effective national market system plan;
>
> (2) Are reasonably designed to assure the reconciliation of locked or crossed quotations in an NMS stock; and
>
> (3) Prohibit its members from engaging in a pattern or practice of displaying quotations that lock or cross any protected quotation in an NMS stock, or of displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an effective national market system plan.

This language seems eerily familiar to CBOE because it is very similar to a standard that has been imposed in the options markets. Section 7(a)(i)(C) of the Intermarket Options Linkage Plan (the "Plan") provides that the "dissemination of 'locked' or 'crossed' markets shall be avoided." It further provides for a methodology to be followed by members involved in an intermarket lock/cross (namely that the member that "caused" the lock/cross should either change its quote so that the lock/cross no longer exists, or ship an order through the linkage to trade against the bid or offer that was locked/crossed). Although not stated in the Plan, there is an expectation that options exchanges will treat a pattern or practice of locked/crossed markets by members as a regulatory matter subject to sanctions. We note that significant surveillance efforts attach to such regulation.

The Intermarket Options Linkage Operating Committee is in the process of seeking to drastically modify the way locked/crossed markets are addressed in the Plan and the way they are perceived. Our experience with the avoidance concept has made clear to the options markets that it doesn't make sense and it doesn't work. We hope the Commission avoids adopting in the equities markets a structure that has proven unworkable in the options markets.

CBOE believes that as long as quotations are accessible (as they will be under proposed Rule 610), locked or crossed markets are consistent with fair and orderly markets and, indeed, beneficial to investors. As such, they should be allowed. We also believe that regulatory resources are better-utilized surveilling for conduct that is actually detrimental to the investing public as opposed to conduct that can result in favorable markets for investors. Our thoughts are discussed in greater detail below.

Locks and Crosses Create Unique Opportunities. An intermarket cross is when the best bid disseminated by one market center (lets say $19.90) is higher than the best offer disseminated by a different market center (perhaps $19.87). A crossed market creates an arbitrage opportunity, and assuming there is access to the exchanges involved in the cross (which proposed Rule 610 will cause), CBOE is certain that the crossed market would be uncrossed expeditiously. An observer recognizing the crossed market could buy shares of the stock for 19.87 and contemporaneously sell them for 19.90 thereby pocketing an instantaneous profit. These profit opportunities are highly sought after and never neglected by the investing public, so why adopt rules that would preclude them? Further, not one single investor is ever harmed by a crossed market or by its uncrossing. Crossed markets create opportunities and any concern over perceived "confusion" caused by the cross should be assuaged with the knowledge that market forces will uncross these markets faster than any regulation can.

An intermarket lock is when the best bid disseminated by a market center (30.50) is the same price as the best offer disseminated by another market center (30.50). If the market weren't locked it might be 30.50 – 30.54. In that instance, a selling investor would receive a price of 30.50 per share, while a buying investor would pay 30.54 per share. With a locked market, the selling investor still receives 30.50 per share, but the buying investor pays 30.50 per share instead of 30.54, realizing a savings. One side of the market will always get a better price in a locked scenario than if the market weren't locked. As with crosses, not one single investor is ever harmed by a locked market or its unlocking. So again we ask, why adopt rules that would preclude locks? They can only be considered to provide pro-investor pricing. The Commission has historically endeavored to tighten markets (e.g. decimalization) and there is nothing tighter than a locked market.

Locks and Crosses are Natural and Contribute to Fair and Orderly Markets. Market pricing reflects the processing of market information. Market information can be processed by different measures and at different rates. To the extent a market maker on one exchange could post a bid price faster than a market maker on another exchange, he should be allowed to do so, and he should not be inhibited by an unnecessary rule.[1] In liquid products and especially in liquid derivative products like many exchange-traded funds with tight bid-ask spreads, it is entirely natural for markets to frequently lock and cross. This activity reflects competitive quoting, and it should not be prohibited. Indeed, it is unnatural and inconsistent with efficient pricing to cause liquidity providers to not post improved market prices.

As we have learned in the options markets, placing obligations on members that lock/cross, no matter how fleeting the lock/cross, often results in needless and inefficient order traffic. Requiring orders to be transmitted through networks to "resolve" or prevent locks/crosses that often last less than a second often results in (i) orders getting rejected because the ever-changing market has moved prior to receipt, or (ii) executions that deprive truly interested investors from the benefit of the locked/crossed price. A market maker that is about to post an $80 bid that would lock an $80 offer is always free to route an order to the market posting the $80 offer as an alternative to locking, but sometimes a market maker just wants to post an $80 bid despite the existence of an $80 offer. This could be because the size associated with the offer is insufficient, because the market maker does not want to incur the execution fee levied by the market posting the offer, or for no reason at all. The point is it shouldn't matter because, as noted above, the locked market is a choice market for those seeking an execution at that price. If the parties to the lock don't want to ship orders, there is no harm to the marketplace. To the extent one of those parties is a customer limit order, business pressures will cause it to be filled-competition between brokerage firms and between market centers will ensure that.

Avoidance provisions necessarily preclude aggressive quoting, and in an environment where market centers are providing point and click access to their markets (which seems to be a central purpose of the proposed Access Rule) there is no compelling reason to discourage aggressive quoting.

Regulatory Considerations. As we have demonstrated, locked and crossed markets provide unique opportunities to investors and, importantly, cause no harm to investors or the markets. Therefore, we believe it is an inefficient use of regulatory resources to require exchanges to surveil for this conduct. Capturing and dissecting quote traffic to determine whom locked/crossed who involves significant processing. Further monitoring that activity to detect a pattern or practice complicates these surveillance efforts. As exchanges, we are expected to enforce compliance with a multitude of rules and regulations. If the Commission leaves this antiquated locked/crossed avoidance concept in the final approved version of Regulation NMS, it will cause market centers to expend regulatory resources for conduct that is harmless.

Other Commenters. In the re-proposal, the Commission notes that several commenters have expressed support for the proposed locked/crossed provisions of Rule 610. We have reviewed those comments and offer the following responses:

- By repeating over and over that locked/crossed markets are "confusing to investors" and "reflect inefficiencies in the marketplace" does not make it so. None of those commenters actually provided any evidence supporting these contentions. In fact the

[1] In discussing the speed of generating quotes and processing information, CBOE notes that we are not referring to situations where two market makers utilize the exact same pricing models but one market maker is closer geographically to an index value distributor or has a slightly faster computer network (i.e. everything is identical but the hardware or its location). Instead we are referring to one market maker having a more accurate or comprehensive pricing scheme.

Nasdaq letter[2] seems to disregard its own concerns with confusion and inefficiencies one paragraph after expressing those concerns in order to lobby for allowing locked/crossed markets when they involve a slow or manual quote. Is a customer less confused by a locked quote on an ILX screen if it involves a slow market?

- A larger question is: what is confusing or inefficient about a market quote that is $10 bid and $10 offer? To us, that implies that the price of the stock is $10. It couldn't be simpler or more efficient.
- We believe that the data provided by Nasdaq in its letter supports our view that locked/crossed markets need not be prohibited or over-regulated. During a one-week period in March, Nasdaq found that Nasdaq stocks were locked/crossed an average of 509,018 times a day. Of those, 314,380 lasted *less* than 1 second- and without the benefit of a rule prohibiting locks or crosses![3]
- What we suspect as the real reason behind these commenters concerns relate to ECN access fees and certain rebate structures. Those concerns can and should be addressed without prohibiting locked/crossed markets.

CBOE respects that the Commission has historically considered comments on proposed rules and modified proposals when compelling arguments are made. We hope our views on the locked/crossed aspects of the Regulation NMS proposal are seriously considered.

Trade-Throughs

Between the choices presented in the re-proposal, CBOE prefers the market BBO/ Top of Book ("TOB") proposal to the Depth of Book ("DOB") proposal. The TOB proposal would prevent trade-throughs of automated top of book quotations, whereas the DOB alternative would deem all automated quotations disseminated by market centers (including at varying price points) as protected. We believe that DOB is overbearing and prohibitive to customers exerting choice with respect to market centers.

Today, market centers offer alternatives to investors. Those include speed of execution, differing trade allocation algorithms, price discovery efficiencies and other services. Those choices become severely muted with the imposition of depth of book price protection. A nationwide consolidated limit order book would, aside from causing exchanges to undertake significant systems projects, stifle intermarket competition.

In addition to our general preference for TOB, we will also take this opportunity to comment on certain language contained in the Regulation NMS proposal. First, it is clear that the Commission intends for brokers as well as market center *specialists and market makers* to able to route intermarket sweep orders, however the proposed definition of Intermarket sweep orders in proposed Rule 600(b)(30) implies that more than one limit order must be routed simultaneously to qualify as an Intermarket sweep order. This does not seem to comport with the notion that a specialist on an exchange could receive a plain customer order and then generate an intermarket sweep order to satisfy a better-priced quote on another exchange, because in that instance only one intermarket sweep order has been sent (contemporaneous with the execution of the plain customer order).

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[2] See July 2, 2004 letter from Edward S. Knight, Nasdaq Stock Market, Inc. at 23-24.

[3] The average duration of the 509,018 locks/crosses crosses was 3.1 seconds, and obviously that number reflects a mean and is thus inflated by a handful of locks/crosses that persisted for lengthy periods of time (likely in connection with system problems).

Second, the crossed market exception to the proposed trade-through rule contained in proposed Rule 611(b)(4) seems to only except trade-throughs of crossed markets that involve the crossing of *protected* bids and offers. We do not see why a "trade-through" during a crossed market involving a manual (i.e. non-protected) quote on at least one side of the cross should be any different. In other words, we think that an execution during any crossed market (not just crossed protected markets) should be exempt from being considered a trade-through. For example, Exchange A is posting a manual bid of $13 while Exchange B posts and automated offer of $12.95, an execution at $13 should not be deemed a trade-through of Exchange B's quote.

Conclusion

We believe our comments merit strong consideration, and we hope the Commission follows the recommendations of this letter as well as our July 1st letter. We stand ready to work with the Commission and the Commission staff on the implementation of Regulation NMS. Please contact Joanne Moffic Silver, General Counsel and Corporate Secretary, at (312) 786-7462, Angelo Evangelou, Managing Senior Attorney, at (312) 786-7464, or the undersigned with any questions.

Sincerely,

Edward J Joyce