March 8, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington D.C. 20549-0609

Re: File No. S7-39-04
Fair Administration and Governance of Self-Regulatory Organizations

Dear Mr. Katz:

The Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") is pleased to provide comments on the SEC's proposed rules concerning governance, administration, transparency and ownership of self-regulatory organizations ("SROs").[1]

CBOE commends the SEC Commissioners and the SEC staff for undertaking such a comprehensive review of these issues. CBOE shares the SEC's goals in enhancing exchanges' governance structures and practices so that they serve to protect investors and the public interest and assure that exchanges act consistent with their self-regulatory obligations and be effective regulators. As you know, in the past several years CBOE conducted a thorough review of its governance structure and practices and implemented numerous changes, including changes to the composition of its Board of Directors and Board committees that required SEC review and approval. CBOE also implemented other changes that are similar to the proposals contained in the Release, for example establishing a Regulatory Oversight Committee, composed solely of public directors, and a Governance Committee, appointing a Lead Director (from among CBOE's public directors), and implementing the practice of CBOE's Board meeting in executive session without management present. As a result, CBOE believes that its existing governance structure and practices serve not only to protect investors and the public interest and assure the integrity of CBOE's regulatory activities, but also to enhance the ability of CBOE to develop and implement sound business strategies.

Nonetheless, CBOE believes it is appropriate for the SEC and SROs to continue to enhance the governance structure and regulatory functions of exchanges, and welcomes the adoption of some of the "best practices" the SEC has identified. CBOE generally agrees with the SEC that expanding the role of independent directors in the governance of exchanges serves to mitigate the conflicts of interest the SEC identifies that are inherent in self-regulation. However, CBOE believes that some of the SEC's proposals are duplicative of one another and unnecessary to achieve their intended objective, which is to assure that exchanges act consistent with their self-regulatory obligations. Moreover, some of the proposals appear to give insufficient weight to

[1] Securities Exchange Act Release No. 51019 (November 18, 2004) ("Release").

the benefits of member involvement in SRO governance, which is one of the underpinnings of self-regulation.

CBOE's response primarily focuses on those proposals relating to governance and administration of exchanges that it believes are most important to assure the adequacy and independence of an SRO's regulatory programs. CBOE has not sought to respond to each of the questions raised by the SEC in its Release. Additionally, attached is an addendum to CBOE's response that addresses some of the other proposals as to which CBOE's comments are more specific in nature, or as to which CBOE seeks further clarification from the SEC.

Fair Administration and Governance

Board of Directors Composition

In its Release, the SEC proposes to establish "minimum governance standards" for national securities exchanges.[2] These minimum standards include, among other things, the requirement that the governing board of each exchange must be composed of a majority of "independent" directors, that each exchange must establish certain board standing committees (Audit, Compensation, Governance, Regulatory Oversight and Nominating), and that each standing committee must be composed solely of independent directors.[3]

According to the Release, these proposals will "help address the conflicts of interest that otherwise might arise when persons with a nexus to the SRO are involved in key decisions."[4] By lessening the influence of members in the governance of exchanges, the SEC believes that these proposals will increase the likelihood that an exchange will act in accordance with the mandates of the Exchange Act and in the best interests not only of the exchange and its members, but also the investing public. In support of these proposals, the SEC notes that they are consistent with accepted corporate governance "best practices," and comport with exchange rules applicable to listed companies that the SEC recently approved to address "similar governance concerns and conflicts of interest that can arise between a company's management and its public shareholders."[5] These "best practices" and listing rules generally require a public company to have a board composed of a majority of independent directors and require that the standing committees be composed entirely of independent directors.

CBOE disagrees with the proposal to the extent it mandates that an exchange's governing board must be composed of a majority of independent directors. Although exchanges certainly should be free to adopt this standard or implement a greater proportion of independent directors, CBOE does not believe that the requirement of a majority of independent directors is necessary to assure that an exchange acts consistent with its self-regulatory obligations.[6] Rather, CBOE

[2] The SEC's proposed rules also would apply to registered securities associations, *i.e.*, the NASD.
[3] As proposed, an "independent" director is a person who has no material relationship with the exchange, any member of the exchange, or any issuer of securities that are listed or traded on the exchange.
[4] Release at p. 39.
[5] Release at p. 38.
[6] CBOE also questions the SEC's authority to mandate this minimum board composition standard. Corporate governance traditionally falls within the purview of state law, and the SEC does not appear to have been granted any specific authority to supplant state corporation law regarding the governance of SROs. Additionally, CBOE questions the SEC's authority to adopt rules that are inconsistent with the specific standards of the Exchange Act pertaining to SRO corporate governance in reliance on the general standards of the Act. Moreover, even if the SEC has the authority to impose this proposal, CBOE does not

believes that minimum standard that the SEC should adopt is that an exchange's governing board must be composed of at least 50% independent directors, as well as persons representing the various constituencies of the exchange's membership overall.

As an initial comment, CBOE believes the SEC's significant reliance for this proposal upon corporate governance "best practices" and exchange listing rules for public companies is misplaced. In the Release, the SEC correctly points out that the conflicts of interest that these "best practices" and exchange listing rules seek to address and minimize are conflicts that may arise *between a public company's management and its shareholders*. Specifically, in the case of public companies, there exists the possibility that senior management may be more concerned with their own self-interest at the expense of the best interests of the corporation and the shareholders. Strengthening the role of independent directors in public companies thus serves to act as a check on the self-interest of management and helps assure that the board acts in the best interests of the corporation and the shareholders.[7]

Although conflicts between a company's management and its owners/shareholders can arise in exchanges, the Release does not suggest that the application of this "best practice" to SROs is to mitigate this particular conflict. Rather, the specific conflict of interest that the SEC identifies and seeks to address through these proposed changes is a different one – that is, the conflict is between exchange members who may have an interest in lessening the costs and burdens of regulation and the SRO's obligation to be an effective regulator. Simply because this "best practice" may serve to mitigate the conflicts between management and shareholders faced by public companies does not mean that it is appropriate or useful to address the conflicts inherent in self-regulation that SROs face. In CBOE's opinion, the Release does not explain how or why the adoption of this corporate governance "best practice" or remedy will address or minimize this other type of conflict inherent in self-regulation and assure that an exchange acts consistent with its self-regulatory obligations.

CBOE believes that determining the appropriate board structure involves balancing the potential conflicts that are inherent in self-regulation while providing members with a reasonable role in the governance of the exchange and also obtaining member expertise and knowledge of the marketplace to assist the exchange in performing its self-regulatory role.[8] CBOE agrees with the SEC that the representation of a significant number of independent directors on exchange governing boards is important to mitigate the conflicts of interest inherent in self-regulation. However, CBOE believes that the minimum governance standard that the SEC should adopt is that an exchange's governing board must be composed of at least 50% public directors, as well as persons representing the various constituencies of the exchange's membership overall. A 50% balanced board minimizes the conflict of interest identified by the SEC while preserving the benefits of self-regulation. Moreover, the Release does not explain why a 50% balanced board, which is the governance standard that many exchanges (including CBOE) adopted in recent years with the SEC's urging and approval, is insufficient to assure an exchange will act in accordance

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believe it is a judicious use of its authority to require a governing board such as CBOE's Board to be composed of a majority of independent directors, as opposed to at least 50% independent directors.

[7] See The Business Roundtable, Principles of Corporate Governance (May 2002), at 11-12; James E. Cheek, III, et al., Report of the American Bar Association Task Force on Corporate Responsibility (2003), at 10-12.

[8] The traditional arguments in favor of self-regulation note that self-regulation "provides the securities industry with professionals who are more knowledgeable about the intricacies involved in the marketplace and the technical aspects of regulations, resulting in a more precise regulatory function." See Remarks by Lori Richards, Director, Office of Compliance Inspections and Examinations, "*Self-Regulation in the New Era"*, NRS Fall 2000 Compliance Conference (September 11, 2000).

with the mandates of the Exchange Act and in the best interests not only of the exchange and its members, but also the investing public. In fact, in connection with its recent review and approval of rules pertaining to the demutualization of the Chicago Stock Exchange, the SEC determined that a 50% balanced board is consistent with the Exchange Act.[9]

CBOE's Board of Directors is required to be equally balanced between 11 public directors and 11 member directors, plus the Chairman of the Exchange. CBOE's public directors cannot be members of CBOE or broker dealers, or affiliated with a broker dealer. Unlike stock exchanges, CBOE does not have so-called "listed company" directors. As a result, CBOE's public directors are truly independent and representative of the public interest. Implicit in the SEC's proposal is the supposition that unless a board is composed of a majority of independent directors, an exchange would make decisions and take certain actions that would result in it not vigorously fulfilling its regulatory obligations. Also underlying the SEC's proposal is the belief that directors typically vote according to their classification, with public directors on one side of an issue and member directors on the other side. It is CBOE's experience that neither of these assumptions is accurate. CBOE's directors believe that CBOE must be an effective and vigorous regulator, and as a general matter decisions by CBOE's Board or its Board committees are not made on the basis of whether the director is a public director or member director. Moreover, CBOE's member directors are not a homogenous group; rather, the member directors represent the various aspects of the securities industry overall and the directors recognize that it is in their long-term self-interest that CBOE operate a well-regulated marketplace. Accordingly, CBOE believes that the minimum governance standard that the SEC should adopt is that an exchange's governing board must be composed of at least 50% public directors, as well as persons representing the various constituencies of the exchange's membership overall.

"Issuer" Director

The SEC also proposes that at least one director must be representative of issuers and at least one director must be representative of investors, and in each case, such director cannot be associated with a member or broker or dealer. CBOE does not believe that the requirement to have at least one director representative of issuers should be applicable to it since CBOE does not have any "listed" companies. As you know, CBOE has primarily functioned as a national securities exchange for the listing and trading of options on underlying securities throughout its over 30-year history. CBOE does trade a handful of equity-related securities,[10] although none of which is stock of an individual company. Accordingly, CBOE requests that the SEC revise this proposal such that the issuer director requirement only applies to exchanges with some minimum number of listed companies, or some other meaningful minimum standard.

Restriction on Certain Directors Voting on Matters Within Authority of Standing Committees

To further bolster the proposed requirement that the majority of the board must be independent, the Release proposes that when the governing board of an exchange considers any matter within the authority or jurisdiction of a standing committee, a majority of directors who vote on the matter must be independent. To ensure that exchanges comply with this requirement,

[9] See Rel. No. 51149, approving SR-CHX-2004-26 (February 8, 2005), stating "The Commission finds that the requirement that at least one-half of the directors of the CHX Board be Public Directors is consistent with Sections 6(b)(1) and 6(b)(3) of the Act, which requires that one or more directors be representative of issuers and investors."

[10] The equity-related securities traded on CBOE include a small number of exchange traded funds and structured products, including equity-linked notes.

each exchange would be expected to adopt procedures which would determine which non-independent directors would vote in the event one or more independent directors are absent and a majority of independent directors are not present.

CBOE disagrees with this proposal. First, it conflicts with state corporation law which generally requires that each director has the right and responsibility to vote on all matters brought before the board, unless a conflict precludes his/her participation. The SEC does not appear to have been granted any specific authority to supplant state corporation law regarding the governance of SROs in this regard. Second, and as explained above, it is premised on a misunderstanding as to the manner in which governing boards operate, namely, that directors vote according to their classification, with public directors on one side of an issue and member directors on the other side. Accordingly, CBOE requests that the SEC withdraw this proposed change.

Additionally, CBOE believes that requiring exchanges to adopt procedures that would disenfranchise certain non-independent directors if a majority of independent directors are absent and the matter to be voted upon falls within the authority or jurisdiction of a standing committee is flawed. Specifically, the SEC's proposal improperly focuses on the procedure pursuant to which an issue comes before the board, *i.e.*, it applies broadly to any issue that is recommended or otherwise within the jurisdiction of a standing committee, as opposed to focusing on the subject matter being voted upon. Thus, the proposal not only paints with too broad a brush (any issue recommended by a standing committee), but paints with the wrong brush.

Board Standing Committees

The SEC proposes that each exchange have the following board standing committees: Audit, Compensation, Governance, Nominating, and Regulatory Oversight. Additionally, the SEC proposes that each standing committee shall be composed solely of independent directors and also have a written charter addressing the committees' duties and responsibilities. In support of this proposal, the SEC again relies upon corporate governance "best practices" for public companies, and states that requiring all members of these committees to be independent "would result in a greater degree of objective-decision making" regarding the exchange's core responsibilities. The SEC notes that these committees "generally are charged with overseeing an exchange's regulatory responsibilities, including the SRO's commitment of financial resources to fund those responsibilities."[11]

Establishment of Standing Committees

CBOE agrees with the SEC's proposal to the extent it requires the establishment of the above board standing committees, with the exception of the establishment of a board level Nominating Committee. As further discussed below, CBOE believes that an exchange should have the discretion to determine whether its Nominating Committee is a board level committee as opposed to a committee composed of other qualified persons who are not directors.

CBOE has had for many years standing Audit and Compensation Committees of its Board, and more recently standing Governance and Regulatory Oversight Committees of its Board. In 2002, CBOE's Board established a standing Regulatory Oversight Committee, which is comprised solely of public directors. Pursuant to its Board approved charter, the Regulatory Oversight Committee oversees the independence and integrity of the regulatory functions of the

[11] Release at p. 53.

Exchange, and seeks to ensure that that the regulatory functions remain free from the inappropriate influence of CBOE members. In 2003, CBOE's Board established a standing Governance Committee of the Board, to assure that as an ongoing matter, questions pertaining to governance that may arise from time to time will be reviewed promptly and brought to the attention of the Board. All CBOE committees, including its Audit, Compensation, Governance, Nominating, and Regulatory Oversight Committees, operate pursuant to Board approved charters that specify each of the committees' duties and responsibilities.

Composition of Standing Committees

CBOE, however, does not agree with the SEC's proposal to the extent it eliminates the opportunity for non-independent directors to serve on the Audit, Compensation, and Governance Committees. By totally excluding member directors from these standing committees, the SEC gives insufficient weight to the benefits of member involvement in SRO governance, and goes too far in order to mitigate conflicts that are not the result of member influence in the first place.

In general, CBOE believes that the composition of the standing committees should depend upon the committee's duties and responsibilities, and the type of matters that fall within its jurisdiction. In some limited instances, it may be appropriate to not have members participate on certain standing committees in order to minimize the potential that action taken by the committee will be unduly influenced by conflicts inherent in self-regulation. In most instances, though, CBOE believes that member representation on the standing committees is beneficial and appropriate, and does not in any way inhibit an exchange from fulfilling its self-regulatory obligations.

CBOE believes that an appropriate minimum standard that the SEC should adopt is that the Audit, Compensation, and Governance Committees should be comprised of at least 50% independent directors, and that the chairman of these committees should be an independent director. This is the current governance standard that many exchanges have adopted in recent years with the Commission's urging and approval, and the Release does not address why this standard is suddenly insufficient or how it inhibits an exchange from fulfilling its self-regulatory obligations. With respect to the composition of the Regulatory Oversight Committee, CBOE agrees with the SEC proposal that only independent directors should serve on this committee in light of its duties and responsibilities.

As support for its proposal, the SEC again relies upon the fact that its proposal is consistent with corporate governance best practices for public companies, which generally require these board committees to be comprised solely of independent directors. As discussed above with regard to board composition, CBOE believes that the SEC's reliance on these best practices as support is misplaced. Simply because this best practice may serve to mitigate the conflicts between management and shareholders faced by public companies does not mean that it is appropriate or useful to address the conflicts inherent in self-regulation that SROs face.

Moreover, the SEC's contention that allowing only independent directors to serve on these committees (excluding the Regulatory Oversight Committee) will result in "a greater degree of objective-decision making as to an exchange's core responsibilities" is not persuasive and is more likely to have the opposite effect. The proposal places responsibility for various exchange matters in the hands of persons who are highly qualified and distinguished, and yet who, in most instances, do not have direct knowledge and experience with respect to the securities industry in general and the intricacies of operating an exchange in particular. At the same time, the proposal completely excludes an entire category of persons (members) with meaningful perspectives on

the securities industry, in general, and the operation of the exchange, in particular, from participating in the decision-making on significant matters. The latter are persons who are both owners (or shareholders) of the exchange and users or customers of its facilities. CBOE's experience is that the input and involvement of members on these committees is invaluable and appropriate, and enhances CBOE's ability to develop and implement sound business strategies.

Additionally, the SEC's contention that these standing committees "generally are charged with overseeing an exchange's regulatory responsibilities, including the SRO's commitment of financial resources to fund those responsibilities," while accurate with respect to the Regulatory Oversight Committee, misstates the role and functions of the other standing committees -- even as proposed by the SEC. For example, the duties of the Governance Committee, as proposed, include the development of governance principles applicable to the exchange. CBOE's Governance Committee currently has the specific responsibility for evaluating CBOE's governance structure and committee structure, and various issues pertaining to the Board meeting process. The duties of the Compensation Committee, as proposed, include the responsibility to review corporate goals and objectives pertaining to compensation of executive officers and to evaluate the performance of the executive officers in light of those objectives. None of these responsibilities directly relate to "overseeing an exchange's regulatory responsibilities" or the "SROs commitment of financial resources to fund those responsibilities" as the Release states. Accordingly, CBOE does not understand the basis for excluding members from the committees that exercise these responsibilities.

The total exclusion of members from these committees is also unnecessary, given all of the other proposals the SEC is making to assure the adequacy and independence of an SRO's regulatory programs, such as (i) requiring the separation of an exchange's regulatory programs from its business functions, (ii) restricting the use of regulatory revenues to fund only regulatory programs, (iii) requiring the Chief Regulatory Officer to report directly to the Regulatory Oversight Committee, (iv) granting the Regulatory Oversight Committee significant authority over the SRO's regulatory program, and (v) imposing significant disclosure and reporting requirements on SROs to the SEC concerning their regulatory programs. All of these proposed requirements are in addition to the proposed change to the composition of the board, to which these standing committees report.

Although the input of members arguably could be provided through separate member advisory committees and panels, requiring such a structure and additional processes would be inefficient and less productive. CBOE believes, and has found over the years, that there is a significant benefit to the contemporaneous discussion and exchanging of views and opinions as issues and matters are being addressed, and this benefit is lost if the standing committee must reconvene without members present to finish its business. The SEC's proposal also is burdensome and costly in that it would likely require more time and effort by independent directors who would also need to meet with member advisory committees in order to obtain member input.

Finally, CBOE believes that if this proposal is adopted as proposed, it may limit the ability of exchanges to establish smaller boards, which would be contrary to the conclusions and recommendations of the corporate governance "best practices" that the SEC cites in its Release which conclude smaller boards are more cohesive and effective. Exchanges will need to ensure that they have enough independent directors to assume all of the responsibilities they are being required to undertake through the SEC's rule proposals.

Thus, for all of the foregoing reasons, CBOE strongly believes that the minimum governance standard that the SEC should adopt is that the Audit, Compensation and Governance committees should be comprised of at least 50% independent directors, and that the chairman of these committees should be an independent director.

Nominating Committee

With regard to the Nominating Committee, CBOE believes that an exchange should have the discretion whether to establish its Nominating Committee as a board level committee as opposed to a committee composed of other qualified persons who are not directors.[12] First, restricting who may serve on the committee to only directors is not necessary to assure the adequacy and independence of an SRO's regulatory programs, provided the committee's composition otherwise provides for sufficient independent representation, and particularly in light of all of the other rules and procedures being proposed. Second, having a separate committee comprised of qualified persons who are not directors may actually be beneficial in that it could lessen any conflicts that could arise with sitting directors being called upon to evaluate and possibly re-nominate themselves and their co-directors. Third, CBOE's nominating process traditionally has been a very time-consuming process that entails meeting on numerous occasions to interview all candidates for the Board and CBOE's Nominating Committee, which is an elected committee, and ultimately slate candidates. Given all of the other duties and responsibilities independent directors will be undertaking in connection with these other rule proposals, CBOE believes that it would be an unnecessary burden to require that only directors may serve on the Nominating Committee. Thus, CBOE recommends that the SEC reconsider this proposal, and provide exchanges with the discretion whether to establish its Nominating Committee as a board level committee or as a committee composed of other qualified persons who are not directors (or possibly even both directors and non-directors).

With regard to composition of the Nominating Committee, for the reasons noted above pertaining to the composition of the board standing committees, CBOE believes that the committee should be composed of at least 50% independent persons, and that the chairman of the committee should be independent. By totally excluding members from the Nominating Committee, the SEC again appears to give insufficient weight to the benefits of member involvement in SRO governance. The rationale set forth in the Release to support this proposal is, as noted above, not persuasive. Excluding members entirely from the Nominating Committee will not result in "a greater degree of objective-decision making as to an exchange's core responsibilities," nor is the Nominating Committee "generally charged with overseeing an exchange's regulatory responsibilities." Moreover, it is only logical that if the Nominating Committee is charged with nominating a governing board composed of at least 50% independent directors as CBOE proposes (or, a majority of independent directors the SEC proposes), the Nominating Committee should be similarly composed.

Although the Release contemplates that a separate member advisory panel could be created that would serve as the "nominating committee" for member directors (thus satisfying the "fair representation" requirements of the Exchange Act), CBOE believes that such a structure and process is inefficient and unnecessary, and has no direct correlation with assuring the adequacy and independence of an SRO's regulatory programs. The Release offers no persuasive reasons to support the establishment of these two separate nominating committees. Additionally, apart from

[12] CBOE's Nominating Committee, unlike some other exchanges, is not a board level committee, but a committee composed of persons representing a cross-section of its membership and as well as representatives of the public.

whether the SEC's proposal creates an inefficient structure and process for the nomination of directors, CBOE believes there is a significant benefit to having a single Nominating Committee with the responsibility for nominating all director candidates, as opposed to a committee composed of only independent directors responsible for nominating the independent candidates, and a separate committee or panel composed of only members nominating the member candidates. CBOE believes that there is a value to all of the persons (both independent and non-independent) on the Nominating Committee having the opportunity to assess the strengths and weaknesses of all director candidates, and for the Committee as whole to deliberate and nominate the candidates for the board.

Duties of Regulatory Oversight Committee

CBOE believes the specific duties assigned to the Regulatory Oversight Committee in the proposed rules would significantly broaden the traditional role of the directors who serve on this committee from one of oversight to one of management. Directors should evaluate, oversee and monitor management performance and establish broad policy objectives for management to implement, not function as "managers" of the exchange. As noted in the Business Roundtable Report on corporate governance cited by the SEC in its Release:

> The board of directors has the important role of overseeing management performance on behalf of stockholders. It primary duties are to select and oversee a well qualified and ethical CEO who, with senior management, runs the corporation on a daily basis, and to monitor management's performance and adherence to corporate standards. Effective corporate directors are diligent monitors, but not managers of corporate operations.[13]

However, the minimum duties and responsibilities that the proposal seeks to assign to the Regulatory Oversight Committee are inconsistent with the traditional role of directors, and would effectively make the directors serving on this committee managers of CBOE's regulatory program. For example, the Release proposes that the Committee *assure* the adequacy and effectiveness of the regulatory program of the exchange, and *assure* that the exchange's disciplinary and arbitration proceedings are conducted in accordance with the exchange's rules and policies and any other applicable laws or rules, including those of the SEC. CBOE believes it is inconsistent with the oversight function of the Committee to require that it "assure" various aspects of an exchange's regulatory program; rather, the Committee should be expected to "review and assess" the regulatory program and whether the exchange's disciplinary and arbitration proceedings are being conducted in accordance with the rules and policies. CBOE also believes it is inconsistent with the role of directors to require that they *determine* the regulatory plan, programs, budget, and staffing for the regulatory functions of the exchange. That is the role of senior management of the exchange, and the Committee should instead be required to "evaluate and make recommendations" to the Board as to the regulatory plan, programs, budget, and staffing for the regulatory functions of the exchange.

Finally, CBOE does not believe it is appropriate to require the Regulatory Oversight Committee to "certify" an exchange's listing of an affiliated security, and therefore, CBOE recommends that the SEC delete this specific responsibility.

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[13] The Business Roundtable, Principles of Corporate Governance, at 1. *See also*, Report of the American Bar Association Task Force on Corporate Responsibility, at 26 ("It is not desirable for directors to try to manage the corporation directly and comprehensively, and there are inherent limitations on the abilities of outside directors to assure corporate responsibility.")

Separation of Regulatory and Market Operations

The proposed rules would require an exchange to establish policies and procedures to assure the independence of its regulatory programs from its market operations or other commercial interests. Additionally, the SEC proposes that an exchange's regulatory program must be (i) structurally separated by means of separate legal entities, or (ii) functionally separated within the same legal entity from the market operations. In either case (structural or functional separation), the board must appoint a Chief Regulatory Officer (CRO) to administer the regulatory program of the exchange, and the CRO must report directly to the Regulatory Oversight Committee.

CBOE generally supports the SEC's recommendation that requires the functional separation of its regulatory programs from its market operations or other commercial interests. CBOE is committed to fulfilling it statutory mandate as an SRO to surveil and vigorously enforce its rules and the federal securities laws, and to assuring the independence and integrity of CBOE's regulatory programs. CBOE, however, does not believe that it would be appropriate, efficient or necessary to require that the CRO must report directly to the Regulatory Oversight Committee in order for CBOE to assure the independence of its regulatory programs. First, as noted above, the responsibility of the independent directors serving on the Regulatory Oversight Committee should be to oversee and monitor CBOE's regulatory programs, not act as management of the regulatory programs and directly supervise the CRO.

Second, because the responsibility of the independent directors serving on the Committee is to oversee and monitor CBOE's regulatory programs, it would not be efficient or practical for a board committee that only meets periodically to undertake the responsibility of supervising the CRO. The directors serving on the Regulatory Oversight Committee may not have the time or knowledge base to assume this responsibility, and should not be put into a position of having to be "on call" in a managerial sense in the event matters arise that require immediate attention from the CRO. Additionally, even though CBOE is committed to adopting practices to assure the independence of its regulatory programs from its market operations, there will undoubtedly be matters in which the CRO and senior management will need to work together such as assessing regulatory fees and matching expenditures and funding. CBOE is concerned that requiring the CRO to report directly to the Regulatory Oversight Committee will be dysfunctional in that it will result in too great a separation from exchange management and the operation of the exchange.

Third, CBOE does not believe it is necessary for the CRO to report directly to the Regulatory Oversight Committee in order for the Exchange to assure the independence of its regulatory programs from its market operations. Although CBOE's current operational structure provides that the CRO reports to CBOE's President, CBOE has adopted a number of policies and practices to assure the independence of its regulatory programs. For instance, and consistent with its committee charter, CBOE's Regulatory Oversight Committee meets regularly with the CRO and possibly other senior staff in the Regulatory Division to learn of new developments and issues confronting the Division, and to hear their reports and concerns. CBOE's Regulatory Oversight Committee also has advised CBOE's CRO that it is available to meet with the CRO in private to discuss any regulatory issue, and the Committee sent a memo to CBOE's Regulatory Division inviting the staff to contact the Committee with regard to any issues relating to CBOE's regulatory program and compliance. CBOE believes that it would be appropriate to require by rule that the CRO meet privately with the Regulatory Oversight Committee on a regular basis to discuss regulatory issues. The Committee also meets on an annual basis with senior SEC staff from the SEC's Division of Market Regulation and the Office of Compliance Inspections and

Examinations. CBOE's Regulatory Oversight Committee is also required to review and make recommendations to the Board of Directors regarding the staffing and budget for regulatory operations, including the budget for needed technology or technology support. Thus, CBOE believes that its current operational structure in which the CRO reports to CBOE's President and also meets regularly with CBOE's Regulatory Oversight Committee assures the independence of its regulatory programs from its business activities and should be acceptable.

Confidentiality of Regulatory and Trading Information

The SEC proposes to require that an exchange adopt policies to prevent the dissemination of regulatory information[14] to any person other than an officer, director, employee, or agent of the exchange directly involved in carrying out the exchange's regulatory obligations.

Although CBOE generally agrees with the SEC recommendation that an exchange should prevent the dissemination of regulatory information to any persons not involved in the regulatory process, the SEC's definition of "regulatory information" is overly broad and in fact would conflict with existing CBOE rules. Specifically, the proposed definition of "regulatory information" includes information pertaining to an existing disciplinary matter, disciplinary action against a member, and the amount of a fine imposed on a member. CBOE Rule 17.14 requires CBOE to report to the NASD's Central Registration Depository (CRD) for disclosure to the public various information pertaining disciplinary proceedings including the issuance of charges and all changes relating to the disciplinary matter. CBOE, also, as a matter of policy discloses disciplinary decisions in its Regulatory Bulletin, and makes disciplinary decisions available on its website. CBOE believes that the public disclosure of disciplinary decisions and the amount of a fine imposed on a member provides certain public policy benefits, including acting as a deterrent to possible wrongful conduct members. Thus, CBOE requests that the SEC review and amend its definition of "regulatory information".

Proposed Rule 17a-26 – Periodic Reporting Obligations of Exchanges

In proposed Rule 17a-26, the SEC proposes to require an exchange's CEO certify that an exchange's quarterly and annual reports relating to the regulatory program of the exchange are current, true and complete as of the date they are submitted to the SEC.

In light of the significant changes the SEC is proposing to separate an exchange's regulatory functions from its market operations and other commercial interests, and all of the other proposals the SEC is making to assure the adequacy and independence of an SRO's regulatory programs, CBOE believes it is inconsistent to require that the CEO certify that an exchange's quarterly and annual reports relating to the regulatory program of the exchange are current, true and complete. Rather, CBOE believes that the CRO should certify that an exchange's quarterly and annual reports are current, true and complete.

[14] "Regulatory information" means "any information collected by [an exchange] in the course of performing its regulatory obligations under the Act." Examples of "regulatory information" include: information relating to an on-going disciplinary investigation or action against a member, the amount of a fine imposed on a member, financial information, or information regarding proprietary trading systems gained in the course of examining a member.

Conclusion

CBOE is committed to fulfilling it statutory mandate as an SRO, and to assuring the independence and integrity of CBOE's regulatory programs. Although CBOE disagrees with a number of the proposed changes contained in the Release, in general CBOE supports the SEC's proposals and welcomes the opportunity to work with the SEC Commissioners and SEC staff on these important issues of governance and self-regulation. In the meantime, if you have any questions on points raised in CBOE's response, please contact Joanne Moffic-Silver, CBOE's General Counsel, at (312) 786-7462, or me.

Sincerely,

William J. Brodsky
Chairman and Chief Executive Officer

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
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Addendum to CBOE's Response to File No. S7-39-04

In addition to CBOE's comments concerning the governance and administration of exchanges that are contained in its letter dated March 8, 2005, CBOE raises the following points concerning some of the other proposals as to which CBOE's comments are more specific in nature, or as to which CBOE seeks further clarification from the SEC. In many instances, CBOE believes that it would be beneficial for the SEC and SROs to jointly develop "best practices" concerning the implementation of certain of the proposed rules, as well as uniform methods and formats for the providing of information and data to the SEC as required by the proposed rules relating to regulatory reporting and periodic exchange reporting.

Separation of Regulatory and Market Operations

- Jurisdiction Over Business Conduct Committee. Proposed Rule 6a-5(j)(4) states that any committee, subcommittee, or panel that is responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters must be subject to the jurisdiction of the Regulatory Oversight Committee.

  CBOE Comment: CBOE requests clarification and further guidance from the SEC with respect to what "subject to the jurisdiction of the Regulatory Oversight Committee" means. Specifically, for CBOE's Business Conduct Committee, which is generally responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters, in what manner would it be subject to the jurisdiction of CBOE's Regulatory Oversight Committee? Also, it is unclear from the proposal whether CBOE's Floor Officials Committee, which has the authority under CBOE rules to, among other things, assess fines for violations of trading conduct and decorum policies (see CBOE Rule 17.50(g)(6)), would fall within the jurisdiction of the Regulatory Oversight Committee. In CBOE's view, "subject to the jurisdiction of the Regulatory Oversight Committee" should not mean that the Regulatory Oversight Committee has any supervisory responsibility or authority over these committees, or act as "managers" of these committees. On the other hand, CBOE believes that it would be appropriate for the Regulatory Oversight Committee to periodically review the activities the Business Conduct Committee and review its duties and responsibilities, and make recommendations to the Board of Directors for changes to the committee's duties and responsibilities.

  Additionally, CBOE rules provide that appeals of disciplinary decisions following a formal hearing are reviewed by CBOE's Board of Directors, or a panel of CBOE's Board whose decisions must be affirmed by the entire Board.[15] It is unclear from the SEC's proposal whether such a review process would be consistent with the proposed requirement that any committee that is responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters must be subject to the jurisdiction of the Regulatory Oversight Committee. CBOE believes that its current rules and procedures for review of disciplinary decisions by CBOE's Board of Directors are appropriate and should not be changed by the proposal.

- Composition of Business Conduct Committee. Proposed Rule 6a-5(j)(3) states that at least 20% of any committee, subcommittee, or panel that is responsible for conducting hearings, rendering decisions, and imposing sanctions with respect to disciplinary matters must be members of the exchange.

[15] See CBOE Rule 17.10.

CBOE Comment: CBOE requests that the SEC clarify and amend this proposal to provide that the requirement that at least 20% of a disciplinary committee must be comprised of members may include persons who are associated with a member.[16] CBOE's Business Conduct Committee traditionally has been comprised of CBOE members, persons representing the public, and persons who are associated with a member. The latter category includes senior financial and sales practice compliance officers of CBOE member firms.

- Use of Regulatory Fees. Proposed Rule 6a-5(n)(4) provides that any funds received by an exchange from regulatory fees, fines or penalties must be applied only to fund programs and operations directly related to such exchange's regulatory operations. As the Release notes, the scope of categories of regulatory fees is very broad, and would include all member fees, dues and assessments charged and collected by an exchange that are assessed for the purpose of funding the operation of the exchange's regulatory program, and any revenue received from fines or penalties resulting from disciplinary or enforcement actions.

  CBOE Comment: CBOE disagrees with the requirement that funds received by an exchange from regulatory fees, fines or penalties must be applied only to fund programs and operations directly related to such exchange's regulatory operations. CBOE does not question the appropriateness of the SEC requesting detailed information concerning an exchange's expenditures on regulation and the regulatory fees that an exchange receives (see Proposed Exhibit I to revised Form I), and believes that this information will be helpful to the SEC in assessing whether an exchange has met its obligation to regulate its market and its members. However, CBOE does not believe that the SEC should prescribe or limit the use of so-called regulatory fees. Money is fungible, and provided an exchange is expending sufficient funds on its regulatory programs for the exchange to meet is statutory obligations, and the SEC is able to assess this fact, that should be sufficient.

  Additionally, CBOE notes that the SEC's description of the categories of fees that are included within "regulatory fees" appears to be broader in the SEC's Concept Release Concerning Self-Regulation. Specifically, in the Concept Release, fees such as membership fees and dues and "other member fees" are included in a discussion of regulatory fees.[17] CBOE requests that the SEC clarify exactly which fees are included in scope of categories of regulatory fees, and expressly exclude fees such as membership fees and dues and any other fees that are not directly related to such exchange's regulatory operations.

- Code of Conduct Waivers. Proposed Rule 6a-5(p)(1) states that exchange rules must provide for a code of conduct and ethics for directors, officers and employees that, at a minimum, establishes policies and procedures regarding: conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection and proper use of the exchange's assets; compliance with laws, rules, and regulations by directors, officers and employees; and the reporting of illegal or unethical behavior. The proposed rule also requires that any waiver of this of the code of conduct and ethics must be approved by the Board.

[16] CBOE Rule 1.1(qq) states that the term "associated person" or "person associated with a member" means any partner, officer, director, or branch manager of a member (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with a member, or any employee of a member.

[17] See Concept Release, Section IV.D.2.a, and footnote 201

CBOE Comment: CBOE supports the requirement that exchanges should establish a code of conduct and ethics for directors, officers and employees, and notes that it has for years adopted and implemented similar policies for CBOE directors, officers and employees. Nonetheless, CBOE believes that requiring the Board to approve any waiver of the code of conduct and ethics is unnecessary and that it should be appropriate for exchange senior management, such as the exchange's president, to approve any waivers for employees, with annual reporting requirements to the Board or a standing committee of the Board such as the Audit Committee or the Regulatory Oversight Committee.

- Confidentiality of Trading Information. Proposed Rule 6a-5(n)(5)(C) would require an exchange to adopt policies and procedures to maintain the confidentiality of any information required to be submitted to effectuate a transaction on or through such exchange or its facilities[18], unless such information is aggregated to such an extent that no person whose information is included in the aggregated information can be identified, or unless the person has consented to the dissemination and use of its information by the exchange.

  CBOE Comment: CBOE believes that the SEC's proposal to require that an exchange adopt policies and procedures to maintain the confidentiality of any information required to be submitted to effectuate a transaction on or through such exchange or its facilities is overly broad and confusing, and the Release does not identify specific problems or abuses that would justify this proposal. The only rationale provided is that the proposal would help "to assure an independent and effective regulatory function," but the Release does not explain how this proposal promotes this. By its language, the proposal would prevent an exchange from disclosing order information (including the terms of an order) and related trade information to CBOE member firms who handle/receive and route such orders and that would like to conduct their own internal compliance review. It also could limit exchanges from reviewing and using certain trading information for otherwise appropriate business and marketing purposes, such as reviewing aggregate information relating to orders and contract volume from members. Moreover, the proposal does not specify to whom an exchange is prohibited from disclosing the information. Accordingly, CBOE requests that the SEC clarify and revise this proposed change so that it does not restrict the appropriate use of trading information.

Ownership of Securities Exchanges

- Disclosure of 5% Ownership Interest. Proposed Rule 17a-27 would require a member of an exchange that is a broker or dealer to provide notice to the SEC and the exchange of which it is a member when it acquires more than a 5% ownership interest in the exchange, or in a facility of the exchange through which it is permitted to effect transactions. Proposed Exhibit Q to revised Form I separately would require an exchange to disclose information pertaining to any person that directly or indirectly beneficially owns more that 5% of any class of securities or other ownership interest in the exchange.

  CBOE Comment: With respect to these two proposals, CBOE notes that for purposes of determining whether a person directly or indirectly beneficially owns more than 5% of CBOE, CBOE does not consider a member of the Chicago Board of Trade (CBOT) to have an "ownership interest" in CBOE (and thus subject to this reporting requirement) unless and until the CBOT member "exercises" his CBOT memberships and becomes an effective

[18] This information could include the name of the member, or the member's customer, submitting the order for execution, and the terms of the order.

member of CBOE. CBOE believes that this conclusion is appropriate and consistent with the stated purpose of the proposals, which is to provide information concerning persons or groups of persons who potentially could control or influence an exchange. CBOT members who have not "exercised" their memberships have no ability to influence or exercise any control over CBOE. Moreover, CBOE has no authority over such persons and no ability to obtain information concerning such persons in the event disclosure was required.

Regulatory Reporting Requirements

- Electronic SRO Trading Facility Audit. Proposed Rule 17a-26(a)(2) would require each exchange that owns, operates or sponsors an "electronic SRO trading facility" to file, as part of its annual report, a report of an independent audit designed to assess whether the operation of any electronic SRO trading facility of the exchange complies with the rules governing such facility. The internal audit report must be prepared by a third party not affiliated with the exchange that is qualified to render such an opinion. Proposed Rule 17a-26(j)(3) would define "electronic SRO trading facility" as a facility of an exchange that executes orders in securities on an electronic basis.[19]

  CBOE Comment: It appears from the Release that this proposal is intended to apply to exchanges that own or operate an electronic SRO trading facility, such as Arca-Ex which is the electronic trading facility of PCX Equities, Inc., or the BOX which is the electronic options trading facility of the Boston Stock Exchange. Both Arca-Ex and the BOX operate as separate electronic trading facilities from the exchanges or entities that own them. CBOE is concerned, however, that based on the definition of "electronic SRO trading facility", this proposal could be construed to apply to it due to the fact that it operates electronic systems (*i.e.*, its Hybird Trading System) that execute orders in securities on an electronic basis. Accordingly, CBOE requests that the SEC clarify and amend this proposal to make clear that it does not apply to exchanges like CBOE as long they do not own or operate separate electronic trading facilities to execute orders. In the event, however, that this proposal is intended to apply to exchanges such as CBOE that simply operate trading systems that execute orders in securities on an electronic basis, CBOE would like to further discuss this proposal with the SEC staff, including the necessity for such an independent audit, the manner in which it would be performed, and the anticipated burden of complying with this requirement on an annual basis.

- Internal Controls. Proposed Rule 17a-26(b)(3)(iii) would require each exchange to include in its annual regulatory report a discussion of the internal controls implemented by the exchange that are designed to detect, prevent, and control for any conflicts of interest between the market operations and other commercial interests of the exchange and its self-regulatory responsibilities.

  CBOE Comment: CBOE requests clarification from the SEC as to what intended by the term "internal controls", and that the SEC specify the internal controls that it expects exchanges to implement.

- Quarterly Reports. Proposed Rule 17a-26(b)(2) would require exchanges to file reports on a quarterly basis within 20 business days following the end of each calendar quarter. These quarterly reports would contain information pertaining to an exchange's surveillance programs, complaints received, investigations, examinations and enforcement actions.

[19] The term "facility" is defined in Section 3(a)(2) of the Exchange Act.

CBOE response: CBOE believes that the SEC has underestimated the time and expense exchanges will incur to prepare these reports on a quarterly basis. CBOE believes that it would be more appropriate to require that the information proposed to be included in the quarterly reports be furnished to the SEC on a semi-annual basis. Additionally, CBOE believes that it would be beneficial for the SEC to provide additional guidance as to the information that would be submitted in connection with the reports required by proposed Rule 17a-26, and consider developing with the exchanges a uniform format or template for these reports.

- Revised Form 1 and Exhibits – Disclosure to Public. SEC Rule 6a-2 as proposed to be amended would require that exchanges post amendments to Revised Form 1 and the Exhibits thereto on their publicly available websites. Among other things, Rule 6a-2 would require exchanges to publicly disclose the following:

    - Proposed Exhibit F would require exchanges to post on their websites waivers of the code of conduct and ethics for directors, officers, and employees;
    - Proposed Exhibit H would require exchanges to disclose significant changes planned for the regulatory program, and to discuss any new significant regulatory issues or events that have arisen involving the exchange's regulatory program and responsibilities; and
    - Proposed Exhibit I would require exchanges to disclose detailed information pertaining to expenditures and revenues for regulatory activities (including subcategories of regulatory activities); all material contracts and all related material party transactions.

CBOE Response: Although CBOE believes it is appropriate for the SEC to require that the foregoing information be provided to it, CBOE does not believe that it is appropriate or necessary for this information to be disclosed publicly. Information concerning waivers of the code of conduct and ethics for directors, officers, and employees are generally of a minor and personal nature, and should be not be publicly available provided the information is otherwise available to the SEC and an exchanges' governing board. With regard to the disclosure of significant information pertaining to an exchange's regulatory programs, including a discussion of the significant regulatory issues that have arisen and how they may impact the future operation of the exchange's regulatory program, CBOE can see no public policy benefit for the disclosure of this information beyond the SEC. CBOE similarly does not see the public policy benefit in disclosing to the public detailed information pertaining to its expenditures and revenues for its regulatory activities, and in fact such information may be misleading to the public if one were to simply look at the total amount spent on regulation. As CBOE noted in its response to the Concept Release, in the area of evaluating SRO regulatory expenditures, while the total amount of money spent by an SRO on regulation may be one of many factors that should be taken into account in evaluating whether the SRO has met its obligation to regulate its market and its members, this one factor should not be given undue emphasis over others, so that SROs lose all incentive to be more efficient in the way in which they regulate. The ultimate test should be the effectiveness of each SRO's regulatory program, and if an SRO is able to provide more effective regulation for less money, it should be credited, not criticized, for that accomplishment. Accordingly, CBOE requests that the SEC amend these proposals to the extent they require the public disclosure of sensitive personal and regulatory information pertaining to an exchange and its employees.

Implementation of Proposals

- Proposed Rules. Proposed Rule 6a-5(r) would require an exchange to submit proposed rule changes within four months of SEC adoption of the proposed changes. Each exchange must have final rules approved by the SEC within 10 months of publication of the SEC's final rules in the Federal Register.

  CBOE Response: CBOE is concerned that four months is too short a time frame to file rule changes that would implement all of the SEC's rule proposals. The SEC's proposals, if approved, will require CBOE to amend its Constitution, which will require CBOE to schedule and hold a membership vote, and its rules in numerous respects. Depending on the final approved rules that the SEC adopts, CBOE may want to assess what changes to its governance structure would be most appropriate consistent with the SEC's final approved rules, and therefore CBOE requests at least six months to file proposed rule changes.