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Edward T. Tilly
Chief Executive Officer

Phone: 312-786-7088
tillye@cboe.com

October 2, 2014

Stephen I. Luparello, Director
Division of Trading and Markets
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Inappropriate Trading in OTC Options where Substantially Identical Standardized Options are Available

Dear Mr. Luparello:

The Chicago Board Options Exchange, Incorporated ("CBOE") is becoming increasingly concerned that the current structure of the U.S. options markets may be promoting the use of over-the-counter ("OTC") options by market participants where substantially identical standardized options are available.[1] OTC options are not subject to the price discovery, price improvement and trade reporting functions of national securities exchanges, potentially resulting in harm to customers and market participants generally.[2] We therefore request that the Securities and Exchange Commission ("SEC" or "Commission") remind broker-dealers of their obligations to seek best execution and otherwise act in the best interest of their customers when effecting OTC options transactions. We also request that the Commission consider appropriate changes in

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[1] CBOE notes that since the development of standardized options trading on national securities exchanges, broker-dealers have retained the ability to negotiate bilateral, individually customized transactions in OTC options with their institutional customers. CBOE does not dispute the value of such trades where substantially identical standardized options are not available. CBOE notes further, however, that since the introduction of Flexible Exchange Options ("FLEX Options") on CBOE in 1993, the need for individually customized, bilateral trades in equity and index options has been substantially reduced. See http://www.cboe.com/institutional/IndexFlex.aspx.

[2] As of December 2013, the global market for OTC options on equity securities had a notional value exceeding $4.28 trillion, with a gross market value exceeding $498 billion, and the global market for exchange-traded options on equity indexes had a notional value exceeding $5.75 trillion. A high percentage of the OTC options on equity instruments traded during the past few years have included options for which a liquid exchange-traded market is available. For example, the outstanding amount of OTC options on equity instruments with one year or less until maturity exceeded $2.3 trillion as of December 2013, and the amount outstanding with between one and five years until maturity exceeded $1.5 trillion as of December 2013. (Source: BIS Quarterly Review, June 2014).

options market structure, including those described below, to encourage the use of standardized options where practicable and to provide greater transparency of OTC options transactions. CBOE commends the Commission for its market structure efforts to date, and we believe we share a common goal of seeking the fairest, most efficient markets for investors and market participants generally.

The benefits to investors of trading exchange-traded, standardized options over trading OTC options is well established. Investors in exchange-traded options enjoy greater price discovery, price improvement and secondary market liquidity than investors in comparable OTC options. Moreover, market participants benefit generally from exchange transactions over OTC transactions due to trade reporting, exchange surveillance of trading and anti-manipulation rules, and increased secondary market liquidity in those options. Because exchange trades in standardized options are also centrally cleared, market participants enjoy the lack of counterparty risk, operational standardization, and greater possibilities to hedge options positions with positions in other instruments, including standardized options. Clearing agency netting of positions also reduces risk to the financial system generally.

Despite the relative benefits of exchange trades in standardized options, CBOE is concerned that certain market participants may instead be recommending OTC options transactions to their institutional customers, even when substantially identical standardized options are available, resulting in market fragmentation, reduced liquidity, reduced price transparency, and often inferior prices for the institutional customers (and market participants generally) than if the trades had been effected on a national securities exchange. One reason for this recommendation may be a form of regulatory arbitrage by market participants, as exchange members are required to comply with a host of rules regarding trading, for the protection of investors, while market participants trading OTC options are subjected to a lighter regulatory regime.

Although the lighter regulatory burden of OTC options trades may benefit certain broker-dealers effecting OTC options trades, OTC trading often does not inure to the benefit of OTC options customers or to the marketplace as a whole. When options transactions are effected OTC, market participants do not receive the order interaction and price discovery benefits of transactions effected on options exchanges. This is true not just for the OTC options customers, but also for the customers of options transactions effected on a national securities exchange, as their orders never have the opportunity to interact with OTC options customers. Although, presumably, OTC options traders may rely on open exchange orders and last sale reporting to inform their pricing of OTC options trades, customers on options exchanges do not receive similar knowledge of the price and size of OTC options orders or last sale information regarding similar OTC options transactions when pricing their exchange orders. Moreover, because OTC options trades are not reported, CBOE (and other regulators) may be unaware of the relationship between OTC options and standardized options transactions (or transactions in other instruments) and therefore would have difficulty surveilling for any legal or regulatory issues raised by OTC options transactions.

Request for Commission Action

In response to the concerns raised above, CBOE respectfully requests that the Commission take the following actions. We request that the Commission remind broker-dealers of their obligation to seek best execution of customer orders, including seeking price improvement where practicable. In connection with this requested Commission statement to broker-dealers, we request further that the Commission direct the regulators of options markets participants, including the Financial Industry Regulatory Authority ("FINRA") and the Commission's own inspections staff, to surveil for use of OTC options by broker-dealers in customer transactions where substantially identical standardized options are available. The regulators should consider whether use of OTC options in lieu of standardized options was in the best interest of customers, as well as whether related exchange trades in the standardized options to which the OTC options are substantially identical may indicate an attempt by the broker-dealer to influence the price of the standardized options in order to obtain for itself a more favorable price for the OTC options.

CBOE requests also that, as part of the Commission's recently stated review of possible changes in market structure, it consider ways to make transactions in OTC options more transparent, and in doing so possibly encourage the use of standardized options to the benefit of market participants generally. CBOE notes the recent statement by SEC Chair White,[3] that she intends to create a Market Structure Advisory Committee to review market structure issues and recommend improvements to the national market system. In particular, CBOE notes Chair White's concerns with market fragmentation caused by trading in multiple venues, and in particular through reliance on dark pools. Because OTC options trades are not offered through an exchange and are therefore not susceptible to price improvement, and they are not reported to the Options Price Reporting Authority ("OPRA"), trading in OTC options, when substantially identical exchange trades options are available, would raise the market fragmentation concerns Chair White mentions.

As part of its review of market structure, CBOE requests that the Commission consider alternatives to improve transparency in trading of OTC options. For example, the SEC or FINRA could adopt rules requiring the reporting of OTC options transactions in a manner similar to reporting of transactions in exchange-traded options. We note the Commission's approval of recent efforts by FINRA to improve transparency in the OTC market for equity securities[4] and

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[3] See "Enhancing Our Equity Market Structure," Mary Jo White, Chair, SEC (June 5, 2014), available at: http://www.sec.gov/News/Speech/Detail/Speech/1370542004312.

[4] See Securities Exchange Act Release No. 71341 (January 17, 2014), 79 FR 4213 (January 24, 2014) (notice of filing of amendment number one and order granting accelerated approval of proposed rule change by FINRA to require alternative trading systems ("ATSs") to report trading volume to FINRA and use unique market participant identifiers ("MPIDs")). See also Securities Exchange Act Release No. 71911 (April 9, 2014), 79 FR 21316 (April 15, 2104) (notice of filing and immediate effectiveness of proposed rule change relating to reporting and MPID requirements for ATSs).

request that the Commission seek similar improved transparency in the market for OTC options. CBOE also notes the mandate in The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[5] to require trade reporting for security-based swaps, and we believe that similar requirements should be imposed on OTC options transactions.[6]

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CBOE appreciates the SEC's consideration of this matter, and we would welcome the opportunity to discuss it with you further at your convenience. Should you require any additional information, please do not hesitate to contact me or to contact Joanne Moffic-Silver, General Counsel, at 312-786-7462, or Angelo Evangelou, Associate General Counsel, at 312-786-7464.

Sincerely,

Edward T. Tilly

Cc: Mary Jo White, Chair
Luis A. Aguilar, Commissioner
Daniel J. Gallagher, Commissioner
Michael S. Piwowar, Commissioner
Kara Stein, Commissioner
Mark J. Flannery, Chief Economist and Director of Economic and Risk Analysis
Heather Seidel, Associate Director, Division of Trading and Markets

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[5] Public Law 111-203, 124 Stat. 1376 (2010). See Testimony on "Oversight of the SEC's Division of Trading and Markets," Stephen Luparello, Director, Division of Trading and Markets, SEC, Before the United States House of Representative Subcommittee on Capital Markets and Governmental Sponsored Enterprises, Committee on Financial Services (June 26, 2014) (discussing the requirement to adopt a new regulatory regime for security-based swaps). See also Commodity Futures Trading Commission, Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182 (January 9, 2012) (imposing trade reporting requirements for transactions in swaps regulated by the CFTC).

[6] We also understand that under the European Markets Infrastructure Regulation, the European Union is imposing an obligation to report transactions in OTC derivatives, including OTC options, to trade repositories. See http://www.lseg.com/markets-products-and-services/post-trade services/unavista/regulation/european-market-infrastructure-regulation-emir.