CBOE® EXECUTE SUCCESS℠

Edward T. Tilly
Chief Executive Officer

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

May 11, 2015

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

Re: Impact of Equity Market Structure Reform on the Listed Option Market

Dear Mr. Luparello:

The Chicago Board Options Exchange, Incorporated ("CBOE") submits this letter to the newly formed Securities and Exchange Commission ("SEC" or "Commission") Equity Market Structure Advisory Committee (the "Committee"). We understand the Committee will discuss significant market structure matters over the coming months and that the initial meeting will focus on the Order Protection Rule of Regulation NMS. CBOE supports the general objective of evaluating and modernizing our equity market structure to promote efficiency and transparency. However, CBOE fully believes that market structure reviews and changes should be addressed in a more holistic manner that contemplates impact on the derivative markets. As evidenced by the flash crash of 2010, actions in derivative markets can affect the cash equity market and vice versa.

We take this opportunity to express support for maintaining the existing order protection framework, to reiterate the critical differences between the option and equity markets and to remind the Committee that structural changes to the underlying cash marketplace can inadvertently impact the listed option market.

Maintaining Order Protection

The general concepts of order protection and avoiding trade-throughs pre-exist the adoption of Regulation NMS in 2005. The Intermarket Trading System and the original options Linkage Plan existed for decades and years, respectively, before the Commission approved Regulation NMS. The objectives of both were to provide customer orders with the best price and avoid trade-throughs absent a justifiable exception. Those objectives are no less important today than they were in the past.

CBOE believes that intermarket trade-through protection is an important component of a national market system. It generally fosters fair competition among market centers and reduces fragmentation of the price discovery process. Protection of customer limit orders and incentives for liquidity providers to quote competitively contribute to the health of our markets. We see no reason to dismantle this critical aspect of our national market system. To the extent unusual and less-than-transparent order types allow users to exploit order protection requirements to the detriment of other market participants, then we suggest the Committee re-examine these order types and behavior, rather than consider the complete elimination of a central component of our national market system.

We offer one area of order protection that is ripe for modernization: restrictions around the execution of multi-component orders where the execution of one component is contingent on the execution of another component (i.e. complex orders). These orders should generally be exempt from order protection and other order handling requirements. Complex orders, regardless of whether they involve cross-product strategies, are valuable investment tools and have become increasingly popular with market participants. Because a complex order cannot, by its terms, be filled by a single simple order, it should be free to execute irrespective of the displayed simple leg market prices, *including on the executing exchange*. CBOE believes it makes no sense and benefits no customer to suspend the execution of a complex order because of a simple limit order resting in a limit order book. We urge the Committee to recommend a re-evaluation of the application of Commission order handling rules and requirements to complex orders.

Key Differences Between Equity and Option Markets

As the Committee is aware, all listed options transactions must occur on an exchange. Option dark pools or other off-exchange option execution venues do not exist. Further, with very limited exception, option cross transactions must be exposed to an exchange price improvement auction process (either electronic or open outcry) prior to execution. These important distinctions help foster a healthy and balanced listed option marketplace.

Unlike the equity markets where a sizable percentage of order executions occur off-exchange pursuant to opaque trading processes, all listed option trades occur pursuant to transparent and publicly available exchange trading rules. This transparency reduces investor confusion and fosters confidence in our markets. Further, by requiring that option orders be exposed to an auction process before crossing, the option market avoids the fragmentation and imbalance that currently exists in the equity market. In this regard, the option market is a healthier "eco-system" than the equity market, as these features result in more interaction between institutional and retail order flow and better reward market-maker liquidity provision and competition, which are more likely to improve execution prices for all market participants.

It is important to ask whether non-exchange stock trading venues add enough value to offset the regulatory inequity and fragmentation that they create. CBOE believes they do not add sufficient value. More importantly, however, we believe that the manner in which these venues process and execute orders (especially orders for the accounts of retail investors) should be completely transparent. We further believe that regulation of off-exchange trading should be vigorous and should resemble the regulatory framework imposed on registered securities exchanges. CBOE notes that this call for expanded transparency and consistent regulation should also apply to over-the-counter (OTC) look-alike products like OTC options.[1] The OTC option market is vast and largely unregulated. It should be a goal of the Committee to curb regulatory inequity and to insist that similar financial products be similarly regulated.

Careful Consideration of Impact on the Derivatives Markets is Warranted Before Recommending Structural Changes to the Equity Market

It is often the case that structural changes to the equity market are encouraged and replicated in the option market. We consider it highly beneficial to contemplate how any changes in the equity market would translate to the option market if implemented. For example, the equity market recently adopted a pilot "trade-at" rule. Presumably the point of this rule is to ensure that non-exchange venues price improve on the lit NBBO provided by registered exchanges before executing orders off exchange. However, the application of the trade-at provision is not limited to non-exchange venues. The proposed rule would also preclude lit exchanges that add price discovery value via their own lit quotations from matching prices displayed by other lit exchanges. This practice (often referred to as "step-up") is common in the option market, and it affords brokers greater latitude regarding where to send orders and how to navigate varied transaction fee structures on the option exchanges while still receiving NBBO executions. Thus, the equity market is considering the elimination, at least on a pilot basis for some traunch of stocks, of a common practice in the option market, which practice creates a healthy and competitive dynamic among exchanges that all supply lit, meaningful, and accessible bids and offers.

More concerning are equity market changes that may immediately but indirectly affect behavior in the option market. For example, developing and implementing trading pauses or tick size modifications for equity securities can affect liquidity and pricing in the option market. Often options act as a surrogate for the underlying stock, and, unless derivative pricing is taken into consideration when making structural changes, resulting option pricing can be disjointed or unfairly subjected to predatory conduct.

Similarly, the Committee should not broadly structure any of its efforts to halt trading behaviors that it characterizes as detrimental high frequency trading activity in any way that may inadvertently impair option traders. Like high-frequency trading, algorithms and electronic trading drive option market-making. Option market-makers add unquestionable value to the option marketplace as it is, unlike the stock market, a quote driven market. That is to say, marketable customer orders predominantly execute against market-maker quotes and not other customer orders. Rules attempting to define or curtail some form of high-frequency trading should not impair option market-makers from performing their obligations or from providing liquidity across the thousands of option series that populate the Exchange market.

---

[1] These options are bilateral agreements that seek to match the terms of listed option contracts but are not fungible with conventional listed options. On October 2, 2014, CBOE submitted a letter to the Division of Trading and Markets expressing concern over these instruments: http://www.cboe.com/aboutcboe/legal/commentletters.aspx

Indeed, the Committee should carefully craft any efforts to contain any aspect of seemingly troublesome trading to not inadvertently impact the option market, which has generally not witnessed the trading behaviors that have been subject to recent media scrutiny. We note that the option market does not utilize nearly as many order types as the equity market, maker-taker pricing does not predominate in the option market, and dark venues do not exist in the option market.

* * * * *

While we believe that option exchanges should have a seat at the table as the Committee discusses and negotiates important market structure programs, we appreciate the Committee's efforts and its consideration of our views as it formulates important recommendations that could shape the future of our securities markets. We would welcome the opportunity to discuss them with you further.

Sincerely,

Edward T. Tilly

cc: Mary Jo White, Chair
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner