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February 27, 2007

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Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Attn: Nancy M. Morris, Secretary

Re: File Number: SR-CBOE-2006-106

Ladies and Gentlemen:

On behalf of CBOT Holdings, Inc. ("CBOT Holdings") and its wholly-owned subsidiary, the Board of Trade of the City of Chicago, Inc. (together, "CBOT"), we write to express strong opposition to SR-CBOE-2006-106, a proposed rule change (the "Proposed Rule Change")[1] filed with the Securities and Exchange Commission ("SEC" or "Commission") by the Chicago Board Options Exchange, Incorporated ("CBOE").

The Proposed Rule Change must be disapproved. It is an improper use of CBOE's self-regulatory authority to resolve in its favor a private property dispute that is being litigated in the Delaware courts. It fails to meet fundamental requirements of the Securities Exchange Act of 1934 ("Exchange Act"), and was adopted by CBOE without any measure of due process. In short, it is not consistent with the Exchange Act in a number of material respects, and the Commission therefore cannot make the findings necessary to approve it.

For these reasons, CBOT respectfully requests that the Commission institute proceedings under Section 19(b)(2)(B) of the Exchange Act, including a public evidentiary hearing, to disapprove the Proposed Rule Change.

BACKGROUND

In 1972, CBOT and its members established CBOE as a new and separate exchange, with its own membership, dedicated to the trading of listed securities options. When creating CBOE, CBOT provided the necessary seed capital and loan guarantees and shared its valuable

[1] The SEC published the Proposed Rule Change for comment on February 6, 2007. Self-Regulatory Organizations, Exchange Act Release No. 34–55190, File No. SR–CBOE–2006–106, 72 Fed. Reg. 5,472 (Feb. 6, 2007) (hereinafter "Proposed Rule Change Notice").

intellectual property. CBOT and its members also agreed to develop dues paying members for the new exchange and provide it with persons experienced in the trading and clearing of futures contracts. In recognition of CBOT's very substantial contributions, Article Fifth(b) of CBOE's Certificate of Incorporation ("CBOE Charter") has provided since CBOE's inception that CBOT members are entitled to become members of CBOE without having to purchase a separate CBOE membership. This right is called the "Exercise Right."

Since then, CBOE and CBOT have entered into a number of agreements amplifying and defining the scope of the Exercise Right. Most significantly, in 1992, CBOT and CBOE executed an agreement ("the 1992 Agreement")[2] that further expressed the parties' understanding as to the scope of the Exercise Right as set forth in Article Fifth(b). In particular, the 1992 Agreement:

- confirmed that CBOT members who exercise their Exercise Right to become CBOE members ("Exerciser Members") "have the same rights and privileges of CBOE regular membership as other CBOE Members ("Regular Members"), including the rights and privileges with respect to the trading of all CBOE products;"

- made clear that the phrase "same rights and privileges of CBOE regular membership" in respect to the rights of Exerciser Members *includes* rights to any cash or property distribution made by CBOE;

- provided that if CBOT merged with or was acquired by another entity, the Exercise Right would survive such a merger or acquisition, subject to certain conditions;

- provided each party the right to bring suit, either on its own behalf or on behalf of its members, to enforce, and to recover damages for any breach of, the 1992 Agreement.

After contemplating demutualization for several years, on September 14, 2005, CBOE formally announced that its board of directors (the "CBOE Board") had approved a plan to begin the demutualization.

The CBOE Board is comprised of 23 persons. CBOE considers 11 of those directors, who are not in management and do not hold and are not affiliated with persons who hold memberships in CBOE, to be independent directors ("independent directors"). At about the time that CBOE announced its intention to demutualize, the CBOE Board appointed a Special Committee of the CBOE Board ("Special Committee"), comprised of four independent directors of CBOE, and gave the Special Committee, among other things, sole authority to determine the

[2] A copy of the 1992 Agreement is attached as Exhibit 1.

manner in which the membership interest held by the more than 200 CBOE members who are Exerciser Members, *i.e.*, those CBOT members who have already exercised their rights and are current CBOE members, and CBOE Seat owners would be converted into the consideration to be received in any demutualization of CBOE.[3] CBOE created the Special Committee to deal with the fact that many of its directors had significant personal financial interests in the matter.

On October 17, 2006, a proposed merger between CBOT Holdings and Chicago Mercantile Exchange Holdings, Inc. ("CME Holdings") was announced ("Merger").[4] CBOT itself is not a party to the Merger, and it will survive the Merger fully intact as an exchange but as a separate subsidiary of CME Holdings instead of CBOT Holdings. CBOT Full Members (including those Full Members who still hold Exercise Rights) will still have their memberships in CBOT and will continue to have the same trading rights on CBOT.[5]

The Special Committee of the CBOE Board continued its work, and on November 2, 2006, held an open hearing at which its chairman stated that the Special Committee was trying to reach a solution that treated regular CBOE members, Exerciser Members, and those CBOT Full Members who hold Exercise Rights but have not exercised them ("Eligible Exerciser Members") "fairly."

On December 12, 2006, however, the CBOE Board abruptly suspended the Special Committee's work (although the Special Committee had not reached a decision) and simultaneously voted to approve the Proposed Rule Change. It was submitted to the SEC on the same day. The Proposed Rule Change contained a one-sentence explanation: "The proposed rule change is consistent with and furthers the objectives of the [Exchange] Act, and Section 6(b)(5) of that Act in particular, in that it is a reasonable interpretation of existing rules of the Exchange that is designed to promote just and equitable principles of trade, to perfect the mechanisms of a free and open market, and to protect investors and the public interest."[6]

The four members of the Special Committee – each an independent director of CBOE – were all recused from the CBOE Board's deliberations and decision concerning the Proposed Rule Change and left the room.[7] As a result of the recusal of the Special Committee members, at

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[3] CBOE Holdings, Inc., Registration Statement Under the Securities Act of 1933 (Form S-4) (February 9, 2007) (hereinafter "Form S-4"), at 34.

[4] The Merger is expected to close in mid-2007.

[5] Under the terms of the Merger, CBOT Holdings stockholders will receive 0.3006 shares of CME Holdings Class A common stock per share of CBOT Holdings Class A common stock.

[6] CBOE, Proposed Rule Change (Form 19b-4) (Dec. 12, 2006), at 14-15.

[7] Following the approval of these actions, the directors on the Special Committee were invited to rejoin the December 12 meeting and were informed of the CBOE Board's decision. In turn, the Special Committee informed the CBOE Board that, based on the Board's interpretation of the impact of the Merger and the Board's understanding that the Merger would likely close prior to the demutualization of CBOE, the Special Committee would defer further deliberations until such time as it became appropriate to either resume the Special Committee's (cont'd)

best only 7 of the remaining 19 CBOE directors available to attend the meeting and to vote to approve and file the Proposed Rule Change could have been independent directors.[8] Those CBOE directors who are also Regular Members will receive much larger shares of the cash or property in CBOE's demutualization if the Exerciser Members and Eligible Exerciser Members can be excluded, as the Proposed Rule Change aims to do. By excluding all members in this class, the CBOE Board would dramatically decrease the number of CBOE members eligible to participate in the demutualization from 2,261 CBOE members to only 930.[9] Thus, each Regular Member on the CBOE Board could expect to significantly increase the value of his or her ownership interest in CBOE by voting in favor of the Proposed Rule Change.[10]

The Proposed Rule Change states that CBOE interprets Article Fifth(b) such that "the right of members of the Chicago Board of Trade to become or remain members of CBOE without having to purchase a [separate] CBOE membership will be terminated" upon the completion of the Merger. CBOE's stated rationale for the Proposed Rule Change is that CBOT will not have "individuals who qualify as a member of CBOT" after CBOT's parent company merges with CME Holdings, and, consequently, all of the rights conferred upon Exerciser Members and Eligible Exerciser Members in Article Fifth(b) and the subsequent agreements will become null and void.

Article Fifth(b) generally requires an 80% class vote of **each** of (1) CBOE members who are admitted pursuant to the Exercise Right (*i.e.*, Exerciser Members) **and** (2) other CBOE members to amend Article Fifth(b).[11] CBOE did not hold a vote of members on the Proposed Rule Change.

The Exerciser Members who were not allowed to vote on the matter have been participating members of CBOE and actively trading on the CBOE for years. The Proposed Rule

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deliberations, terminate the Special Committee's existence, or take such other action as would be warranted. Form S-4, at 35.

[8] Independent directors do not have any membership in the CBOE. Eleven of the other directors are CBOE members or affiliated with CBOE members. *See* Form S-4, at 44. William J. Brodsky is the chairman of CBOE's board of directors, and he is not independent of the Regular Members because his place on the board depends on his continued employment as CEO of CBOE, a position that depends on the continued support of the Regular Members.

[9] *See* CBOE Membership Meeting Slides at 9, Feb. 14, 2007, available at: http://www.cboe.org/legal/secfilings.aspx ("S-4 Registration Statement assumes that at the time of CBOE's restructuring, there will no longer be any CBOT members who are eligible to become or remain CBOE exercise members and therefore only the owners of the 930 outstanding CBOE seats will receive stock"). In addition to the 930 CBOE Members, there are 1331 Exerciser Members and Eligible Exerciser Members combined.

[10] *See* Form S-4 (litigation "could require us to issue significantly more equity, which would dilute materially the equity of our stockholders").

[11] CBOE Charter, Article Fifth(b).

Change will extinguish their trading rights, and they will receive no equity in the CBOE demutualization.[12]

On January 16, 2007, CBOE filed an Amended Proposed Rule Change that included, among other things, a legal opinion from its regular counsel (also dated January 16) to the effect that the CBOE Board has the authority to interpret Article Fifth(b) "in good faith when questions arise as to its application."[13]

CBOE then moved forward with its demutualization efforts by approving the proposed terms of the transaction and filing its registration statement on Form S-4 with the SEC on February 9, 2007, for the securities to be issued in the demutualization. The S-4 confirms CBOE's intention to eliminate memberships entirely, to deny Exerciser Members and Eligible Exerciser Members any interest in the demutualization (that is, no trading rights and no share in the new corporation), and to exclude Exerciser Members from participating in a vote on the demutualization.

PENDING LITIGATION

During 2006, CBOT received substantive and reliable information that CBOE did not intend to treat the Exerciser Members and Eligible Exerciser Members equitably in the CBOE demutualization. Accordingly, in reliance in part on the provision of the 1992 Agreement that allows either exchange to bring suit to enforce the terms of the Agreement, CBOT filed suit in Delaware,[14] seeking a declaratory judgment that CBOE will be in breach of the 1992 Agreement if, as it earlier had threatened, it does not permit Exerciser Members and Eligible Exerciser Members to participate equally with regular CBOE members in any cash or property distribution resulting from CBOE's proposed demutualization (the "Delaware Action").[15]

The complaint in the Delaware Action also seeks a declaration that CBOE and its directors would breach their fiduciary duties to the Exerciser Members and Eligible Exerciser Members if it did not permit them to participate equally with other CBOE members in the demutualization. CBOE moved to dismiss CBOT's Complaint on October 2, 2006, arguing that there was no actual controversy ripe for adjudication because CBOE had not yet decided

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[12] CBOE purchased an Exercise Right Privilege ("ERP") as recently as February 2, 2007, for $127,000, despite its position that the Exercise Rights will terminate and be worthless upon the consummation of the Merger. CBOE also purchased an Exercise Right Privilege on August 25, 2006, for $135,000. ERPs are the Exercise Right component of a CBOT Full Membership, and although a CBOT member must have all parts of a full membership, including an ERP, to become an Exerciser Member of CBOE, the ERPs may be sold separately, including to CBOE.

[13] CBOE, Amended Proposed Rule Change (Form 19b-4) (Jan. 16, 2007) ("CBOE Form 19b-4"), at Exhibit 3f.

[14] CBOT Holdings, Inc., The Board of Trade of the City of Chicago, Inc., and Chicago Board Options Exchange, Inc. all are Delaware corporations.

[15] *See CBOT Holdings, Inc. v. CBOE*, C.A. No. 2369-N (Del. Ch. filed Aug. 23, 2006).

precisely how the Exerciser Members would be treated in its demutualization. CBOE pointed to the fact that the CBOE Board-appointed Special Committee was charged with considering the issue and argued that any litigation should await the outcome of the Special Committee's deliberations.

In a letter to the Delaware court on December 12, and after having suspended the Special Committee, CBOE argued that the filing of the Proposed Rule Change mooted the Delaware Action.[16] On January 4, 2007, CBOT filed a Second Amended Complaint specifically addressing the Proposed Rule Change. CBOE then moved to dismiss the Delaware Action on January 16, 2007, arguing that CBOT cannot challenge CBOE's interpretation of Article Fifth(b) because the SEC has exclusive jurisdiction over CBOT's claims. CBOT filed a motion for partial summary judgment on January 11, 2007.

DISCUSSION

The facts show the real reason for CBOE's Proposed Rule Change: to eliminate one group of an exchange's owners for the benefit of another group of owners by depriving Exerciser Members of their CBOE memberships and Eligible Exerciser Members of a valuable property right in dereliction of basic principles of fairness, due process, and fiduciary duty. CBOE is attempting to abuse its quasi-governmental authority and the SEC's SRO rule approval process to adopt a proposed rule change that is: (1) not an appropriate subject of SRO rulemaking; (2) inconsistent with the requirements of the Exchange Act; (3) inconsistent with basic principles of due process; and (4) inconsistent with its obligations under state law.

I. The Proposed Rule Change is not an Appropriate Subject of SRO Rulemaking.

As a threshold matter, the SEC should disapprove the Proposed Rule Change because it is not an appropriate subject for a SRO rulemaking under the Exchange Act. Rather, the subject matter of the Proposed Rule Change concerns a dispute over the interpretation of CBOE's Delaware Charter, contracts between CBOE and CBOT, and fiduciary duties that should be adjudicated in state court.

The SEC may not approve a rule outside the authority granted to it pursuant to Section 19(b) of the Exchange Act. In ruling that the SEC lacked the authority to impose "one share/one vote" listing standards on national securities exchanges and the NASD, the Court of Appeals for the District of Columbia Circuit said in *Business Roundtable v. SEC*, 905 F.2d 406, 413 (D.C. Cir. 1990):

> [H]ere the SEC's assertion of authority directly invades the "firmly established" state jurisdiction over corporate governance and shareholder voting rights . . . . Upholding the Commission's

[16] The letter is attached as Exhibit 2 (hereinafter "CBOE December 12 letter").

> advance into an area not contemplated by Congress would circumvent the legislative process that is virtually the sole protection for state interests.

This principle applies equally to CBOE, which, in exercising its quasi-governmental rulemaking powers expressly granted under Section 6(b) of the Exchange Act, cannot exceed that express grant of power. And, as we demonstrate below, the Proposed Rule Change represents a dramatic incursion into matters that CBOE lacks authority to regulate under the Exchange Act.

A. The Proposed Rule Change is not Within the Powers of a SRO.

SROs are granted quasi-governmental authority under the Exchange Act with respect to their members. They exercise that authority by: (i) imposing disciplinary sanctions on members or persons affiliated with members, including barring members; (ii) denying membership to specific applicants based on specific grounds; (iii) prohibiting members from doing business with particular non-members or with respect to particular securities; and (iv) adopting and enforcing rules on matters specified or approved by the Commission.[17] When Congress enacted the Securities Acts Amendments of 1975, it "eliminate[d] the seemingly open-ended authority" of exchanges to make rules and "limit[ed] . . . the scope of the self-regulatory organizations' authority over their members."[18] Congress limited that authority by listing specific purposes in furtherance of which SROs may regulate, *and* by prohibiting SROs from using their quasi-governmental authority to regulate for any other reasons.[19]

The Proposed Rule Change does not fit within any of the quasi-governmental powers granted to CBOE, nor does it address any of the enumerated subjects of proper SRO rulemaking. Instead, the Proposed Rule Change concerns disputed issues of state law over which CBOE has no authority under the Exchange Act. The Commission should not sanction the attempt by CBOE and its interested directors to use the rulemaking process to misappropriate valuable private property from Exerciser Members and Eligible Exerciser Members in breach of duties imposed by state contract and corporation law.

In addition, CBOE has exceeded its authority in filing the Proposed Rule Change because the Proposed Rule Change is arbitrary and capricious and lacks a rational basis. The Fifth Amendment's Due Process Clause prohibits governmental regulations that are arbitrary, unreasonable, or capricious, and this requirement applies to CBOE in this context.[20] Regulations

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17 *See* 15 U.S.C. § 78s(d)-(g).

18 Securities Act Amendments of 1975, Senate Report 94-75 to Accompany S.249 (1975) (hereinafter "Senate Report 94-75") at 27.

19 15 U.S.C. § 78f(b)(5).

20 *See* discussion at Section III below.

must be rationally related to a legitimate government objective.[21] In particular, regulations that "make[] worthless substantial past investment incurred in reliance upon [a] prior rule" may be considered arbitrary and capricious.[22] Also, as a general matter, a quasi-governmental body such as a SRO must have some evidence substantiating its reasons for a rule.[23] Agencies cannot "deny the property owner of some beneficial use of his property or . . . restrict the owner's full exploitation of the property" unless such action is "justified as promoting the general welfare" and has a "reasonable basis."[24] In addition, a governmental rule must be "rational," meaning that it must "bear a logical relationship to its objective and have a reasonable likelihood of accomplishing it."[25]

The Proposed Rule Change satisfies none of these standards. First, it is not rationally related to a legitimate government objective. In fact, the Proposed Rule Change does not have *any* legitimate objective because it does not relate to any proper subject of SRO rulemaking. As in *Harwell v. Growth Programs, Inc.*, 451 F.2d 240, 245 (5th Cir. 1971), "[t]here appears little doubt that this Interpretation was aimed directly at" CBOT and its members. CBOE states that the Proposed Rule Change is necessary due to the planned Merger, but CBOE has offered no reason why the Merger would in any way affect CBOE or its Regular Members. In fact, because the 1992 Agreement limited the Exercise Right to the 1,402 then-existing Full Memberships in CBOT, the Merger could not dilute CBOE's membership or otherwise negatively affect CBOE.

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[21] *SBC Enters., Inc. v. City of S. Burlington*, 892 F. Supp. 578, 583 (D. Vt. 1995) (rule must be rationally related to a legitimate government objective); *Walsh v. La. High Sch. Athletic Ass'n*, 428 F. Supp. 1261, 1269 (E.D. La. 1977), *rev'd on other grounds*, 616 F.2d 152 (5th Cir. 1980).

[22] *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 220 (1988) (Scalia, J., concurring); *see also Patten Sec. Corp. v. Diamond Greyhound & Genetics, Inc.*, 819 F.2d 400, 406 (3d Cir. 1987) (finding that a rule interpretation by the NASD could "be set aside if it is considered to be arbitrary or subjective").

[23] *See* 15 U.S.C. § 78s(b)(1) (requiring SROs to submit to the SEC a statement of the "basis and purpose" of a rule change); *Goldstein v. SEC*, 451 F.3d 873, 882-83 (D.C. Cir. 2006) (holding that a rule is unreasonable, and thus arbitrary and capricious, if not adequately explained and justified); *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 359 (1963) (government oversight is necessary to prevent discriminatory and capricious self-regulation); *Timpinaro v. SEC*, 2 F.3d 453, 458-59 (D.C. Cir. 1993) (requiring the NASD to substantiate the reasons for its rule based on due process considerations); Exchange Act Release No. 34-33377, 55 SEC Docket 2005, 1993 WL 534173, at *2 (Dec. 23, 1993) (hereinafter "Release No. 34-33377") (requiring a rule to be based on an actual threat to the market and to provide a "rational and measured response" to that threat). The Commission has long recognized the importance of "insur[ing] that action in the name of self-regulation is neither discriminatory nor capricious." SEC Chairman William L. Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244, 246 (1963).

[24] *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 163 (1980); *see also Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 485-86 (1987) (agencies can only interfere with "investment-backed expectations" if such action serves the public interest—the rule cannot be "enacted solely for the benefit of private parties").

[25] *Walsh*, 428 F. Supp. at 1269; *see also Goldstein*, 451 F.3d at 883-84; *SBC Enters., Inc.*, 892 F. Supp. at 583 (rule must be rationally related to a legitimate government objective).

CBOE provided no reasonable explanation or justification for this Proposed Rule Change other than a conclusory one-sentence statement that it is consistent with the Exchange Act.[26] Therefore, CBOE has not met the "standards of policy justification that the Administrative Procedure Act imposes," as required by the Exchange Act.[27]

CBOE has not articulated any ways in which the Proposed Rule Change will accomplish any legitimate objective. The fact that the Proposed Rule Change is not a reasonable interpretation of the CBOE Charter and other agreements with CBOT and its members, as discussed below in Section IV, demonstrates that it is not a rational, logical way of achieving any legitimate goal. The Proposed Rule Change therefore exceeds CBOE's rulemaking authority.

B. The Proposed Rule Change Involves State Law Questions that the Delaware Court Should Decide.

At its core, CBOE's Proposed Rule Change is an improper attempt to induce the Commission to take sides in a private contractual dispute governed by state law. The Delaware Action pending before the Delaware Court of Chancery is the proper vehicle for the resolution of the core state law contract, corporate, and fiduciary questions at issue in this matter.

In asserting in the Delaware Action that the SEC should resolve these issues, which in significant part concern matters of corporate governance, CBOE appears to have forgotten its recent statements that the SEC does not have authority over these issues.[28] The Commission, in approving SRO rule changes (including those of CBOE), has also rightfully acknowledged the applicability of state laws to such rules, and has not suggested that its rulemaking authority extends beyond the determination of whether a SRO rule is consistent with the requirements of the Exchange Act.[29] That is because the Commission has recognized that jurisdiction to enforce matters of state law resides in, and generally has been left to, state courts.[30]

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[26] Such an unreasonable and unjustified interpretation of a rule, particularly one that departs from prior interpretations, is outside the CBOE's rulemaking authority. *See Goldstein*, 451 F.3d at 881.

[27] Senate Report 94-75 at 29.

[28] *See* Comment Letter from William J. Brodsky, Chairman and CEO of CBOE, to Jonathan Katz, re: File No. S7-39-04, Fair Administration and Governance of Self-Regulatory Organizations, at 2 n.6 (March 8, 2005) (hereinafter "Brodsky Letter") (responding to the SEC's Notice of Proposed Rulemaking concerning SRO governance, "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.").

[29] *See, e.g.*, Exchange Act Release No. 34-51252, File No. SR-CBOE-2004-16, 70 Fed. Reg. 10442, 10444 (Mar. 3, 2005) (hereinafter "Release No. 34-51252"); *see also Bus. Roundtable*, 905 F.2d at 408 ("[W]e find that the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of . . . the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states.").

[30] *See* Notice of Proposed Rulemaking, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71126, 71140, 71145-6 (proposed Nov. 18, 2004) (hereinafter "Release No. 34-50699"); *see also Barbara v. N.Y. Stock Exch. Inc.*, (cont'd)

Consequently, we believe that the Commission should have the benefit of the Delaware court's ruling on the corporate governance issues at the core of the Proposed Rule Change, and do so by taking the steps necessary to disapprove the Proposed Rule Change at this time. To do otherwise would waste the Commission's scarce resources without serving any investor protection, market regulation, or public interest purpose; would facilitate CBOE's improper attempt to use the SRO rulemaking process to avoid a proper adjudication of CBOT's state law claims; and would unnecessarily force the Commission to risk engaging in an unconstitutional taking of CBOT members' property, as explained below.[31]

1. Questions Pertaining to Corporation Charter Changes and Interpretations Lie at the Heart of State Corporations Law.

CBOT filed suit against CBOE in Delaware state court on August 23, 2006, well before CBOE filed its Proposed Rule Change with the SEC. The issues presented in the Delaware Action will not be resolved by SEC approval of the Proposed Rule Change, although CBOE will likely attempt to use SEC approval to unfairly prejudice that suit.[32]

The central question raised in the CBOT Complaint in the Delaware Action is the status of the Exercise Right in light of CBOE's proposed demutualization and the proposed Merger. This is a state law question because it concerns an interpretation of the CBOE Charter, which is treated as a contract under Delaware law between CBOE and CBOT members given the right under the CBOE Charter to be or become members of CBOE pursuant to the Exercise Right,[33] and of other agreements between CBOE and CBOT relating to the Exercise Right. As explained in Sections II.A.2 and IV, the Proposed Rule Change violates Delaware law by breaching the

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99 F.3d 49 (2d Cir. 1996); *Bernstein v. Lind-Waldock & Co.*, 738 F.2d 179, 184-85 (7th Cir. 1984) ("State courts, deploying a mature body of contract principles that seem well suited to resolving contractual disputes among members of commodity exchanges, have been adjudicating such disputes for a century, with satisfactory results as far as we can tell.") (citations omitted).

[31] When faced with such "significant uncertainties," agencies must articulate the need for regulating before those uncertainties have been resolved. *Int'l Ladies' Garment Workers' Union v. Donovan*, 722 F.2d 795, 814 (D.C. Cir. 1983). Here, CBOE has not presented any reason why its Proposed Rule Change must be resolved by the CBOE Board with SEC approval before the Delaware Action is decided.

[32] In that regard, CBOE sent a letter to the Delaware court on December 12, 2006, arguing that the *filing* of the Proposed Rule Change mooted the Delaware Action. This letter highlights the fact that CBOE is using this rulemaking for improper purposes.

Moreover, CBOE's assertion that SEC approval would moot the Delaware action conveniently overlooks contrary assertions previously made by CBOE. *See* Brodsky Letter, *supra* note 28.

[33] *See Morris v. Am. Pub. Util. Co.*, 122 A. 696 (Del. Ch. 1923); *State v. U.S. Realty Improvement Co.*, 132 A. 138 (Del. Ch. 1926); *Lawson v. Household Fin. Corp.*, 147 A. 312 (Del. Ch. 1929), *aff'd*, 152 A. 723 (Del. 1930); *Voege v. Am. Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965).

contractual rights created by the CBOE Charter and violates Illinois law by breaching the 1992 Agreement between CBOT and CBOE. In that agreement, CBOE confirmed that Exerciser Members "have the same rights and privileges of CBOE regular membership as other CBOE Regular Members, including the rights and privileges with respect to the trading of all CBOE products," and the rights to any cash or property distributions made by CBOE. CBOT's pending complaint seeks relief for these violations of state law.

The Proposed Rule Change also raises corporate governance issues under Delaware law. By the terms of the CBOE Charter, the authority of the CBOE Board to interpret the CBOE Charter is limited to actions taken "in good faith, consistent with the terms of [Article Fifth(b)], and not for inequitable purposes."[34] The CBOE Board acted in bad faith, for inequitable purposes, inconsistently with the clear terms of the CBOE Charter, and in breach of its fiduciary duties. Moreover, CBOE's interpretation of Article Fifth(b) was approved by a CBOE Board dominated by members with personal financial interests in expropriating the rights of CBOT members.

As noted above, CBOE, the Commission, and the courts have acknowledged that the Commission does not have authority to resolve such state law issues.[35] Moreover, these state law claims are substantial. Because CBOT's Delaware claims raise core state law issues relating to the interpretation of the CBOE Charter and related contracts and the sufficiency and integrity of its corporate governance processes, and have substantial merit, the SEC should defer to the Delaware courts and disapprove the Proposed Rule Change.

2. State Law Applies to SRO Rules in the Absence of a Clear Conflict with the Exchange Act.

CBOE wrongly suggests that the Commission should ignore the Delaware Action because Commission approval of the Proposed Rule Change would "preempt" CBOT's state law claims. While the SEC can preempt state law on matters within the scope of the Exchange Act, this preemption does "not bar [a] plaintiff from pursuing at his option remedies based solely on state law, even though the action may be based on the same factual circumstances" that establish a violation of the exchange's rules.[36] Accordingly, even if the Commission were to determine that the Proposed Rule Change is within the scope of and consistent with the Exchange Act (although it is not), that approval would not resolve or preempt the state law issues.

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[34] Letter from Wendell Fenton to Joanne Moffic-Silver, CBOE Form 19b-4, Ex. F; *see also Hill v. Wallace*, 259 U.S. 44, 73 (1922) (indicating that the directors of a SRO may not "exercise their powers fraudulently or otherwise in violation of their trust").

[35] *See* Release No. 34-51252, 70 Fed. Reg. 10444; *see also Bus. Roundtable*, 905 F.2d at 408.

[36] *Buckley v. CBOE*, 440 N.E.2d 914, 917 (Ill. App. 1982).

The questions of Delaware corporation law and Illinois contract law are not matters within the scope of the SEC's preemption authority. Any preemption analysis must begin with "the presumption against finding pre-emption of state law in areas traditionally regulated by the States."[37] That is because "[w]hen Congress legislates in a field traditionally occupied by the States, 'we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'"[38] The regulation of corporations is one such field traditionally occupied by the states.[39] This presumption against preemption also extends to "common law . . . contract remedies in business relationships."[40]

While federal law requires a SRO to comply with the Exchange Act, this is in addition to and not in lieu of the SRO's obligations to comply with state law requirements, such as the fiduciary duties imposed on the board of a SRO organized as a corporation or the obligation to honor binding contracts.[41] The SEC itself has declined to decide issues of state law.[42] In fact, the SEC recently noted that "directors [of SROs] have fiduciary obligations under state law."[43] It therefore follows that holding CBOE to its prior contracts and imposing fiduciary duties on the CBOE Board in no way "conflicts" with federal law or "stands as an obstacle to the accomplishment of the objectives of Congress."[44]

Moreover, CBOE does not and cannot assert that it is impossible for it to comply with the Exchange Act on the one hand, and its contractual commitments and the fiduciary duties imposed by state law on the other hand. Nor could CBOE plausibly assert that enforcing contracts voluntarily entered into by a SRO, and imposing the same fiduciary duties on a SRO's board that apply to other corporate boards of directors, somehow thwarts the objectives of the Exchange Act. In fact, if Congress had intended to exempt SROs from state laws governing

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37 *Cal. v. ARC Am. Corp.*, 490 U.S. 93, 101 (1989).

38 *Id.* (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)).

39 *Air Line Pilots Ass'n, Int'l v. UAL Corp.*, 874 F.2d 439, 447 (7th Cir. 1989) ("[T]he regulation of corporations is . . . a matter of primary state responsibility," and thus is one of the "areas [where] the presumption is against federal preemption.").

40 *G.S. Rasmussen & Assoc. v. Kalitta Flying Serv., Inc.*, 958 F.2d 896, 906 (9th Cir. 1992) (quoting *West v. Northwest Airlines, Inc.*, 923 F.2d 657, 659 (9th Cir. 1990)).

41 *See N.Y. v. Grasso*, 350 F. Supp. 2d 498, 504 (S.D.N.Y. 2004) (finding that plaintiffs could hold the former chairman and CEO of the NYSE liable for breaches of fiduciary duty).

42 *See* Release No. 34-51252, 70 Fed. Reg. 10444.

43 *See* Release No. 34-50699, 69 Fed. Reg. 71140.

44 *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119, 1132 (9th Cir. 2005). As the Seventh Circuit stated in *Bernstein*, 738 F.2d at 184-85 (7th Cir. 1984), "[a]lthough federal regulation of commodity exchanges is much more extensive than it used to be, no reason is suggested why adjudication by state courts of the contract disputes among members of those exchanges should be expected to interfere with the current federal regulatory scheme."

corporations and other private entities, it could have made them full government agencies, or could have expressly stated so in the Exchange Act.[45] Instead, Congress maintained SROs as private organizations with quasi-governmental powers.

CBOE erroneously argues in its January 12, 2007, letter to the SEC (the "January 12 Letter") that, because Section 6 of the Exchange Act requires a national securities exchange to comply with its own rules, the question of whether CBOE's Proposed Rule Change complies with the CBOE Charter likewise is subject to the Commission's exclusive jurisdiction under the Exchange Act. The meaning of the CBOE Charter, however, and whether the contractual rights granted by the CBOE Charter will be violated by the Proposed Rule Change, are purely questions of state law that cannot be preempted by the Exchange Act.[46]

Moreover, the Delaware Action raises state law issues that do not depend on an interpretation of the CBOE Charter – namely, whether CBOE has committed a breach of contract with respect to the agreements with CBOT relating to the Exercise Right, and whether the CBOE Board has breached its fiduciary duties with respect to its actions purporting to dilute the value of or extinguish the Exercise Right.[47] Again, the Delaware court's enforcement of these state law obligations of CBOE will not conflict with, or frustrate the purposes of, the Exchange Act, or in any way interfere with the regulatory functions of CBOE.[48]

Indeed, CBOE's suggestion that CBOT cannot enforce CBOE's contractual commitments in state court is belied by the agreements themselves. The 1992 agreement between CBOT and CBOE expressly provides that "either party . . . may bring suit (on its own behalf or on behalf of its members, or both) to enforce the terms of this Agreement and to recover damages for any

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[45] *See Grasso*, 350 F. Supp. 2d at 505 ("Like any other private entity, [the NYSE] must organize itself in accordance with state corporation law, and engage in ordinary contractual relations . . . . Congress specifically determined that certain functions under the securities laws would be performed *not* by a federal governmental agency . . . but by private entities authorized to perform certain regulatory functions . . . .").

[46] The CBOE Charter is a contract under Delaware law. *See supra* note 33.

[47] *See Grasso*, 350 F. Supp. 2d at 503-04 (finding that state law applied when the claims against the former chairman and CEO of the NYSE did not depend on a federal law analysis, whether or not the facts also stated a claim under federal law).

[48] *See id.* at 507 ("Permitting a state government to enforce the corporate governance norms under which an exchange or self-regulating organization is established violates no policy embodied in the federal securities laws.") A careful reading of the case on which CBOE primarily relies in its January 12 Letter, *Buckley v. CBOE*, 440 N.E.2d 914 (Ill. App. 1982), actually refutes CBOE's exclusive jurisdiction argument. In *Buckley*, the court *rejected* CBOE's assertion that the state court lacked jurisdiction over plaintiffs' state law claims because CBOE's "Certificate of Incorporation is an exchange rule . . . and the Act requires the CBOE to comply with its own rules." *Id.* at 917. The court held that the Act "does not bar plaintiff from pursuing at his option remedies based solely on state law, even though the action may be based on the same factual circumstances" that establish a violation of the exchange's rules. *Id.* In other words, while the factual circumstances supporting CBOT's state law breach of contract and breach of fiduciary duty claims may *also* show that CBOE has violated the Exchange Act by breaching its own rules, those state law claims provide an independent basis for state court jurisdiction.

breach of this Agreement." That, of course, is precisely what CBOT has done. For CBOE to assert that CBOT's right to enforce the 1992 Agreement is limited to matters such as "confidentiality and information-sharing" is absurd.[49] Nothing in the 1992 Agreement or the Exchange Act supports CBOE's suggestion that CBOT's contractual right to bring suit "to enforce the terms of this Agreement" is limited to some subset of the Agreement's terms.

CBOE must be stopped in its attempt to place CBOT's state law claims beyond the reach of state courts simply by inserting its desired resolution of those claims into a change to one of its rules. The Delaware court's adjudication of the contractual rights of CBOT and its members and the fiduciary duties of CBOE's directors under applicable state law will do no violence to the Congressional purposes underlying the Exchange Act or to its express language. CBOT therefore urges the Commission not to interject itself into this state law controversy.

3. Commission Approval Could Effect a Taking.

Even if CBOE were correct that Commission approval of the Proposed Rule Change would "preempt" CBOT's state law contract claims, that is no reason for the Commission to approve the Proposed Rule Change. To the contrary, it is all the more reason for the Commission to refuse to approve the Proposed Rule Change, because any Commission order that "preempted" CBOT's contractual rights would result in an uncompensated taking of valuable property, in violation of the Fifth Amendment.

"The Fifth Amendment commands that property be not taken without making just compensation," and "[v]alid contracts are property, whether the obligor be a private individual, a municipality, a state or the United States."[50] Neither CBOE nor the Commission has authority to destroy the valuable contractual Exercise Right held by the Exerciser Members and Eligible Exerciser Members without paying just compensation, as CBOE asks the Commission to do in the Proposed Rule Change. "Agreements between private parties . . . give rise to protected property interests, irrespective of whether the subject matter of the contracts is under the government's regulatory jurisdiction."[51] Thus, "the abrogation by legislation of clear, unqualified contract rights requires a remedy, even in a highly regulated industry, . . . because the contracts embod[y] the commitments of the contracting parties."[52] The abrogation of the clear contract rights of the Exerciser Members and Eligible Exerciser Members by Commission

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49 January 12 Letter, at 5.

50 *Lynch v. United States*, 292 U.S. 571, 579 (1934).

51 *Cienega Gardens v. United States*, 331 F.3d 1319, 1334 (Fed. Cir. 2003).

52 *Id.*

approval of the Proposed Rule Change would similarly require a remedy – full compensation for the value of the contract rights CBOE seeks to extinguish.[53]

Because the issue of whether CBOE's proposal to extinguish the Exercise Right is a breach of contract under state law will not be resolved until the Delaware court acts, the Commission cannot know whether approval of the Proposed Rule Change would result in a taking of the contract rights of CBOT's Exerciser Members and Eligible Exerciser Members. CBOE is thus asking the Commission to assume a huge risk, at potentially little cost to CBOE itself: if the Commission's approval of the Proposed Rule Change (which is necessary for the Proposed Rule Change to take effect) is deemed to preempt, and thus destroy, CBOT members' valuable contract rights, then it would be necessary to pay compensation to the affected CBOT members for the taking of that property. Viewed in this light, CBOE's proposal that the Commission extinguish the contractual Exercise Right via approval of the Proposed Rule Change is merely a scheme to shift CBOE's potential liability to the Commission.

The Commission should not fall prey to CBOE's scheme. Rather, the Commission should refuse to approve the Proposed Rule Change, because only after a court determines whether CBOE's actions violate its contracts can the Commission know whether CBOE's Proposed Rule Change may result in an unconstitutional taking of CBOT members' property.

C. <u>The Proposed Rule Change is an Adjudication, not a Rulemaking.</u>

In addition, the Proposed Rule Change is not a "rule" at all. It is not a policy or standard of general applicability to all members, but rather a targeted action adversely affecting the existing rights of a specific and limited class – Exerciser Members and Eligible Exerciser Members – with respect to the outcome of CBOE's demutualization and the proposed Merger. The Proposed Rule Change therefore is a quasi-judicial determination, not a rulemaking. This conclusion is supported by Congress' indication that actions involving denial of SRO membership or access to the markets, which the Proposed Rule Change would do, are "quasi-adjudicatory" in nature.[54]

Certain standards of due process— including a hearing—apply when an agency proceeding is "quasi-judicial" or "adjudicatory" rather than a "promulga[tion of] policy-type rules or standards."[55] Here, CBOE's Proposed Rule Change singles out a defined group "based

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[53] Moreover, because the taking effected by the Proposed Rule Change has no apparent public purpose and is intended to "confer[] a private benefit on . . . particular private part[ies]," approval of the Proposed Rule Change would violate the Fifth Amendment by taking the property rights of Exerciser Members and Eligible Exerciser Members, whether compensation was paid or not. *Kelo v. City of New London*, 545 U.S. 469, 477-78 (2005).

[54] Senate Report 94-75 at 26.

[55] *United States v. Fla. E. Coast Ry. Co.*, 410 U.S. 224, 245 (1973); *see also* 5 U.S.C §§ 556, 557 (federal agency administrative procedure; adjudications); *Londoner v. Denver*, 210 U.S. 373, 386 (1908) (requiring a hearing). Although CBOE may not be subject to the Administrative Procedure Act ("APA"), the APA's analogous differentiation between "rules" and "orders" is also instructive because Congress intended self-regulatory

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on its own peculiar circumstances" that resulted from CBOT's involvement in the creation of CBOE.[56] This is not a case in which the Proposed Rule Change *may* affect some interested parties more than others.[57] CBOE adopted the Proposed Rule Change with the specific intent of depriving a particular, identifiable group (Exerciser Members and Eligible Exerciser Members) of its property rights.[58]

CBOE is also attempting to "adjudicat[e] a particular set of disputed facts."[59] Further, although the Merger has not yet occurred, CBOE's Proposed Rule Change is not truly "prospective," as a typical rule or legislative decision would be. Rather, it contemplates a specific set of facts based on the definitive merger agreement between CBOT Holdings and CME Holdings that was announced approximately two months before CBOE filed the Proposed Rule Change.[60] The Proposed Rule change can only have retroactive effects because, as it would extinguish the Exercise Right, it could never affect any future actions by CBOT.[61] Finally, this dispute is in fact already the subject of an adjudicatory proceeding—the Delaware Action. An adjudication of these members' rights is therefore not a proper subject of a rulemaking proceeding – it requires, at a minimum, a hearing, and the proper forum for that hearing plainly is the Delaware courts.[62]

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organizations to adhere to the same general principles of agency due process behind the APA. *See* Senate Report 94-75 at 29.

56 *Fla. E. Coast Ry.*, 410 U.S. at 246.

57 *Cf. Bi-Metallic Inv. Co. v. State Bd. of Equalization*, 239 U.S. 441 (1915).

58 *See Goodman v. FCC*, 182 F.3d 987, 994 (D.C. Cir. 1999) (finding that an agency action was an adjudication, not a rulemaking, when it affected "licenses that had already been issued"); *Scott v. Greenville County*, 716 F.2d 1409, 1420 (4th Cir. 1983) (act is not legislative when directed at one pending application). The fact that the Proposed Rule Change may affect a large number of persons or entities does not make it a rulemaking. *See Goodman*, 182 F.3d at 994.

59 *Fla. E. Coast Ry.*, 410 U.S. at 246; *see also Bowen*, 488 U.S. at 219 (noting that, in contrast to rulemaking, "'adjudication is concerned with the determination of past and present rights and liabilities'") (*quoting* Attorney General's Manual on the Administrative Procedure Act) (Scalia, J., concurring).

60 *See Bowen*, 488 U.S. at 217 (stating that "a rule is a statement that has legal consequences *only* for the future") (emphasis added) (Scalia, J., concurring); *Scott*, 716 F.2d at 1420 n.16 (act is not legislative when taken after potential sale of property is known).

61 *See Bowen*, 488 U.S. at 217 (Scalia, J., concurring).

62 *See Londoner*, 210 U.S. at 386.

II. The Proposed Rule Change is Inconsistent with the Requirements of the Exchange Act.

Not only is the Proposed Rule Change outside CBOE's quasi-governmental rulemaking power, it is also inconsistent with the purposes of the Exchange Act and the statutory requirements for SRO rules. The SEC must therefore disapprove the Proposed Rule Change.[63]

As a threshold matter, item 3(b) of Form 19b-4 requires a SRO filing a proposed rule change to, at a minimum, "[e]xplain why the proposed rule change is consistent with the requirements of the [Exchange] Act and the rules and regulations thereunder applicable to the self-regulatory organization." Item 3(b) also provides that "[a] *mere assertion* that the proposed rule change is consistent with those requirements is *not sufficient*."[64] CBOE has provided no factual or legal support for its boilerplate recitation of the purpose clause of Section 6 of the Exchange Act and its one-sentence assertion that the Proposed Rule Change complies with these purposes.[65] CBOE has not even attempted to explain how or why the Proposed Rule Change is consistent with the purposes of the Exchange Act, probably because there is no explanation that CBOE could provide. CBOE's "mere assertion" of consistency is not enough.[66]

In fact, the Proposed Rule Change is inconsistent with the stated purposes of the Exchange Act. First, the Proposed Rule Change unfairly discriminates among members by revoking the memberships of a defined group for reasons that do not apply to all CBOE members or potential members, in violation of Sections 6(b)(3), 6(b)(5), and 6(b)(7) of the Exchange Act. Second, the Proposed Rule Change fails to allocate fairly fees and dues by increasing the value of one group's CBOE memberships and forcing another group to purchase new memberships, in violation of Section 6(b)(4) of the Exchange Act. Third, the Proposed Rule Change does not promote free and open markets because it reduces the number of members of the CBOE, in violation of Section 6(b)(5) of the Exchange Act. Fourth, the Proposed Rule Change places an unnecessary burden on competition, in violation of Section 6(b)(8) of the Exchange Act. Fifth,

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63 15 U.S.C. § 78s(b)(2). We also note that Section 23(c) of the Exchange Act requires that, when approving a rule change with significant policy implications, the Commission should issue its own statement as to the regulatory need for and appropriateness of the SRO rule change, in addition to the justification provided by the SRO. 15 U.S.C. § 78w(a). The Proposed Rule Change plainly would have significant policy implications for CBOE by summarily extinguishing, without due process, the vested membership rights of an entire class of members. This substantial disenfranchisement of a significant number of CBOE members is contrary to the Exchange Act's policy of maintaining open exchange membership. Consequently, the Commission would not be able to make the required statement of regulatory need and fitness, further demonstrating the Proposed Rule Change's inconsistency with the Exchange Act.

64 Exchange Act Form 19b-4, Item 3(b) (emphasis added).

65 *See* Proposed Rule Change Notice, Section II.A(2).

66 *See Timpinaro*, 2 F.3d at 458-59 (requiring the NASD to substantiate the reasons for its rule); *see also Bowen*, 488 U.S. at 212 (declining to grant *Chevron* deference to agency actions "wholly unsupported by regulations, rulings, or administrative practice").

the CBOE has failed to comply with its own rules as required by the Exchange Act by ignoring the procedures necessary for amending Article Fifth(b), in violation of Section 6(b)(1) of the Exchange Act. We discuss each of these points in turn.

A. The Proposed Rule Change Unfairly Discriminates Among Members.

Section 6(b)(5) of the Exchange Act and Note 1 to Item 3(b) of Form 19b-4 both specifically state that the rules of a national securities exchange may not permit unfair discrimination between customers, issuers, brokers, or dealers, or, by inference, members.[67] CBOE's rules must also assure a "fair representation of its members in the . . . administration of its affairs,"[68] and provide fair procedures with respect to membership and trading access.[69] In approving the Proposed Rule Change, the CBOE Board also breached its fiduciary duty to treat all classes of members equally. The Proposed Rule Change discriminates among classes of CBOE members by applying different membership rules to Regular Members and Exerciser Members without justification and by denying Exerciser Members and Eligible Exerciser Members' contractual rights in the CBOE demutualization.

1. The Proposed Rule Change Arbitrarily Applies Different Rules to Different Classes of Members.

The Proposed Rule Change on its face unfairly discriminates between Regular Members on the one hand, and Exerciser Members and Eligible Exerciser Members on the other hand. The membership of Regular Members can only be revoked or restricted for certain reasons and according to certain procedures.[70] However, the Proposed Rule Change would not simply eliminate the Exercise Right. It singles out the Exerciser Members and revokes their existing memberships for no reason and without proper procedures, despite the provision of the 1992 Agreement confirming that Exerciser Members have the same rights and privileges as Regular Members.

CBOE has no reason for discriminating between the Exerciser Members and Regular Members in this respect, and nothing in the CBOE Charter supports such a distinction.[71] The

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67 15 U.S.C. § 78f(b)(5).

68 15 U.S.C. § 78f(b)(3).

69 15 U.S.C. § 78f(b)(7).

70 *See* CBOE Rules 3.16, 3.19, 4.10, Chapters 16-17.

71 *See Bright v. Phila.-Balt.-Wash. Stock Exch.*, 327 F. Supp. 495, 504 (E.D. Pa. 1971) (condemning the exchange's "distinction without a difference" in its treatment of two groups); Release No. 34-33377 at *5 (stating that distinctions between groups must be "procedurally fair and . . . otherwise consistent with the Act"). CBOE stated in its November 2, 2006, Motion to Dismiss in the Delaware Action that the limitations on transferability of the Exercise Rights somehow affects the different treatment of Exercise and non-Exercise members of CBOE with respect to the demutualization of CBOE. CBOE fails to explain how the transferability of the Exercise Right relates (cont'd)

Proposed Rule Change "unfairly disadvantage[s]" Exerciser Members and Eligible Exerciser Members for the benefit of Regular Members.[72] The Proposed Rule Change also gives the Regular Members a competitive advantage over the Exerciser Members by requiring Exerciser Members to purchase another CBOE membership (or trading rights on CBOE after its demutualization) if they desire to continue their involvement with CBOE.[73]

Moreover, the Proposed Rule Change is expressly inconsistent with the requirements of Section 6(b)(3) of the Exchange Act, which requires fair representation of CBOE members in the administration of its affairs. The Exerciser Members and Eligible Exerciser Members clearly would not approve the elimination of a valuable property right such as the Exercise Right without proper consideration for that elimination. The mere fact that the Proposed Rule Change would entirely eliminate the Exercise Right for no compensation demonstrates, *per se*, that the interests of the 1331 Exerciser Members and Eligible Exerciser Members were not represented in the administration of CBOE's affairs.

2. <u>The Proposed Rule Change Denies CBOT Full Members' Rights in the Demutualization.</u>

The Proposed Rule Change's elimination of the Exercise Right upon the closing of the Merger means that, contrary to the CBOE Charter and the 1992 Agreement, Exerciser Members and Eligible Exerciser Members will not share in the equity or other compensation distributed pursuant to CBOE's demutualization plan. This unjustified discrimination, which benefits only Regular Members of CBOE, is inconsistent with the Exchange Act's requirement that the rules of a national securities exchange must not permit unfair discrimination.

The CBOE Charter unequivocally provides for equal treatment for Exerciser Members.[74] The 1992 Agreement affirms the essential terms of the CBOE Charter. CBOE expressly agreed that Exerciser Members would have the same rights and privileges as Regular Members, with the sole exception being the absence of any right to transfer separately from their CBOT membership their CBOE exercise membership and the "trading rights and privileges appurtenant thereto."[75]

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to this issue, and in any case this does not justify CBOE's discriminatory treatment of Exercise Right holders in the filing of the Proposed Rule Change.

72 Release No. 34-33377 at *7.

73 *See* 15 U.S.C. § 78c(a)(36) (defining "equal regulation" as when "no member of the class [of persons] has a competitive advantage over any other member thereof resulting from a disparity in their regulation . . . [which] is unfair and not necessary or appropriate").

74 CBOE Charter, Article Fifth(b).

75 1992 Agreement at Section 3a.

The 1992 Agreement further provides that Exerciser Members have the right to participate on an equal basis in any cash or property distribution made by CBOE.[76] CBOE also agreed to give CBOT at least 90 days' notice prior to making any cash or property distribution, in order to give Eligible Exerciser Members who had not yet exercised their Exercise Right the opportunity to do so for the purpose of participating in any such distribution. Paragraph 3(b) of the 1992 Agreement specifically allows Eligible Exerciser Members to exercise their Exercise Right *solely* for the purpose of participating in a distribution or offer of cash or property.

Pursuant to the CBOE Charter, Exerciser Members would also have the right to participate fully in the distribution of stock in CBOE's new holding company. The CBOE Charter provision vesting in all Exerciser Members "all rights and privileges . . . of membership" necessarily entitles them to the very same right to convert their memberships into stock that the Regular Members will receive in the demutualization.[77] Nothing whatsoever in the 1992 Agreement argues against this fundamental conclusion. If the Proposed Rule Change is approved, however, the rights of the Exerciser Members and Eligible Exerciser Members under the CBOE Charter would not only be diluted — they would be utterly destroyed.[78] Indeed, giving Exerciser Members and Eligible Exerciser Members anything less than the opportunity to participate on an equal basis with the regular CBOE members would necessarily "dilute the value" of an Exerciser Membership, in violation of the 1992 Agreement.[79] This constitutes a breach of contract that results in unfair discrimination among CBOE members in violation of the Exchange Act.[80]

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[76] "In the event the CBOE makes a cash or property distribution, whether in dissolution, redemption or otherwise, to other CBOE Regular Members as a class, which has the effect of diluting the value of a CBOE Membership, including that of a CBOE membership under Article Fifth(b), *such distribution shall be made on the same terms and conditions to Exerciser Members.***"** *Id*. (emphasis added).

[77] The demutualization plan put forth by CBOE in its Form S-4 also breaches the CBOE Charter and discriminates against Exerciser Members and Eligible Exerciser members by eliminating CBOE membership (by converting memberships into rights to receive common stock in a new holding company), even though Article Fifth(b) clearly contemplates that CBOT Full Members will always have the right to become members of CBOE. In contrast, when CBOT demutualized, it retained a membership structure, even though it also issued stock in CBOT Holdings to members.

[78] Directors cannot "override contractual obligations [owed to a minority group] set forth in a certificate of incorporation." Folk on the Delaware General Corporation Law § 141.2.1.7 (5th ed. 2006) (citing *Halifax Fund, L.P. v. Response USA, Inc.*, C.A. No. 15553, transcript at 3, 5 (Del. Ch. May 13, 1997)).

[79] *See Continental Airlines Corp. v. Am. Gen. Corp.*, 575 A.2d 1160, 1167 (Del. 1990) "The simple response to the appellant's argument is that, pursuant to § 3.8 of the Warrants, when Texas Air granted an option to *some* of the stockholders of Continental (the employee-stockholders), it was required [sic] offer the same consideration to American General."

[80] This matter is strikingly similar to *Continental Airlines*, in which American General, as part of consideration received for a loan to Continental, received "the right . . . to receive the same consideration received by other Continental shareholders in the event of a merger involving Continental." *Id*. at 1162. Then, when Continental entered into a going-private merger with its majority-shareholder parent, one class of Continental shareholders—employees—were given an opportunity to receive stock of the parent in addition to the cash

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3. The CBOE Board Breached Its Fiduciary Duties to Treat Members Equally.

When determining whether CBOE and the CBOE Board have unfairly discriminated against Exerciser Members and Eligible Exerciser Members, the Commission should take into consideration that the CBOE Board breached its fiduciary duty to Exerciser Members by failing to treat them equally with Regular Members. This violation of state law speaks directly to whether the Proposed Rule Change would result in unfair discrimination between classes of members and among potential members of CBOE and unfair representation of CBOE's members in the administration of its affairs.

Under the governing documents, Exerciser Members are not a separate and less-favored class of CBOE members. Instead, they are entitled to equal treatment with Regular Members. Under Delaware law, the CBOE Board plainly owed a fiduciary obligation to the 243 Exerciser Members, just as they would to any other group of minority shareholder, to treat them even-handedly and not to prefer the interests of the majority of Regular Members.[81] In addition, to the extent that the directors were themselves Regular Members, they had an obligation to ensure that whatever decisions they made as directors were not tainted by their personal interest in maximizing the value of their own memberships.[82]

The undisputed facts demonstrate that the interested CBOE Board members breached these obligations.[83] On December 12, 2006, these CBOE Board members breached their obligations by suddenly taking the entire issue away from the Special Committee, ushering the members of the Special Committee from the room and having the remaining members of the CBOE Board decide that the Exercise Rights would be a nullity once the Merger was

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consideration given to all other minority shareholders. The main beneficiaries of the extra consideration were a small group of officers and senior managers. The parent then tried to separate the stock conversion from the rest of the merger to head off a suit by American General. The court said that the stock conversion did constitute consideration for the merger, and Continental had breached its contract with American General, in part because it was clear to the court that American General would not have extended the loan without the guarantee of long-term equity in Continental. The court rejected Continental's claims that American General was not "eligible" for the same consideration. Here, CBOT members would not have provided significant capital to CBOE without a guarantee of long-term membership in CBOE, and CBOE cannot read CBOT members out of the CBOE Charter.

[81] *See Burton v. Exxon Corp.*, 583 F. Supp. 405, 414 (S.D.N.Y. 1984) (interpreting Delaware law and stating the majority shareholders have a fiduciary duty to minority shareholders to be fair in dealing with minority shareholders); *Strassburger v. Earley*, 752 A.2d 557, 576-77 (Del. Ch. 2000) (finding that minority interests must be represented and that certain transactions must be "fair" to minority shareholders).

[82] *See Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.").

[83] Under Delaware law, a director is "interested" when that director "appear[s] on both sides of a transaction []or expect[s] to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

completed.[84] In so doing, the CBOE Board members not only attempted to destroy the rights of more than a thousand Eligible Exerciser Members, they also purported to destroy the interests of over two hundred current CBOE members (the Exerciser Members), many of whom have been CBOE members for decades. That many of the CBOE Board members had a personal financial stake in the outcome of the decision raises an inference of a breach of the duty of loyalty.[85] That the Special Committee members — who had been selected to serve on that Committee precisely because they lacked any personal financial stake — were affirmatively *excluded* from participating in the discussion confirms that the other CBOE directors failed to properly discharge their fiduciary duties. These breaches discriminated against Exerciser Members and Eligible Exerciser Members by greatly increasing the influence of the directors who have the interests identical to those of Regular Members.

Finally, the CBOE Board members breached their fiduciary duties (and CBOE breached its contractual obligations) by declaring that, pursuant to its interpretation of Article Fifth(b) in the Proposed Rule Change, CBOE intended to "move ahead with its own demutualization" without providing any compensation whatsoever to Exercise Right holders, including those who had already exercised. If allowed to succeed, this ploy would effectively transfer hundreds of millions of dollars of wealth from the Exercise Right holders to the current majority of Regular Members, including members of the CBOE Board.[86]

B. The Proposed Rule Change does not Provide for the Equitable Allocation of Fees or Dues.

CBOE's rules must "provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities."[87] CBOE's attempt to extinguish summarily the membership rights of Exerciser Members and deprive the Eligible Exerciser Members of their vested rights to become members of CBOE has the opposite result of these express requirements of the Exchange Act. The Proposed Rule Change would force Exercise Right holders to pay twice to have trading rights on CBOE, which is not an equitable allocation of fees and dues.

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[84] *See Strassburger*, 752 A.2d at 574 (when remaining directors allowed the director with the "strongest conflicting interest" to "dominate the decision making process with the result that the outcome was favorable to him," finding strong evidence of improper motives and breach of fiduciary duty).

[85] *See Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (stating that directors have fiduciary duties of care and loyalty, and these encompass avoiding conflicts between their duties as directors and their own interests).

[86] *See Strassburger*, 752 A.2d at 572-73 (finding a breach of fiduciary duty where directors entered into transactions to entrench their own control of the corporation at the expense of minority shareholders); *see also* Folk on the Delaware General Corporation Law § 141.2.1.2 (5th ed. 2006) (stating that a breach of the duty of loyalty can include "deceptive action intended to benefit one class of stockholders to the detriment of another class").

[87] 15 U.S.C. § 78f(b)(4).

The Exerciser Members and Eligible Exerciser Members, by virtue of CBOT's provision of seed capital and other valuable consideration in the establishment and continued growth of CBOE, already have paid for the right to become members of CBOE. CBOE has acknowledged the substantial economic value of the Exercise Right by purchasing ERPs in a recent sale and in a 2005 auction.[88] The Proposed Rule Change would completely extinguish the value of the membership of the Exerciser Members and the value of the Exercise Right. As a result, any Exerciser Members or Eligible Exerciser Members who wish to become members of CBOE after the Proposed Rule Change takes effect would effectively have to pay twice; having already paid for the Exercise Right, they would have to pay again through the submission of fees and dues for acquiring another CBOE membership if the Proposed Rule Change became effective.[89] We cannot see how CBOE could possibly defend such a rulemaking as being an equitable allocation of fees and other charges among CBOE's members.

Similarly, eliminating the Exercise Right would substantially *increase* the value of a CBOE membership for Regular Members (including current members of the CBOE Board). If the number of CBOE members decreases through the elimination of Exerciser Members and Eligible Exerciser Members, the value of each Regular Member's membership would increase very substantially. This would artificially inflate the value of a CBOE membership for a select class of CBOE members (Regular Members) to the detriment of another class of CBOE members (Exerciser Members and Eligible Exerciser Members). The effects of this inflation will be exacerbated in the CBOE demutualization, inasmuch as the number of members that will be entitled to receive CBOE stock will be dramatically decreased if the Proposed Rule Change is approved.[90] In turn, the substantial increase in the value of the CBOE memberships of Regular Members and the total elimination of the memberships of the Exerciser Members and Exercise Rights of the Eligible Exerciser Members cannot, under any reasonable standard, support an equitable allocation of fees and dues. CBOE cannot allow certain members to "treat[] the exchange as their private domain" at the expense of other members.[91] CBOE must ensure that "the highest ethical standards prevail as to every aspect of" its activities.[92]

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88 *See* Exhibit 3.

89 The 1992 Agreement provided that the Exercise Right would only attach to existing Full Memberships in CBOT, so any new memberships created by CBOT, whose owners would not have contributed to the formation of CBOE, are not at issue here. Full memberships in CBOT currently cost approximately $2 million.

90 CBOE has stated that its demutualization plans are based on the assumption that the Merger will close before CBOE holds a vote on demutualization, and also on "the assumption that the SEC will have approved the CBOE's determination regarding the effect of the CME/CBOT transaction on the exercise right." CBOE, *Questions & Answers Regarding the Proposed Demutualization of the Chicago Board Options Exchange*, Information Circular IC07-19 (Feb. 13, 2007).

91 *Bright*, 327 F. Supp. at 502.

92 *Silver*, 373 U.S. at 366.

C. The Proposed Rule Change does not Perfect the Mechanisms of a Free and Open Market or Protect Investors or the Public Interest.

CBOE's rules must be designed "to remove impediments to and perfect the mechanism of a free and open market and a national market system."[93] The elimination of an entire class of exchange members (the Exerciser Members) and increasing the barrier to entry for an even larger constituency (the Eligible Exerciser Members) is more likely to impede the mechanisms of a free and open market than it is to perfect them. CBOE's rule change filing acknowledges that the Proposed Rule Change is likely to adversely affect the liquidity and depth of CBOE's market.[94] The Proposed Rule Change includes a provision suspending its application for an indefinite period of time,[95] which is a tacit admission by CBOE that the termination of the Exerciser Members' trading rights is likely to create disruption of the market. Even if all Exerciser Members were to decide to repurchase or lease new CBOE memberships (or trading privileges), re-applying for membership or trading access would nonetheless be a time-consuming and disruptive process. Further, the Proposed Rule Change provides no countervailing protection to investors or the public interest. In sum, the proposed limitation on memberships in CBOE is contrary to Congressional intent to maintain open membership policies in SROs and is inconsistent with the Exchange Act.[96]

D. The Proposed Rule Change Imposes Burdens on Competition that are not Necessary or Appropriate Under the Exchange Act.

Section 6(b)(8) of the Exchange Act provides that the rules of a national securities exchange may not impose burdens on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[97] The Proposed Rule Change creates a barrier to competition that did not previously exist, and CBOE has not provided, and cannot provide, any support for why this burden is necessary or appropriate.

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93 15 U.S.C. § 78f(b)(5).

94 Proposed Rule Change Notice § II.A(1).

95 "To prevent any risk that the loss of exercise members upon the termination of the exercise right might adversely affect liquidity in CBOE's market, CBOE is prepared to maintain the status quo for some period of time after the exercise right has been terminated. […] This interim period would continue *for so long as necessary to avoid any disruption to the market as a result of the loss of exercise members* […]" [emphasis added]. Proposed Rule Change Notice § II.A(1).

96 *See* Securities Acts Amendments of 1975, House Report No. 94-229 to Accompany H.R. 4111 at 97-98 (1975).

97 15 U.S.C. § 78f(b)(8); *see* Release No. 34-33377 at *15 (stating that the Commission must evaluate the effects of a rule change on competition); Senate Report 94-75 at 13-14 (emphasizing the importance of reducing burdens on competition not in furtherance of "a legitimate regulatory objective").

The Proposed Rule Change would eliminate the membership rights of 243 current CBOE members – the Exerciser Members – and Eligible Exerciser Members. Thus, the Proposed Rule Change would reduce competition among CBOE members by reducing the total number of members.[98] CBOE has not articulated, nor does there exist, any public interest or other justification for this burden on competition.[99]

This anti-competitive behavior, the result of a conspiracy between CBOE itself and CBOE Regular Members interested in increasing the value of their own memberships by terminating the Exercise Rights in connection with the CBOE demutualization, also violates the principles of the antitrust laws.[100] The principles of antitrust law should inform the SEC's determination of the competitive effects of the Proposed Rule Change,[101] particularly where, as here, the anti-competitive action is taken in violation of the SRO's own rules[102] and the action is not a proper subject of SRO rulemaking under the Exchange Act, and thus no antitrust immunity can exist. Also, because "[s]uch unjustified self-regulatory activity can only diminish public respect for and confidence in the integrity and efficacy of the exchange mechanism," the antitrust implications of CBOE's actions should be considered by the SEC in determining whether the Proposed Rule Change was enacted in conformity with the competitive purposes of the Exchange Act.[103]

E. CBOE Failed to Follow its Own Rules in Promulgating the Proposed Rule Change.

Section 6(b)(1) of the Exchange Act requires CBOE to "comply, and to enforce compliance by its members and persons associated with its members with rules of the

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98 *See Clement v. SEC*, 674 F.2d 641, 647 (7th Cir. 1982) (finding that, when economic reality of CBOE rule was that CBOT members would cease to trade as market makers on CBOE, rule was anticompetitive).

99 *See* Release No. 34-33377 at *6, 15 (applying a balancing test in evaluating the effects of a NASD rule on competition).

100 *See* 15 U.S.C. § 1 *et seq*. "The concerted action" of CBOE and a group of its members was intended to deprive CBOT members of "important business advantages" upon which they rely to "compete effectively," actions that would constitute violations of the antitrust laws. *Silver*, 373 U.S. at 347-48.

101 *See Billing v. Credit Suisse First Boston Ltd*., 426 F.3d 130, 165-66 (2d Cir. 2005) (finding that the application of antitrust principles to particular SRO rules is fact-specific, but stating that when immunity from antitrust laws exists, it is because the "regulatory regime" has assumed that function), *cert. granted*, 127 S.Ct. 762 (2006); *Harwell*, 451 F.2d at 247-48 (connecting NASD's power to make "rules designed to promote just and equitable principles of trade" with the antitrust standards and stating that "[t]he Maloney Act explicitly provides that the Commission is to consider antitrust effect in connection with the rules of the national securities association"); *Nielsen v. Dean Witter & Co.*, No. C-70-1943-OJC, 1975 WL 884, at *2 (N.D. Cal. Mar. 7, 1975) ("The SEC is also empowered to consider the antitrust implications of a dispute . . . .").

102 *See Ricci v. Chi. Mercantile Exch.*, 409 U.S. 289, 304-05 (1973); *see also Silver*, 373 U.S. at 360 (finding that antitrust principles act as a "check upon . . . acts of exchanges which conflict with their duty to keep their operations . . . honest and viable").

103 *Silver*, 373 U.S. at 359.

exchange."[104] The CBOE Board violated Article Fifth(b) in approving the Proposed Rule Change. The provisions of the CBOE Charter are rules of CBOE.[105] Article Fifth(b) generally requires an 80% class vote of **each** of (1) CBOE members who are admitted pursuant to the Exercise Right (*i.e.*, Exerciser Members) **and** (2) other CBOE members to amend Article Fifth(b).[106]

Although CBOE characterizes the Proposed Rule Change as an "interpretation" of Article Fifth(b), under Delaware law, it is a proposed amendment that will eliminate a property right created by Article Fifth(b). In fact, CBOE's so-called interpretation would, as a practical matter, unilaterally extinguish the Exercise Right. This would be a substantive change to the Article rather than a simple application of it to a given set of circumstances.[107] As such, it is an amendment that requires an 80% class vote to become effective. Under the guise of further "defining" member of CBOT for purposes of applying Article Fifth(b), the Proposed Rule Change would effectively define the Exercise Right out of existence. The class vote provision was clearly designed to prevent such a drastic alteration of rights without a concurrence of an 80% majority of those affected by it. Also, eliminating the entire concept of CBOE membership, as is proposed by the CBOE demutualization plan, would work a fundamental change that would require amendment of Article Fifth(b) because Article Fifth(b) clearly contemplates that CBOT Full Members will always have the right to become members of CBOE.

The Proposed Rule Change, however, was approved only by CBOE's directors, many of whom stand to derive a substantial financial benefit from it. The CBOE Board's failure to obtain the approval of at least 80% of CBOE Exerciser Members is contrary to CBOE's own rules and inconsistent with the requirements of Section 6(b)(1) of the Exchange Act.

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104 15 U.S.C. § 78f(b)(1); *see also Brawer v. Options Clearing Corp.*, 633 F. Supp. 1254, 1259 (S.D.N.Y. 1986) (noting the "explicit duty" of SROs to comply with their own rules); *Bright*, 327 F. Supp. at 502 (holding that SROs must enforce compliance with all their rules and cannot enforce internal governance rules arbitrarily or on a "whim").

105 15 U.S.C. § 78c(a)(27); s*ee* Release No. 34-51252, 70 Fed. Reg. 10443.

106 CBOE Charter, Article Fifth(b).

107 CBOE has not submitted any evidence or analysis that the Proposed Rule Change is an interpretation under Delaware law, other than a conclusory letter of CBOE's counsel that refutes the very proposition for which it was submitted. *See* Release No. 34-51252, 70 Fed. Reg. 10444 (finding that the Commission looks to state law to decide this question and relying on CBOE's analysis of the issue). The letter purports to demonstrate that as a matter of Delaware corporate law, the CBOE Board of Directors has the corporate authority to interpret terms in CBOE's Charter, and that the charter interpretation reflected in the Proposed Rule Change is a proper exercise of that authority. *See* Letter of Wendell Felton to Joanne Moffic-Silver, General Counsel, CBOE, dated January 16, 2007, CBOE Form 19b-4 at Exhibit 3f. However, as the letter itself makes clear, the CBOE Board's interpretive authority with respect to CBOE's charter is conditioned on the board acting "in good faith, in a manner consistent with the terms of [Article Fifth(b)] and not for inequitable purposes." Because CBOE did not act in accordance with these basic standards of Delaware law, the letter, far from supporting CBOE's position here, in effect contradicts the very proposition – that CBOE's actions are authorized under Delaware law – for which it is offered.

III. CBOE Failed to Comport with Basic Due Process Standards.

CBOE's rulemaking process failed altogether to comport with basic standards of due process, as required by law. This failure is itself inconsistent with the Exchange Act, which requires CBOE to conduct its business with fairness and due process.[108] It is made all the more egregious by the fact that CBOE's summary elimination, without due process, of the vested membership rights of an entire class of members clearly has significant policy implications under the Exchange Act.

CBOE stated in its Proposed Rule Change that the proposed rule change and filing were authorized and approved by the CBOE Board at a meeting held on December 12, 2006, and that "[n]o further action by CBOE in connection with this filing is required."[109] CBOE failed to provide notice or a hearing to interested parties before issuing its Proposed Rule Change.

1. CBOE Is Required to Conduct its Regulatory Activities in Conformance with Due Process.

The Fifth Amendment to the Constitution prohibits the government from depriving a person of property without due process of law.[110] Under the Exchange Act and significant case law, as a SRO, CBOE is a state actor using its quasi-governmental power to deprive CBOE Exerciser Members of their memberships and to deprive CBOT and its members of a valuable property right. In addition, the Exchange Act unambiguously requires a SRO to adhere to basic standards of due process in carrying out, among other things, its rulemaking activities. In its wholesale 1975 reconfiguration of the self-regulatory process, Congress recognized CBOE's status as a quasi-governmental actor required to act in accordance with due process.[111]

As required by the Exchange Act, CBOE performs governmental functions. Not only is CBOE regulated by the SEC, it acts as a regulator itself.[112] In particular, when it makes decisions concerning the availability and conditions of membership, CBOE is an agent of the

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108 *See* 15 U.S.C. § 78f(b)(5).

109 CBOE Form 19b-4 at 4 .

110 *See, e.g.*, *Mathews v. Eldridge*, 424 U.S. 319, 332 (1976).

111 Senate Report No. 94-75 at 24 (SROs "must exercise governmental power") and 25 (SROs "must be required to conform their activities to fundamental standards of due process").

112 *See* Release No. 34-50699, 69 Fed. Reg. 71131 (referring to the "statutorily-mandated responsibilities as market regulators" of the SROs and stating that SROs are "charged with a public trust to implement and enforce the federal securities laws and rules"); *see also Harwell*, 451 F.2d at 244 (referring to the "public interest that . . . the NASD ha[s] been charged by Congress to protect" and to the "[g]overnmental regulation of the securities market" by the NASD). The Exchange Act "requires national securities exchanges and registered securities associations to be so organized and have the capacity to carry out the purposes of the Exchange Act." Release No. 34-50699, 69 Fed. Reg. 71133.

government.[113] The Exchange Act specifically requires national securities exchanges to set rules that "provide a fair procedure for . . . the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof."[114] The Exchange Act then details aspects of the regulation of membership.[115] These regulations are not optional, unlike the arbitration regulations in *Cremin v. Merrill Lynch Pierce Fenner & Smith*, 957 F. Supp. 1460 (N.D. Ill. 1997). Rather, the government has delegated to CBOE the duty to regulate membership, and this constitutes state action.[116]

The federal courts have recognized SROs as state actors that are required to adhere to due process standards, and CBOE fits well within recent federal judicial precedent on state actors. "When an exchange conducts such proceedings under the self-regulatory power conferred upon it by the 1934 Act, it is engaged in governmental action . . . and the Act imposed upon it the requirement that it comply with fundamental standards of fair play."[117] The quasi-governmental status of a SRO, with its attendant due process responsibilities, was increased by the 1975 amendments to sections 6 and 19 of the Exchange Act, further strengthening the reasoning in the *Crimmins* decision.[118]

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[113] *See Bernstein*, 738 F.2d at 179 (recognizing that a securities or commodity exchange can be an agent of the government in some cases).

[114] 15 U.S.C. § 78f(b)(7).

[115] 15 U.S.C. § 78f(c).

[116] *See R.J. O'Brien & Assoc., Inc., v. Pipkin*, 64 F.3d 257, 262 (7th Cir. 1995). In addition, CBOE has argued to the Delaware court that the filing of the Proposed Rule preempts the Delaware Action. *See* Letter from Samuel A. Nolan to the Honorable John W. Noble, Dec. 12, 2006. The actions of a private entity have no preemptive effect because preemption stems from the Supremacy Clause of the Constitution, which only applies to "Laws of the United States." *See Grunwald*, 400 F.3d at 1128. By taking this position, CBOE concedes that it is acting as a federal agency pursuant to congressionally-delegated authority, even though the SEC has not yet approved the Proposed Rule.

[117] *Crimmins v. Am. Stock Exch., Inc.*, 346 F. Supp. 1256, 1259 (S.D.N.Y. 1972); *see also G.K. Scott & Co. v. SEC*, 56 F.3d 1531 (D.C. Cir. 1995); *Timpinaro*, 2 F.3d 453; *Harwell*, 451 F.2d at 245 (requiring consideration of whether parties were afforded due process in NASD rulemaking); *Intercontinental Indus., Inc. v. Am. Stock Exch.*, 452 F.2d 935 (5th Cir. 1971); *Villani v. N.Y. Stock Exch., Inc.*, 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972); *Dist. Bus. Conduct Comm. v. Gallison*, Compl. No. C02960001, 1999 WL 515765, at *17 (N.A.S.D. Feb. 5, 1999); Senate Report 94-75 at 29 (stating that SROs are not "private clubs," but "quasi-public organizations"). Cases finding that a SRO is not a state actor required to afford due process have generally concerned disciplinary actions against members or arbitration issues, not rulemaking proceedings. *See, e.g., Desiderio v. NASD*, 2 F. Supp. 2d 516 (S.D.N.Y. 1998). In those cases, there is a stronger public policy argument, consistent with the purposes of the Exchange Act, for allowing SROs greater flexibility in investigating and punishing errant members—this flexibility serves the public's interest in a free, fair, and orderly market. *See* William J. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace—Revisited*, 23 Ann. Rev. Banking & Fin. L. 727, 775-6 (2004). No such consideration applies here.

[118] *See* Friedman, 23 Ann. Rev. Banking & Fin. L. at 742.

CBOE also is a state actor under the several tests developed by the Supreme Court. Under the "entwinement" rubric recently articulated by the Supreme Court in *Brentwood Academy v. Tennessee Secondary School Athletic Ass'n*, 531 U.S. 288 (2001), CBOE is a state actor. CBOE shares many of the same characteristics the Supreme Court found relevant in *Brentwood*, such as the fact that it has "historically been seen to regulate in lieu of the [government agency's] exercise of its own authority."[119] Also, by statute, CBOE, as a SRO, sets the membership rules with the approval of the SEC.[120]

Independent of CBOE's status as a state actor, the Exchange Act and the SEC require CBOE to conduct its business with fairness and due process.[121] The SEC has stated that SROs should act with greater transparency.[122] Also, failure to give notice of SRO actions "creates a danger of perpetration of injury that will damage public confidence in the exchanges" and defeats "the aims of the statutory scheme of self-policing—to protect investors and promote fair dealing."[123] Congress expected that SROs would "afford constitutionally adequate due process" both to actions involving members and those involving non-members and that SROs would "follow effective and fair procedures."[124] Although the Exchange Act did not specify rulemaking procedures for SROs, Congress nonetheless expected that SROs would develop procedures consistent with the public interest, going so far as to say that "prevention of inequitable and unfair practices" is one of the "principal goals" of SROs.[125] Also, the SEC has typically required private actors with influence over market regulation to adhere to due process standards.[126]

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119 *Brentwood*, 531 U.S. at 291.

120 *See Walsh*, 428 F. Supp. at 1264 (finding state action when schools had to belong to a voluntary association for their students to compete in interscholastic events, and the state sanctioned these activities).

121 *See* 15 U.S.C. §§ 78f(b) (requirements for securities exchanges involve fairness and fair procedures), 78s(c) (allowing the SEC to amend the rules of a SRO "to insure the fair administration" of a SRO); Senate Report 94-75 at 25 (requiring SROs to conduct their activities in conformity with due process).

122 *See* Release No. 34-50699, 69 Fed. Reg. 71154.

123 *Silver*, 373 U.S. at 361.

124 Senate Report 94-75 at 23, 25.

125 *Id*. at 29; *see also Silver*, 373 U.S. at 364 ("Congress in effecting a scheme of self-regulation designed to insure fair dealing cannot be thought to have sanctioned and protected self-regulative activity when carried out in a fundamentally unfair manner.").

126 *See* 17 C.F.R. § 240.13a-15(c) (allowing use of private standards for internal control evaluations if the group creating the standards "has followed due-process procedures, including the broad distribution . . . for public comment"); Securities Act Release No. 33-8518, 70 Fed. Reg. 1506, 1574 (Jan. 7, 2005) (stating that SEC would consider applicability of certain criteria developed by a private body if that body "followed due process procedures" and was "free from bias").

2. The Proposed Rule Change is a Deprivation of a Valuable Property Right Without Due Process.

CBOT members who hold Exercise Rights are holding a valuable property interest with an ascertainable pecuniary value. Exercise Rights and memberships in CBOE are transferable to a certain extent, and CBOE itself recently purchased an ERP for $127,000.[127] The value of an Exercise Right is also reflected in the total value of a CBOT Full Membership, which in itself is fully transferable. Other, similar rights have also been considered property for the purposes of a due process analysis. For example, seats on the Chicago Mercantile Exchange and CBOT have been considered property.[128] Also, the right to list a stock on an exchange has been characterized as a property right.[129] To the extent the Exercise Right depends on the contracts between CBOE and CBOT, these contractual relationships can create "constitutionally protected property interest[s]."[130] In addition, options on property are considered property interests themselves.[131] Both Exerciser Members and Eligible Exerciser Members also have a property interest in any distribution made as part of the CBOE demutualization, and the Proposed Rule Change would deprive Exercise Right holders of that property.

A rule that upsets a "settled understanding" and "destroy[s] vested rights" constitutes a violation of due process.[132] When the retroactive application of an interpretation of an existing rule will have a severe adverse effect on the reasonable expectations of the parties, it should be given "special scrutiny."[133] Such a retroactive rule must be reasonable and "necessary to protect the public interest."[134]

The Proposed Rule Change is retroactive in application. Although the contingencies contemplated by the Proposed Rule Change have not yet occurred, the Proposed Rule Change affects the current value of the Exercise Rights and CBOT memberships regardless of whether the Merger ever occurs.[135] The clear language of Article Fifth(b) and the contracts between

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127 *See* Exhibit 3.

128 *See Hill*, 259 U.S. at 61 (recognizing "the pecuniary value of [the] memberships" in the CBOT); *Chi. Mercantile Exch. v. United States*, 840 F.2d 1352 (7th Cir. 1988) (referring to "property interest" in CME seat); *Nelson v. Bd. of Trade*, 58 Ill. App. 399, 414 (1895).

129 *Intercontinental Indus.*, 452 F.2d at 941.

130 *Connelly v. Comptroller of the Currency*, 673 F. Supp. 1419, 1425 (S.D. Tex. 1987), *rev'd on other grounds*, 876 F.2d 1209 (5th Cir. 1989) (reversal concerned qualified immunity).

131 *See Scott*, 716 F.2d at 1418.

132 *Cheshire Hosp. v. N.H.-Vt. Hospitalization Serv., Inc.*, 689 F.2d 1112, 1121 (1st Cir. 1982).

133 *Id.* at 1121 (*quoting Adams Nursing Home of Williamstown v. Mathews*, 548 F.2d 1077, 1080 (1st Cir. 1977)).

134 *Harwell*, 451 F.2d at 245 (evaluating an interpretation of a rule by the NASD).

135 *See Chi. Mercantile Exch.*, 840 F.2d at 1356 (stating that purchasers of an exchange seat will "undoubtedly check[] the exchange rules to determine what [they] [are] buying").

CBOE and CBOT demonstrate that the settled understanding of the parties with regard to the Exercise Right is that "every present and future member of the CBOT who applies for membership in the Corporation and who otherwise qualifies shall, so long as he remains a member of the CBOT, be entitled to be a member of the CBOE."[136] The 2001 Agreement, to which CBOE is a party, confirms that CBOE also understood this to be the settled interpretation of Article Fifth(b).[137] Further, the Proposed Rule Change lacks any public interest element because the investing public has no interest in the retroactive application of the Proposed Rule Change that would justify this denial of due process. In fact, the only interest the Proposed Rule Change serves is the financial interest of the other CBOE members.

CBOE has attempted to appropriate this valuable property right by filing the Proposed Rule Change, and it has already affected the value of the Exercise Rights.[138] The publication of the Proposed Rule Change has had the effect of communicating to potential purchasers of Exercise Rights that these rights could be extinguished in the near future, therefore possibly limiting the ability of CBOT members to transfer these rights.[139] The expropriation of the Exercise Rights without compensation is a taking because it would eliminate the CBOE membership to which 1,331 CBOT members are entitled—the memberships they paid for by contributing capital and intellectual property to CBOE at its formation.

3. CBOE's Rulemaking Process Failed to Comport with Due Process.

Due process requires, at a minimum, notice and an opportunity to be heard.[140] The hearing must be conducted by a fair and impartial body, and any existing rules or procedures must be followed. Further, an adjudicatory action, such as this one, requires more than the minimum process sufficient for a rulemaking. However, CBOE provided neither notice nor any opportunity for Exerciser Members or Eligible Exerciser Members to be heard, conducted itself in a biased manner in adopting the Proposed Rule Change, and deviated from its own rules and procedures. In turn, the SEC's review of CBOE's flawed process cannot cure CBOE's due process deficiencies.

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136 2001 Agreement, Appendix E-1.

137 In addition, the 1992 Agreement stated that "[a]ny Eligible CBOT Full Member or Eligible Full Member delegate is entitled to become an Exercise Member pursuant to Article Fifth(b)." Only CBOT can define its own membership. In 2001, Mark Duffy, then Vice Chairman of CBOE, sent a letter to CBOE members stating that CBOE had no ability to extinguish the Exercise Right absent a vote of the membership or a court decision. Even if, as CBOE argues in the CBOE Form 19b-4, the 2001 agreement is no longer relevant, the plain language of Article Fifth(b) indicates the clear understanding of the parties: the Article cannot be read to imply that termination of the Exercise Right is allowed in these circumstances.

138 *PDK Labs Inc. v. Ashcroft*, 338 F. Supp. 2d 1, 11 (D. D.C. 2004).

139 *See id.* at 11.

140 *See, e.g.*, *Mathews*, 424 U.S. at 333; *Crimmins*, 346 F. Supp. at 1259.

a) CBOE did not provide sufficient notice or hearing.

CBOE appointed a Special Committee to consider the issue of Exerciser Members' rights in the proposed demutualization of CBOE. This Special Committee held open hearings and accepted testimony. Then, before the Special Committee reached a decision, CBOE peremptorily announced both the suspension of the Special Committee and the CBOE Board's adoption of the Proposed Rule Change that would terminate the Exercise Right upon the closing of the Merger. The CBOE Board voted on the filing of the Proposed Rule Change without the benefit of the views of the members of the Special Committee, who in fact were recused from consideration of this matter at the CBOE Board's December 12 meeting.

Although CBOE apparently recognized the need for due process when it created the Special Committee, the CBOE Board then disregarded this need entirely. CBOE did not give Exerciser Members or Eligible Exerciser Members notice of its intent to submit the Proposed Rule Change. In fact, CBOE stated in the Proposed Rule Change that it did not solicit or receive comments on the Proposed Rule Change, written or otherwise.[141] The entire process for the consideration by CBOE of the Proposed Rule Change was fatally infected with substantial procedural due process flaws.

b) CBOE's process was biased.

The body that decided on the Proposed Rule Change had an unacceptable bias in favor of the Proposed Rule Change that was inconsistent with due process. The CBOE directors eligible to vote on the Proposed Rule Change in the December 12, 2006, meeting after the departure of the Special Committee members included those directors with a strong personal financial interest in this Proposed Rule Change. Due process forbids "those with substantial pecuniary interest" from conducting administrative proceedings on matters in which they have such an interest.[142] Although CBOE initially appointed a Special Committee of independent directors to consider the issue of the Exercise Rights, the CBOE Board then suspended the Special Committee, and the independent directors that comprised the Special Committee did not take part in the CBOE Board's decision to file the Proposed Rule Change. Pursuant to Section 6.10 of the CBOE Constitution, the fact that these independent directors had already examined the issue did not disqualify them from voting on the issue at the CBOE Board meeting. Therefore, the absence of

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[141] Although, in the context of legislative or quasi-legislative actions, due process is accorded when interested parties are able to influence the process by choosing the rulemakers, that is not the case here. Only CBOE members vote on the election of CBOE directors. Because not all owners of the Exercise Right have become CBOE members, not all the affected parties have "power . . . over those who make the rule." *Bi-Metallic*, 239 U.S. at 445. Due process, by contrast, requires that all affected parties have an opportunity to be heard. *See PDK Labs*, 338 F. Supp. 2d at 8. Even if Exerciser Members were able to participate in some respect in CBOE's process through their influence over the Board of Directors, the Eligible Exerciser Members still have a valuable property interest at stake, and they were not accorded any opportunity whatsoever to be heard.

[142] *Gibson v. Berryhill*, 411 U.S. 564, 579 (1973).

four of the independent directors from the decision-making process unnecessarily exacerbated the bias of interested CBOE Board members.

The SEC has recognized the tension between the tendency of SROs to "promote the economic interests of their members and their owners" and to "preserv[e] and enhanc[e] their competitive positions" on one hand, and their regulatory obligations on the other hand.[143] In particular, the SEC has expressed concern that demutualized SROs could "put their commercial interests ahead of their responsibilities as regulators" and fail to "fulfill their regulatory duties vigorously and impartially."[144] The biased and unreasonable process leading to the Proposed Rule Change is the result of exactly such a conflict. In its quest to demutualize, the CBOE Board has put the commercial and economic interests of a subset of its members ahead of its responsibility to act impartially. This constitutes a violation of the due process rights of the Exerciser Members and Eligible Exerciser Members in addition to constituting a breach of fiduciary duty under state law.[145]

c) CBOE unfairly deviated from its own rules and procedures.

A governmental instrumentality violates the standards of due process when it unexpectedly deviates from its typical procedures without justification. Accordingly, CBOE must follow its own rules and guidelines for rulemaking.[146] This is even more true when the proceedings affect the rights of individuals.[147] CBOE failed to follow the procedure set out in the CBOE Charter for amending Article Fifth(b). CBOE also violated its Constitution by apparently allowing directors with a personal financial interest in the Proposed Rule Change to vote on whether to file it, while excluding four independent directors from the deliberations and vote.[148]

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143 *See* Release No. 34-50699, 69 Fed. Reg. 71132.

144 *Id.*

145 Other SROs have recognized the potential conflicts of interest in situations like these and have taken steps to ameliorate any unfairness. *See* Exchange Act Release No. 34-50057, File No. SR-AMEX-2004-50, at 3 n.7 (July 22, 2004) (AMEX appointed a Special Committee of disinterested Governors to consider a change to its constitution, and all members voted on the change).

146 *Int'l House v. NLRB*, 676 F.2d 906, 912 (2d Cir. 1982); *Montilla v. INS*, 926 F.2d 162, 164 (2d Cir. 1991) (a rulemaker cannot "with impunity ignore or disregard [a rule] as it sees fit"); *Nelson*, 58 Ill App. 399.

147 *See Montilla*, 926 F.2d at 167 (citing *Morton v. Ruiz*, 415 U.S. 199 (1974)).

148 CBOE Constitution Section 6.10.

d) The SEC's process is not a substitute for due process at the CBOE level.

The notice-and-comment process provided by the SEC is not a substitute for due process at the CBOE level. Due process requires a hearing at a meaningful time.[149] Although the SEC's approval process involves a notice and comment period, the Exerciser Members and Eligible Exerciser Members did not have an opportunity to be heard at the meaningful time: before CBOE sent the Proposed Rule Change to the SEC for publication. As explained above, the filing of the Proposed Rule Change has already impaired the property interests reflected by the Exercise Rights held by CBOT members, and no opportunity for hearing or even to submit comments was provided in advance of the filing. Therefore, even an unbiased review by the SEC does not cure the due process violation by CBOE.[150]

IV. The Proposed Rule Change is an Unreasonable Interpretation and Breach of Contract under State Law.

The Commission should evaluate the Proposed Rule Change in light of relevant state law. The Proposed Rule Change flagrantly violates both Delaware and Illinois law in several respects. Two of these failings have already been discussed—CBOE's breach of contract in denying Exerciser Members and Eligible Exerciser Members equal treatment in the CBOE demutualization and the breach of fiduciary duty by the CBOE Board. In addition, the Proposed Rule Change breaches the CBOE Charter and 1992 Agreement because it is based on the erroneous premise that after the Merger CBOT members would not be CBOT members under the CBOE Charter and the 1992 Agreement.

In its Form S-4, CBOE states that the CBOE Board concluded that after the Merger, CBOT would no longer have "members" within the meaning of Article Fifth(b) of the CBOE Charter.[151] The undisputed facts, however, are that CBOT will survive the transaction and will continue to have individuals considered "Full Members" who continue to have all of the same trading rights they had in the past and are therefore entitled to membership in CBOE pursuant to the CBOE Charter and 1992 Agreement. CBOT Full Members who have retained their ERPs will still have their Exercise Rights. The only difference after the Merger is consummated will be that the 27,338 shares of Class A common stock of CBOT Holdings that Exercise Right holders held before the merger was consummated will be converted into 8,217.80 shares of CME Holdings Class A common stock.

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149 *See Mathews*, 424 U.S. at 333; *Bell v. Burson*, 402 U.S. 535, 542 (1971) (requiring a prior hearing for license termination); *Int'l House*, 676 F.2d at 911.

150 *See Ward v. Vill. of Monroeville*, 409 U.S. 57, 61-62 (1972); *Gibbs v. SEC*, 25 F.3d 1056, n.6 (10th Cir. 1994).

151 Form S-4 at 3, 5, 31-39.

In its submission to the SEC, CBOE offered the following rationale for its theory that CBOT members will somehow no longer be CBOT members following the Merger. First, CBOE argues that the various agreements entered into between 2001 and 2005 in connection with CBOT's restructuring would no longer apply if the Merger was completed. In support of that conclusion, CBOE cited language in the 2001 Agreement providing that an individual would be "deemed to be" a CBOT Full Member so long as he or she owned or possessed an ERP, a Series B-1 membership of CBOT, and a certain number of shares of Class A Common Stock of CBOT Holdings upon consummation of the contemplated restructuring and "*in the absence of any other material changes to the structure or ownership of the CBOT . . . not contemplated in the CBOT Restructuring Transactions.*"[152] CBOE contends that the Merger would be a "material change to the structure or ownership of the CBOT" and that accordingly the specific terms of the 2001-2005 agreements no longer apply.

Having eliminated the most recent agreements from the analysis, CBOE goes back to the 1992 Agreement. As previously noted, the 1992 Agreement specifically contemplated the possibility that CBOT might merge or be acquired by another exchange. CBOE agreed that it would continue to recognize the Exercise Right, notwithstanding such a merger or acquisition, so long as three conditions were met: (1) the survivor of such merger or acquisition is an exchange "which provides or maintains a market in commodities futures contracts or options, securities, or other financial instruments"; (2) CBOT Full Members are granted membership in the surviving exchange; and (3) that membership entitles CBOT Full Members to "have full trading rights and privileges in all products then or thereafter traded on the survivor."[153] CBOE argues that these three conditions will not be met in the Merger, because the transaction is structured so that CME Holdings is the surviving corporation of the merger with CBOT Holdings. Since CME Holdings is a holding company and not an exchange, CBOE contends that no CBOT members can possibly meet the conditions set forth in the 1992 Agreement.

CBOE ignores the undisputed fact that the Board of Trade itself is not merging with any entity and will survive the Merger. That CME Holdings also survives the Merger is irrelevant. In CBOT's restructuring, CBOT Holdings was created and ownership of CBOT was transferred to CBOT Holdings via a merger transaction. CBOE agreed then that the CBOT restructuring transaction, which like here involved a merger, did not extinguish the Exercise Right. There is no reason why the result should be any different in this Merger.

Moreover, even if the Merger constitutes a transaction subject to the conditions in the 1992 Agreement, all three conditions will be satisfied with respect to CBOT after the Merger is consummated. First, CBOT is and will continue to be an "exchange which provides or maintains a market in commodities futures contracts or options, securities, or other financial instruments."

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[152] 2001 Agreement (emphasis added).

[153] 1992 Agreement, Section 3(d). CBOT Full Members do not need to have trading rights and privileges for products that, at the time of the merger or acquisition, are traded or listed on the other exchange but not on CBOT.

Second, the transaction will not impact any product trading rights or privileges appurtenant to membership as a CBOT Full Member. Under the terms of the merger agreement, all of the CBOT Full Members will continue to hold a membership in CBOT. Third, as part of the Merger, CBOT Full Members will be granted full trading rights and privileges in all products then or to be traded on CBOT. As a result, the Merger is precisely the kind of transaction that CBOE has already agreed would have no effect on the Exercise Right under the 1992 Agreement.

Separate and apart from the provisions relating to mergers and acquisitions, the definition of "Eligible CBOT Full Member" in the 1992 Agreement also demonstrates that the Exercise Rights would survive the Merger.[154] Paragraph 1(a) of the 1992 Agreement defines an "Eligible CBOT Full Member" as an individual who is the holder of one of CBOT's 1,402 existing full memberships "and who is in possession of all trading rights and privileges appurtenant to such CBOT Full Membership." But CBOT retained the right to decide who qualified as a "Full Member." For its part, CBOE agreed that anyone who fit the definition of an "Eligible CBOT Full Member" or an "Eligible CBOT Full Member Delegate" would continue to hold an Exercise Right.[155]

When CBOT restructured itself in 2005, it split a Full Membership into three components: the ERP, a Series B-1 membership, and stock in CBOT Holdings. So long as a CBOT full member continues to hold the ERP, the Series B-1 membership, and stock that is equivalent to the stock previously held in CBOT Holdings, that suffices to make him or her an "Eligible CBOT Full Member" within the meaning of the 1992 Agreement. That would have been true whether or not, before the restructuring, CBOE and CBOT had entered into agreements confirming that interpretation.

The fact that the parties did enter into confirming agreements, however, evidences their mutual understanding of both the CBOE Charter and the 1992 Agreement.[156] Delaware courts agree that, when confronted with a dispute over the interpretation of an agreement, great weight should be given to the parties' prior interpretations of that agreement.[157] The agreements reached

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[154] An agency's definition of an existing term is limited by the context in which it is used, its place in the overall scheme, and its purpose in achieving the goal of the rule. *See Goldstein*, 451 F.3d at 878 (quoting *PDK Labs, Inc. v. DEA*, 362 F.3d 786, 796 (D.C. Cir. 2004)). CBOE's interpretation of "CBOT Full Member" does not conform to those standards. An interpretation that is unreasonable exceeds agency rulemaking authority. *See Goldstein*, 451 F.3d at 881 (quoting *Aid Ass'n for Lutherans v. United States Postal Serv.*, 321 F.3d 1166, 1174 (D.C. Cir. 2003)).

[155] 1992 Agreement, Section 3(c).

[156] Thus, although the literal terms of the 2005 Agreement may no longer apply, that Agreement is not irrelevant, as CBOE contends.

[157] *See Powers v. Equity Pictures Corp.*, 134 A. 97, 98 (Del. Ch. 1926) ("[i]f [] an agreement as to its meaning was made and a settlement entered into on that basis, it would seem that neither party to the settlement could thereafter come forward and successfully overturn it as plainly erroneous"); *see also Artesian Water Co. v. State*

(cont'd)

in 2001-2005 in connection with CBOT's restructuring embodied the parties' "agreed upon interpretations of Article Fifth(b)" of the CBOE Charter.[158] As CBOE told its members, CBOT Full Members remained CBOT Full Members and retained their Exercise Rights so long as they continued to hold interests that were "equal to all of the interests that were issued in exchange for a full CBOT membership in the restructuring of CBOT."[159]

Similarly, if the Merger is completed as planned, CBOT Full Members will still own an ERP, a Series B-1 membership, and an ownership interest, which represent all of the incidents or parts of "Full Membership" in CBOT — even though the ownership component will now be held through a different holding company, into which CBOT Holdings merged. Thus, CBOE's own agreed-upon interpretation of its Charter and the 1992 Agreement leads to the conclusion that the CBOT Full Members — who will still be recognized as such by CBOT — continue to be "eligible" to exercise the Exercise Right to membership in CBOE, without purchasing a seat on that exchange, so long as they continue to own all of the incidents or parts of a CBOT "Full Membership."

The plain language of Article Fifth(b) of the CBOE Charter also supports this result. It provides simply that "every present and future member of said Board of Trade who applies for membership in the [CBOE] and who otherwise qualifies *shall, so long as he remains a member of said Board of Trade, be entitled to be a member of the [CBOE]*. . . without the necessity of acquiring such memberships for consideration or value from the [CBOE], its members or elsewhere." Notwithstanding the Merger, CBOT Full Members will remain full members of CBOT and are thus entitled to the Exercise Right conferred by the CBOE Charter.

The CBOE Board's attempts to unilaterally appropriate these CBOE Charter-granted rights and to strip the Exerciser Members of the rights they have enjoyed for many years as CBOE members clearly breach the CBOE Charter and 1992 Agreement. As Mark F. Duffy,

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(… cont'd)

Dep't of Highways & Transp., 330 A.2d 441, 443 (Del. 1974) (parties' actions "are of great weight in determining the meaning and applicability of the contract, and lead the Court to a presumptively correct interpretation").

[158] *See* Sept. 13, 2002 Letter Agreement.

[159] Also, in 2005, CBOE stated that "nothing in Article Fifth(b) or in prior interpretations of that Article [] require CBOT full members to own 100% of the equity of CBOT in order to qualify for the Exercise Right," contrary to CBOE's current position that "attenuation" of CBOT members' ownership interest justifies termination of the Exercise Right. Letter from Joanne Moffic-Silver, CBOE Executive Vice President and General Counsel, to Jonathan G. Katz, SEC Secretary, File No. SR-CBOE-2005-19 (May 6, 2005); Proposed Rule Change Notice, 72 Fed. Reg. 5474. The Proposed Rule Change Notice does not state that CBOT members will no longer have any ownership interest in CBOT. Proposed Rule Change Notice, 72 Fed. Reg. 5474. CBOE states that "the surviving acquirer . . . would be a holding company in which many former members of CBOT *may* have no ownership interests whatsoever" (emphasis added). CBOE does not offer any reasons why the *possibility* that *some* CBOT members may no longer hold any ownership interest after the Merger justifies the termination of the Exercise Right of *all* CBOT members.

CBOE's Vice Chairman and Chairman of CBOE's Executive Committee at the time, acknowledged in a 2001 letter to CBOE members, CBOE does not "have the authority to do away with the Exercise [R]ight. It was granted to CBOT members in our Articles of Incorporation and *absent a vote to do away with it or a court determination to do away with it, it will always exist.*" (Emphasis added.)

CONCLUSION

As demonstrated above, the Proposed Rule Change is not a proper subject of CBOE rulemaking under the Exchange Act, and fails in several material respects to comply with the requirements of the Exchange Act. The Proposed Rule Change concerns core matters of state corporations and fiduciary law that are the proper domain of the Delaware courts and that the SEC does not have the responsibility or expertise to decide. For these reasons, CBOT respectfully requests that the SEC institute proceedings under section 19(b)(2)(B) of the Exchange Act to determine whether the Proposed Rule Change should be disapproved, and hold a public hearing to consider the important matters of policy presented by the Proposed Rule Change.

Thank you for your consideration of the foregoing. If you have any questions, please contact the undersigned at (202) 263-3219 or Kathryn McGrath at (202) 263-3374.

Very truly yours,

Charles M. Horn

Attachments

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Annette L. Nazareth, Commissioner

Brian G. Cartwright, Esq., SEC General Counsel
Janice Mitnick, Esq., SEC Assistant General Counsel for Market Regulation
Elizabeth King, SEC
Katherine England, SEC
Richard Holley, SEC
Johnna Dumler, SEC
Joanne Moffic-Silver, CBOE
Patrick Sexton, CBOE
Gordon Nash, Counsel for Plaintiff Class in the Delaware Action

EXHIBIT 1

AGREEMENT

This Agreement is made and entered into this 1st day of October 1992 ("Effective Date"), by and between the BOARD OF TRADE OF THE CITY OF CHICAGO ("CBOT"), an Illinois corporation incorporated by special act of the Illinois General Assembly and located at 141 West Jackson Boulevard, Chicago, Illinois, and the CHICAGO BOARD OPTIONS EXCHANGE, INC. ("CBOE"), a Delaware non-stock corporation located at 400 South LaSalle Street, Chicago, Illinois.

WHEREAS, paragraph (b) of Article Fifth of CBOE's Certificate of Incorporation ("Article Fifth(b)") provides as follows:

> (b) In recognition of the special contribution made to the organization and development of the Corporation by the members of the Board of Trade of the City of Chicago, a corporation organized and existing by Special Legislative Charter of the General Assembly of the State of Illinois, and for the further purpose of promoting the growth and liquidity of the Corporation, developing a broad financial base of dues-paying members, and assuring participation on a continuing basis of persons experienced in the trading and clearing of contracts for future purchase or delivery on a central marketplace, every present and future member of said Board of Trade who applies for membership in the Corporation and who otherwise qualifies shall, so long as he remains a member of said Board of Trade, be entitled to be a member of the Corporation notwithstanding any such limitation on the number of members and without the necessity of acquiring such membership for consideration or value from the Corporation, its members or elsewhere. Members of the Corporation admitted pursuant to this paragraph (b) shall, as a condition of membership in the Corporation, be subject to fees, dues, assessments and other like charges, and shall otherwise be vested with all rights and privileges and subject to all obligations of membership, as provided in the by-laws. No amendment may be made with respect to this paragraph (b) of Article Fifth without the prior approval of not less than 80% of (i) the members of the Corporation admitted pursuant to this paragraph (b) and (ii) the members of the Corporation admitted other than pursuant to this paragraph (b), each such category of members voting as a separate class; provided, however, that any amendment to this paragraph (b) which is required under a final order of any court or regulatory agency having jurisdiction in the matter may be made in accordance with the provisions of Article Twelfth covering amendments to this Certificate of Incorporation generally, without regard to the above provisions concerning such 80% vote by classes.

WHEREAS, the parties, in their own capacity and on behalf of their respective members, dispute the meaning of certain terms as used in Article Fifth(b) and the nature and scope of the entitlement referred to therein of a CBOT member to be a CBOE member (the "Exercise Right"); and

WHEREAS, the parties, in their own capacity and on behalf of their respective members, wish to resolve this dispute to their mutual benefit, including to avoid the costs, delays, and uncertainties of legal proceedings;

NOW, THEREFORE, in consideration of the foregoing and the mutual promises and agreements contained herein (but subject to paragraph 4(a) below), the parties, in their own capacity and on behalf of their respective members, agree as follows:

1. DEFINITIONS.

For the purposes of this Agreement, the following definitions apply:

(a) "Eligible CBOT Full Member" means an individual who at the time is the holder of one of the One Thousand Four Hundred Two (1,402) existing CBOT full memberships ("CBOT Full Memberships") and who is in possession of all trading rights and privileges appurtenant to such CBOT Full Membership. In the event a CBOT Full Membership is registered for a partnership, corporation or other entity, only the individual who is the holder of such CBOT Full Membership and who is in possession of all trading rights and privileges appurtenant to such CBOT Full Membership shall be deemed to be an "Eligible CBOT Full Member."

(b) "Eligible CBOT Full Member Delegate" means the individual to whom a CBOT Full Membership is delegated (leased) and who is in possession of all trading rights and privileges appurtenant to such CBOT Full Membership.

(c) "Trading rights and privileges appurtenant to such CBOT Full Membership" means (1) the rights and privileges of a CBOT Full Membership which entitle a holder or delegate to trade as principal and broker for others in all contracts traded on the CBOT, whether by open outcry, by electronic means, or otherwise, during any segment of a trading day when trading is authorized; and (2) every trading right or privilege granted, assigned or issued by CBOT after the effective date of this Agreement to holders of CBOT Full Memberships, as a class, but excluding any right or privilege which is the subject of an option granted, assigned or issued by CBOT to a CBOT Full Member and which is not exercised by such CBOT Full Member.

(d) "Exerciser Member" means an Eligible CBOT Full Member or Eligible CBOT Full Member Delegate who has exercised the Exercise Right to become and has become a CBOE Regular Member pursuant to Article Fifth(b).

(e) "CBOE Regular Member" or "CBOE Regular Membership" shall mean any CBOE regular member or membership (including an Exerciser Member or membership) entitled to all trading rights and privileges appurtenant to a CBOE membership in accordance with Section 2.1(b) of the CBOE Constitution. There are Nine Hundred Thirty-One (931) CBOE Regular Members, excluding Exerciser Members.

2. THE CBOT'S AGREEMENTS.

(a) The CBOT agrees, in its own capacity and on behalf of its members, that only an individual who is an Eligible CBOT Full Member or an Eligible CBOT Full Member Delegate is a member of the CBOT within the meaning of Article Fifth(b) eligible to have an Exercise Right and to be an Exerciser Member.

(b) The CBOT agrees, in its own capacity and on behalf of its members, that in the event the CBOT splits or otherwise divides CBOT Full Memberships into two or more parts, all such parts, and the trading rights and privileges appurtenant thereto, shall be deemed to be part of the trading rights and privileges appurtenant to such CBOT Full Memberships and must be in the possession of an individual as either an Eligible CBOT Full Member or an Eligible CBOT Full Member Delegate in order for that individual to be eligible to be an Exerciser Member.

(c) The CBOT agrees, in its own capacity and on behalf of its members, that, for the purpose of this Agreement and any rule, regulation or by-law adopted pursuant to or to implement this Agreement, and for the purpose of interpreting the meaning of Article Fifth(b), only the One Thousand Four Hundred Two (1402) existing CBOT Full Memberships shall be deemed to be CBOT Full Memberships entitled to Exercise Rights under Article Fifth(b) and that any additional membership or memberships created by the CBOT, whether categorized by the CBOT as a full membership or as having the same trading rights and privileges as a CBOT Full Membership, shall be specifically excluded from entitlement to Article Fifth(b) Exercise Rights.

(d) Subject to Paragraph 4(a) below, the CBOT agrees to amend its rules and regulations in the form and manner set forth in Exhibit A hereto (the "CBOT Rule Change").

(e) The CBOT agrees that it will maintain an effective record of (i) every trading right and privilege which may hereafter be granted, assigned or issued in respect of each CBOT Full Membership and (ii) every delegation or lease of any CBOT Full Membership (or of any trading right or privilege appurtenant thereto). The CBOT agrees to make such records available to the CBOE promptly upon reasonable request therefor by the CBOE.

3. THE CBOE'S AGREEMENTS.

(a) The CBOE acknowledges and agrees, in its own capacity and on behalf of its members, that all Exerciser Members, including Exerciser Members who are Eligible CBOT Full Member Delegates, have the same rights and privileges of CBOE regular membership as other CBOE Regular Members, including the rights and privileges with respect to the trading of all CBOE products, except that Exerciser Members shall not have the right to transfer (whether by sale, lease, gift, bequest or otherwise) their CBOE regular memberships or any of the trading rights and privileges appurtenant thereto. Notwithstanding the foregoing, all Exerciser Members shall have the right to purchase or to participate in the offer or distribution of any optional or additional CBOE membership or any transferable or nontransferable trading right or privilege offered or distributed by the CBOE after the effective date of this Agreement to other CBOE Regular Members, as a class, on the same terms and conditions as other CBOE Regular Members, and any such additional membership, trading right or privilege so acquired by an Exerciser Member shall be separately transferable by such Exerciser Member on the same basis as the same may be separately transferable by other CBOE Regular Members. In the event the CBOE makes a cash or property distribution, whether in dissolution, redemption or otherwise, to other CBOE Regular Members as a class, which has the effect of diluting the value of a CBOE Membership, including that of a CBOE membership under Article Fifth(b), such distribution shall be made on the same terms and conditions to Exerciser Members.

(b) The CBOE agrees to establish a reasonable record date for any offer, distribution or redemption subject to Paragraph 3(a) above in order to give Eligible CBOT Full Members and Eligible CBOT Full Member Delegates a reasonable opportunity to become Exerciser Members and to participate in such offer, distribution or redemption. The CBOE

agrees to notify the CBOT no less than ninety (90) days prior to every offer, distribution or redemption subject to Paragraph 3(a) above and of the record date established therefor unless impracticable in the circumstances, in which event the CBOE agrees to notify the CBOT no less than (30) days prior to every offer, distribution or redemption subject to Paragraph 3(a) above. In order to permit Eligible CBOT Full Members and Eligible CBOT Full Member Delegates to participate in an offer, distribution or redemption of the kind referred to in the last two sentences of Paragraph 3(a) above, and solely for such purpose, CBOE further agrees to waive all membership dues, fees and other charges and all qualification requirements, other than those that may be imposed by law, that may be applicable to the application for membership on CBOE of each Eligible CBOT Full Member and Eligible CBOT Full Member Delegate who wishes to exercise the Exercise Right during the period commencing on the date CBOE gives notice to CBOT pursuant to this Paragraph 3(b) and ending on the date such individual participates in such offer, distribution or redemption (as the case may be); provided, however, that (i) no Exerciser Member for whom dues, fees and other charges and qualification requirements are waived in accordance with the foregoing shall have any rights as a CBOE member other than to participate in such offer, distribution or redemption, and (ii) the CBOE membership of each such Exerciser Member shall terminate immediately following the time such individual participates in such offer, distribution or redemption.

(c) The CBOE agrees, in its own capacity and on behalf of its members, that any Eligible CBOT Full Member or Eligible CBOT Full Member Delegate is entitled to become an Exerciser Member pursuant to Article Fifth(b), provided such individual qualifies to be a CBOE Regular Member in accordance with the rules of the CBOE applicable generally to CBOE Regular Membership.

(d) The CBOE agrees, in its own capacity and on behalf of its members, that in the event the CBOT merges or consolidates with or is acquired by or acquires another entity ("other entity") and (i) the survivor of such merger, consolidation or acquisition ("survivor") is an exchange which provides or maintains a market in commodity futures contracts or options, securities, or other financial instruments, and (ii) the 1,402 holders of CBOT Full Memberships are granted in such merger, consolidation or acquisition membership in the survivor ("Survivor Membership"), and (iii) such Survivor Membership entitles the holder thereof to have full trading rights and privileges in all products then or thereafter traded on the survivor (except that such trading rights and privileges need not include products that, at the time of such merger,

consolidation or acquisition, are traded or listed, designated or otherwise authorized for trading on the other entity but not on the CBOT), then the Exercise Right of Article Fifth(b) shall continue to apply and this Agreement shall continue in force and effect (with the words "CBOT Full Membership" being interpreted to mean "Survivor Membership"). Article Fifth(b) shall not apply to any other merger or consolidation of CBOT with, or acquisition of CBOT by, another entity.

(e) The CBOE agrees that a significant purpose of the Agreement is to ensure that CBOE will not make any offer, distribution or redemption to CBOE Regular Members as a class which would have the effect of diluting the rights under Article Fifth(b) of Eligible CBOT Full Members and Eligible CBOT Full Member Delegates. It is the intention of the parties that Paragraphs 3(a) and 3(b) above are the agreed and sole means of ensuring that Eligible CBOT Full Members and Eligible CBOT Full Member Delegates will have the ability to participate in every offer, distribution or redemption which would have the effect of diluting the value of CBOE regular memberships, including CBOE memberships under Article Fifth(b).

(f) Subject to Paragraph 4(a) below, the CBOE agrees to amend its Rule 3.16(c) in the form and manner set forth in Exhibit B hereto (the "CBOE Rule Change"), including rescinding and withdrawing its currently proposed Rule 3.16(c) from consideration by the Securities and Exchange Commission.

4. SPECIAL PROVISIONS.

(a) CBOT represents that the CBOT Rule Change requires the approval of both the CBOT membership and the Commodity Futures Trading Commission in order to become effective. CBOE represents that this Agreement and the CBOE Rule Change require the approval of both the CBOE membership and the Securities and Exchange Commission in order to become effective. The parties agree to work in good faith to obtain all such approvals as expeditiously as possible. Should any required approval not be obtained, however, then this Agreement shall be null and void, as if never executed, and neither party shall be deemed to be in any way bound by any term or provision, including any agreement or acknowledgment, of this Agreement.

(b) From and after the Effective Date and so long as this Agreement remains in force and effect, the CBOT Rule Change shall not be amended or modified in any way by the CBOT without the written consent of the CBOE, and the CBOE Rule Change shall not be amended

or modified in any way by the CBOE without the written consent of the CBOT, which consent in either case shall not be unreasonably withheld.

(c) The CBOT agrees to enforce the CBOT Rule Change after the same has been approved and has become effective as set forth in Paragraph 4(a) hereof, and the CBOE agrees to enforce the CBOE Rule Change after the same has been approved and has become effective as set forth in Paragraph 4(a) hereof. In the event that the validity of any provision of this Agreement or any rule, regulation or bylaw adopted pursuant to this Agreement shall be challenged by any person, the parties mutually agree that they will jointly defend the validity of such challenged provision or rule, regulation or bylaw.

(d) The parties mutually agree that it is appropriate, and within the meaning and spirit of Article Fifth(b), for the CBOE to interpret Article Fifth(b) in accordance with the provisions of this Agreement.

5. TERMINATION.

This Agreement shall become effective on the Effective Date, subject to Paragraph 4(a) above, and shall remain in full force and effect thereafter unless and until terminated in accordance with this Paragraph. Either party may terminate this Agreement for cause, and only for cause, by giving the other party fifteen (15) days written notice of the termination and the cause therefore; provided, however, that if the other party remedies the cause for termination to the reasonable satisfaction of the notifying party during such fifteen (15) day period, this Agreement shall not be terminated and shall remain in full force and effect. Cause shall include only (i) a material breach of this Agreement; or (ii) in the event this Agreement, or any part of it, or any rule, regulation or bylaw adopted pursuant to and to implement this Agreement, is set aside by order of a court or regulatory agency of competent jurisdiction.

6. MISCELLANEOUS.

(a) This Agreement constitutes the entire understanding of the parties. No waiver, alteration or modification of any of the provisions hereof shall be binding unless in writing and signed by a duly authorized representative of each party.

(b) Except to the extent that this Agreement or any rule adopted pursuant to this Agreement is governed by any law of the United States or of a rule or regulation adopted by a regulatory agency pursuant to any such

law, this Agreement shall be governed by and construed in accordance with the laws of the State of Illinois.

(c) The parties mutually agree that either party to this Agreement may bring suit (on its own behalf or on behalf of its members, or both) to enforce the terms of this Agreement and to recover damages for any breach of this Agreement.

CHICAGO BOARD OPTIONS EXCHANGE, INC.

BY: [signature]

TITLE: Chairman of the Board

BY: [signature]

TITLE: Vice Chairman of the Board

BOARD OF TRADE OF THE CITY OF CHICAGO

BY: [signature]

TITLE: President and Chief Executive Offic

BY: [signature]

TITLE: Chairman of the Board

EXHIBIT A

CHICAGO BOARD OF TRADE - RULE AMENDMENTS

210.00 Full Member CBOE "Exercise" Privilege. In accordance with the Agreement entered into on ____ , 1992 (the "Agreement") between the Exchange and the Chicago Board Options Exchange ("CBOE"), Eligible CBOT Full Members who maintain all appurtenant trading rights and privileges of a full membership, including any new trading rights or privileges granted, assigned or issued to a CBOT full membership to the extent such right or privilege is deemed under the provisions of such Agreement to be appurtenant to a CBOT Full Membership, are eligible to become regular members of the CBOE pursuant to Article Fifth(b) of CBOE's Certificate of Incorporation. A CBOT Full Member may delegate all of his trading rights and privileges of full membership to an individual who will then be eligible to become a regular CBOE member pursuant to Article Fifth(b) of CBOE's Certificate of Incorporation; provided, however, if a CBOT Full Member delegates some, but not all, of the appurtenant trading rights and privileges of full membership, then neither the member nor the delegate will be eligible to be a CBOE regular member pursuant to Article Fifth(b). No person who is not either an Eligible CBOT Full Member or an Eligible CBOT Full Member Delegate (See Rule 221.00(g)(ii)) shall knowingly apply to become, or knowingly remain, a regular member of CBOE pursuant to Article Fifth(b) of CBOE's Certificate of Incorporation.

For purposes of the Agreement entered into on ____ , 1992 between the Exchange and the CBOE, an Eligible CBOT Full Member means an individual who at the time is the holder of one of the One Thousand Four Hundred Two (1,402) CBOT full memberships ("CBOT Full Memberships") existing on the date of the Agreement and who is in possession of all trading rights and privileges appurtenant to such CBOT Full Membership. In the event a CBOT Full Membership is registered for a partnership, corporation or other entity, only the individual who is the holder of such CBOT Full Membership and who is in possession of all trading rights and privileges appurtenant to such CBOT Full Membership shall be deemed to be an "Eligible CBOT Full Member." "Trading rights and privileges appurtenant to such CBOT Full Membership" means (1) the rights and privileges of a CBOT Full Membership which entitle a holder or delegate to trade as principal and broker for others in all contracts traded on the CBOT, whether by open outcry, by electronic means, or otherwise, during any segment of a trading day when trading is authorized; and (2) every trading right or privilege granted, assigned or issued by CBOT after the effective date of this Agreement to holders of CBOT Full Memberships, as a class, but excluding any right or privilege which is the subject of

an option granted, assigned or issued by CBOT to a CBOT Full Member and which is not exercised by such CBOT Full Member.

221.00 Delegation - An individual member may delegate the rights and privileges of Full and/or Associate Memberships to an individual (a "delegate") upon the following terms and conditions:

* * * * *

(g)(i) In accordance with the Agreement entered into on _____, 1992 ("the Agreement") between the Exchange and the Chicago Board Options Exchange ("CBOE"), only an individual who is an "Eligible CBOT Full Member" or an "Eligible CBOT Full Member Delegate", as those terms are defined in the Agreement, is a "member" of the Exchange within the meaning of paragraph (b) of Article Fifth of CBOE's Certificate of Incorporation ("Article Fifth(b)") and only such individuals are eligible to become and to remain regular members of the CBOE pursuant to Article Fifth(b). No person who is not either an Eligible CBOT Full Member or an Eligible CBOT Full Member Delegate shall knowingly apply to become, or knowingly remain, a regular member of CBOE pursuant to Article Fifth(b) of CBOE's Certificate of Incorporation.

(g)(ii) For purposes of the "Agreement" referenced in Rule 221.00(g)(i), an "Eligible CBOT Full Member Delegate" means the individual to whom a CBOT Full Membership is delegated (leased) and who is in possession of all trading rights and privileges appurtenant to such CBOT Full Membership. "Trading rights and privileges appurtenant to such CBOT Full Membership" means (1) the rights and privileges of a CBOT Full Membership which entitle a holder or delegate to trade as principal and broker for others in all contracts traded on the CBOT, whether by open outcry, by electronic means, or otherwise, during any segment of a trading day when trading is authorized; and (2) every trading right or privilege granted, assigned or issued by CBOT after the effective date of this Agreement to holders of CBOT Full Memberships, as a class, but excluding any right or privilege which is the subject of an option granted, assigned or issued by CBOT to a CBOT Full Member and which is not exercised by such CBOT Full Member.

EXHIBIT B

CHICAGO BOARD OPTIONS EXCHANGE, INC. - RULE AMENDMENT

Rule 3.16(c) of the Chicago Board Options Exchange, Inc. shall be amended to be and read as follows:

Deletions [bracketed].

[Rule 3.16(c) Board of Trade Exercisers. For the purpose of continued entitlement to membership on the Exchange in accordance with Section 2.1(b) of the Constitution and Paragraph (b) of Article Fifth of the Certificate of Incorporation of the Exchange, the term "member of the Board of Trade of the City of Chicago" (the "Board") is interpreted to mean a single individual or organization in possession of a full Board membership as described below. Such membership shall consist of all the trading rights and privileges afforded to Board memberships as in existence on February 4, 1972 (the date the Exchange's Certificate of Incorporation was adopted) except for such rights and privileges which the Exchange may exclude. Where the member is an organization, one individual must possess all of a full membership's trading rights and privileges on the Board. If any part not excluded by the Exchange (but less than all) of a full membership's trading rights and privileges on the Board is sold, leased, licensed, delegated or in any other fashion transferred, then neither the transferor or the transferee of such rights and privileges shall be deemed to be a "member of the Board" entitled to Exchange membership. If a full membership's trading rights and privileges, as they existed on February 4, 1972, should be split into two or more sets of rights or privileges or be segmented or separated in any other manner, then, in order for an individual or organization to be deemed to be in possession of all the pertinent and regular trading rights and privileges afforded such full membership, such individual or organization must be in possession of, and have pertinent and regular trading rights and privileges with respect to all of the split, segmented or separated parts of such original membership except for those excluded by the Exchange.]

Rule 3.16(c). Board of Trade Exercisers. For the purpose of entitlement to membership on the Exchange in accordance with Paragraph (b) of Article Fifth of the Certificate of Incorporation of the Exchange ("Article Fifth(b)") the term "member of the Board of Trade of the City of Chicago" (the "CBOT"), as used in Article Fifth(b), is interpreted to mean an individual who is either an "Eligible CBOT Full Member" or an "Eligible CBOT Full Member Delegate," as those terms are defined in the Agreement entered into on _____ , 1992, (the "Agreement") between the CBOT and the Exchange, and shall not mean any other person. In order to permit Eligible CBOT Full Members and Eligible CBOT Full Member Delegates to participate in an offer, distribution or redemption of the kind referred to in the last two sentences of Paragraph 3(a) of the Agreement, and solely for such purpose, CBOE agrees to waive

all membership dues, fees and other charges and all qualification requirements, other than those that may be imposed by law, that may be applicable to the application for membership on CBOE of each Eligible CBOT Full Member and Eligible CBOT Full Member Delegate who wishes to exercise the Exercise Right during the period commencing on the date CBOE gives notice to CBOT pursuant to Paragraph 3(b) of the Agreement and ending on the date such individual participates in such offer, distribution or redemption (as the case may be); provided, however, that (i) no Exerciser Member (as defined in the Agreement) for whom dues, fees and other charges and qualification requirements are waived in accordance with the foregoing shall have any rights as a CBOE member other than to participate in such offer, distribution or redemption, and (ii) the CBOE membership of each such Exerciser Member shall terminate immediately following the time such individual participates in such offer, distribution or redemption.

CBOT/CBOE Exercise Agreement Q & A

1. Q - What is the basic concept of the Exercise Agreement?

   A. The basic concept is to clarify and solidify the Exercise privilege rights of a CBOT Full Member. Generally, the Agreement allows a Full Member to lease all of his or her trading rights and privileges to another individual who will then become eligible to become a CBOE exerciser. However, should the CBOT Full Member lease only some of his or her trading rights and privileges to another individual, then neither the Member nor the delegate will be eligible to exercise at the CBOE. In other words, the lessees must be in possession of all trading privileges of the Full Membership in order to exercise at the CBOE.

   As the membership said in floor meetings, "Lease it North of Van Buren or South of Van Buren, but not both."

2. Q. Why is this Agreement necessary?

   A. For more than a decade, the extent of the rights of a CBOT Full Member to exercise his CBOE trading rights have been the subject of dispute between the two Exchanges including previous litigation which did not resolve the dispute. Current CBOE proposed rule changes have intensified the dispute particularly regarding the ability of CBOT members to separately lease portions of the Full Member trading privileges and still exercise at the CBOE. Unless some agreement settles these disputes with finality, the likely consequence for both Exchanges is expensive and uncertain litigation.

   The Agreement codifies the desires of CBOT Full Members as expressed at Membership meetings to preserve the Full Membership's value by removing any uncertainty or disputes regarding the ability to exercise and/or delegate CBOE exercise trading rights. It protects the CBOT Members from any dilution of the exercise privilege, and it protects the CBOE from any future dilution of the value of their membership.

3. Q. - What would be the effect on the exercise privileges should the rights and privileges of a Full Membership be expanded to include a new contract(s) and/or trading opportunities?

A. The member (or his delegate) must possess the trading privileges for the new contracts to exercise on the CBOE.

4. Q. - What if a CBOT Full Member is given the option to acquire a new trading right or privilege? Can he still exercise on the CBOE?

A. If the CBOT member chooses to exercise the right to acquire the new right or privilege, he must have it to exercise at the CBOE. If he does not elect to exercise the option, he need not possess it in order to exercise at the CBOE.

5. Q. - Can a CBOT Full Member sell his right to trade on the CBOE while, at the same time, keep his Full Membership intact and continue trading on the CBOT?

A. No. The exercise privilege attaches to the CBOT Full Membership and cannot be severed from the Membership.

6. Q. What rights are guaranteed CBOT Full Members at the CBOE?

A. The Agreement guarantees that exerciser members shall have the same rights as regular CBOE members free of restrictions and discrimination except that the exerciser membership may not be transferred, leased or sold. It also guarantees that if CBOE takes action which gives CBOE Regular Members additional rights or privileges which would dilute the value of CBOE Memberships, CBOT Full Members will be given notice and opportunity to exercise and participate equally in such additional rights.

7. Q. - What if, sometime in the future, the CBOT issues some kind of "new" Full Memberships in addition to the present 1402 Full Memberships or creates new Full Memberships through acquisition and/or merger? Will the additional Full Memberships include the exerciser privilege?

A. No, only the present 1402 CBOT Full Memberships will possess the exercise privilege.

8. Q. - What is the time length of the Agreement?

A. The Agreement does not have a set time length. As long as both the CBOT and the CBOE conform to the terms of the Agreement and there are no regulatory barriers which conflict with any terms of the Agreement, it could last perpetually.

9. Q - Regarding GLOBEX®, must the GLOBEX® screen trading right be in the possession of the CBOT Full Member in order for him to exercise on the CBOE?

A. Yes.

10. Q - Will Ceres Trading LP interests also be subject to the Exercise Agreement?

A. No, the Ceres Trading LP interests are not trading rights or privileges and are therefore not subject to the Agreement.

11. Q - What if the CBOT offers new trading privileges available to more than just Full Members as a class; would a Full Member be required to have the new trading privilege to exercise at the CBOE?

A. No, if the option is offered to a significant number of non-Full Members on the same terms on which it is offered to Full Members. Only when the new trading privilege is part of a benefit given to Full Members as a class must it be possessed in order to exercise at CBOE.

EXHIBIT 2

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SAMUEL A. NOLEN
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December 12, 2006

BY ELECTRONIC FILING
The Honorable John W. Noble
Vice Chancellor
Court of Chancery
417 South State Street
Dover, DE 19901

Re: ***CBOT Holdings, Inc. v. Chicago Board Options Exchange, Incorporated*; Del. Ch. C.A. No. 2369-N**

Dear Vice Chancellor Noble:

I write on behalf of defendants to apprise the Court of recent developments that bear on defendants' pending motion to dismiss.

Plaintiffs purport to represent a class of individuals who are, or have the right to become, members of defendant Chicago Board Options Exchange, Incorporated ("CBOE") by virtue of an exercise right that CBOE's certificate of incorporation granted to members of plaintiff The Board of Trade of the City of Chicago (the "Board of Trade"). The suit arises out of CBOE's announced intention to "demutualize."

The terms of any demutualization transaction have not yet been fixed, but plaintiffs' complaint speculates that CBOE intends to treat persons who became CBOE members through the exercise right ("Exerciser Members") unfairly compared to CBOE's other members ("Seat Owners"). Since no decisions have yet been made by CBOE's Special Committee of independent directors concerning the relative consideration that Exercise Members and Seat Owners would receive in a demutualization, CBOE moved to dismiss this case as not ripe, and filed its opening brief on that issue on November 2. Plaintiffs have not filed an answering brief.

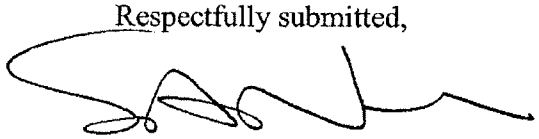
Plaintiff CBOT Holdings, Inc. ("CBOT Holdings"), the parent company of the Board of Trade, has announced entry into a definitive agreement providing for CBOT Holdings to merge with and into Chicago Mercantile Exchange Holdings, Inc. ("CME Holdings"). CME Holdings would be the surviving company and the Board of Trade would become a subsidiary of CME Holdings in that transaction (the "CME Holdings Acquisition"). In order to address the effect on the exercise right of this acquisition of the Board of Trade, CBOE today submitted a rule filing

with the U.S. Securities and Exchange Commission ("SEC"). Federal law gives the SEC exclusive jurisdiction to determine the meaning of the provisions of the certificate of incorporation and the rules of exchanges such as CBOE.[1]

Under this rule filing, once the acquisition of the Board of Trade is completed no one will qualify any longer as an Exerciser Member. Because no one will so qualify, it will not be necessary to determine the treatment of any such persons in the demutualization. Accordingly the Special Committee has suspended further work to value the consideration to which such a person otherwise would have been entitled in the demutualization.

For the same reason, upon approval of CBOE's rule interpretation and completion of the CME Holdings Acquisition plaintiffs' lawsuit will become moot.

Respectfully submitted,



Samuel A. Nolen

SAN/meh
Enclosure
cc: Register in Chancery (by e-file)
Kenneth J. Nachbar, Esquire (by e-file)
Andre G. Bouchard, Esquire (by e-file)

[1] *See* 15 U.S.C. §78s(b)(1); SEC Rule 19b-4, 17 C.F.R. § 240.19b-4; 15 U.S.C. §78c(a)(27) (defining "rules" to include an exchange's certificate of incorporation); *Buckley and Board of Trade of the City of Chicago v. Chicago Board Options Exchange, Inc.*, 440 N.E.2d 914 (Ill. App. Ct. 1982) (holding state action preempted because of SEC's exclusive jurisdiction over questions of exchange membership, referring particularly to the exercise right provision at issue in the present case).

EXHIBIT 3

CBOE
CHICAGO BOARD OPTIONS EXCHANGE

Information Circular IC07-12

Date: February 8, 2007

To: Membership

From: Office of the Chairman

Re: ERP Purchase

The CBOE purchased an additional exercise right privilege (ERP) on February 1, 2007 based on a bid of $127,000 that was placed on August 24, 2006. Currently, CBOE has no bids outstanding.

CBOE has determined that, upon completion of the CME Holdings acquisition of CBOT, there no longer will be any persons who would qualify to become an exerciser member of CBOE. CBOE's position was filed with the SEC and was published for comment on February 6, 2007.

As with any major transaction, the completion of the CME Holdings acquisition of CBOT is contingent on many events, including approval of the Department of Justice. Therefore, until such time as CME's acquisition of CBOT is completed, CBOE may from time to time acquire additional ERPs in the marketplace.