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August 20, 2007

VIA ELECTRONIC DELIVERY

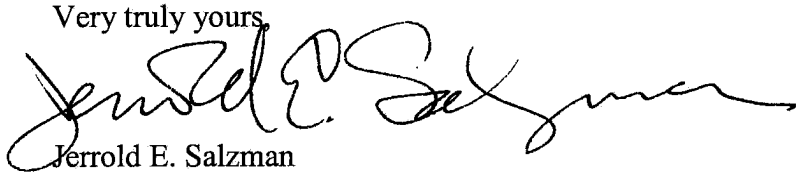
Erik R. Sirri
Elizabeth K. King
Division of Market Regulation
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: SR-CBOE-2007-77

Dear Mr. Sirri and Ms. King:

In connection with our meeting scheduled for tomorrow, we prepared the attached memorandum as a basis for our discussion. I look forward to the opportunity to meet with you regarding these issues.

Very truly yours,



Jerrold E. Salzman

Enclosures

M E M O R A N D U M

August 20, 2007

This memorandum is submitted to the staff of the Division of Market Regulation, U.S. Securities and Exchange Commission ("SEC" or "Commission"), on behalf of CME GROUP INC. ("CME"), its wholly-owned subsidiary BOARD OF TRADE OF THE CITY OF CHICAGO, INC. ("CBOT"), and CBOT members MICHAEL FLOODSTRAND ("Floodstrand") and THOMAS J. WARD ("Ward"), in support of their request that the staff summarily abrogate SR-CBOE-2007-77 pursuant to delegated authority.

Background and Summary of Position

On July 2, 2007, the Chicago Board Options Exchange, Incorporated ("CBOE") adopted and filed with the SEC a purportedly self-executing "Interpretation and Policy" (the "'Interpretation'") to address the status of CBOT full members who have exercised their rights to become CBOE members ("Exerciser Members") if the merger of CBOT Holdings, Inc. ("CBOT Holdings") and Chicago Mercantile Exchange Holdings Inc. ("CME Holdings") were approved and consummated before the SEC took final action on CBOE rule filing SR-CBOE-2006-106, filed on December 12, 2006 (the "Proposed Rule Change"). (*See* SR-CBOE-2007-77; *see also* CBOE Regulatory Circular RG07-71.) The "Interpretation" was filed as immediately effective. (*Id.*) The merger between CBOT Holdings and CME Holdings was approved on July 9, 2007, and closed on July 12, 2007. CME Group Inc. is the surviving entity of the merger.[1]

[1] On July 5, 2007, the Commission gave notice of the rule filing and on July 12, 2007, that notice was published in the Federal Register as Release No. 34-56016. Comments were invited, and CBOT filed comment letters on July 27, 2007, and August 9, 2007. These comments were adopted by Floodstrand and Ward in a letter filed with the Commission on August 14, 2007.

CBOE asserts that the rule was properly filed under Section 19(b)(3)(A), stating,

> The interpretation is designated by the Exchange as constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the Exchange – namely, CBOE Rule 3.19 – thereby qualifying for effectiveness on filing pursuant to Section 19(b)(3)(A)(i) of the Exchange Act and subparagraph (f)(1) of Rule 19b-4 thereunder.

("Interpretation" at 10 (footnotes omitted).)

The "Interpretation" provides, among other things, that:

- Each person who was an Exerciser Member on July 1, 2007, and satisfies certain conditions will be granted "temporary CBOE membership status."
- Commencing July 1, 2007, no additional CBOT full members or their delegates will be granted CBOE membership status until the SEC acts on the Proposed Rule Change.

CBOE has created and implemented a permit program that temporarily permits some Exerciser Members to continue trading on CBOE. But CBOE will require those Exerciser Members who qualify for temporary trading rights under this permit program to pay CBOE a monthly access fee that CBOE says will be based on lease rates for a CBOT B-1 membership, or about $4700 per month.[2] This is yet another step in CBOE's efforts to make improper use of the Commission and its own self-regulatory authority to resolve in its favor a private property dispute that is pending in the Delaware court. As with its Proposed Rule Change filed in December, CBOE seeks to use the "Interpretation" to resolve issues of state law in order to shift

[2] A holder of the new temporary trading rights will not be required to lease or hold the CBOT B-1 membership that Article Fifth(b) of CBOE's Certificate of Incorporation requires Exerciser Members to hold in order to qualify for CBOE membership. In the case of Exerciser Members who previously leased CBOT full memberships in order to qualify as Exerciser Members, CBOE is essentially appropriating these lease payments for itself in the form of access fees. CBOE says the access fees will be held in escrow pending the Commission's decision on the Proposed Rule Change. In the event the Commission disapproves the Proposed Rule Change, CBOE would return the consideration to the holder of the temporary trading rights, not the lessor from whom it was wrongfully appropriated.

over $1 billion in equity value from one class of CBOE members to another class of CBOE members.[3]

Contrary to CBOE's representations to the Commission, CBOE was well aware that the "Interpretation" did not qualify for immediate effectiveness upon filing pursuant to Section 19(b)(3)(A) of the Exchange Act for two reasons:

1. The "Interpretation" did not constitute a stated policy, practice or interpretation with respect to the administration or enforcement of an existing rule, and is not in any sense an "interpretation" of Rule 3.19 cited by CBOE; and
2. The "Interpretation" is not a "housekeeping" or other insubstantial rule but rather has substantial financial consequences for hundreds of individuals by depriving them of property rights protected by Delaware law; it created artificial price movements in the markets for CBOE leases, CBOE memberships, CBOT leases and CBOT memberships; and it precluded additional access to CBOE markets except at the artificial prices created by CBOE's filing and implementation of the "Interpretation."

Moreover, the "Interpretation" was void *ab initio* because it was not validly adopted by CBOE's board for the following three reasons:

1. The "Interpretation" created 221 temporary memberships or trading permits in violation of Section 2.1 of CBOE's constitution, which prohibits the creation of new classes of membership or permits in the absence of a vote. Its adoption directly contradicts CBOE's prior admission in the Proposed Rule Change that such a temporary program "would be

[3] See prior comment letters submitted on behalf of CBOT on February 27, 2007, in connection with the Proposed Rule Change, and on July 27, 2007, and August 9, 2007, in connection with the "Interpretation," as well as prior comment letters submitted on behalf of Floodstrand on February 14, 2007, and on behalf of Floodstrand and Ward on February 27, 2007, in connection with the Proposed Rule Change.

subject to the approval of CBOE members under Section 2.1 of the Exchange's Constitution, and to the approval of the Commission under Section 19(b) of the Act." (*See* Proposed Rule Change at 14.); and

2. The "Interpretation" was adopted by an "interested" board for the financial benefit of board members and certain favored members, in breach of the Board's fiduciary duty to the Exerciser Members of CBOE under Delaware law, as set forth in the opinion of Delaware counsel attached hereto as Exhibit A; and
3. The "Interpretation" amended Article Fifth(b) without the required vote and breached CBOE's contractual obligations in violation of Delaware law.[4]

Applicable Legal Principles

The Staff has clear authority to summarily abrogate the "Interpretation" because it is a change in the rules of a self-regulatory organization, CBOE, and was made pursuant to Section 19(b)(3), 15 U.S.C. §78s(b)(3). The Exchange Act grants the Commission express authority to summarily abrogate the "Interpretation" and thereby require CBOE to refile it as a proposed rule change subject to notice and comment prior to becoming effective. Section 19(c)(3)(C) provides, in relevant part:

> At any time within sixty days of the date of filing of such a proposed rule change in accordance with the provisions of paragraph (1) of this subsection, the Commission summarily may abrogate the change in the rules of the self-regulatory organization made thereby and require that the proposed rule change be refiled in accordance with the provisions of paragraph (1) of this subsection and reviewed in accordance with the provisions of paragraph (2) of this subsection, if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter. . . .

[4] Each of these state law issues is necessarily the subject of the pending action before the Delaware court.

Furthermore, the Commission has delegated this authority to the Director of the Division of Market Regulation to be performed by him or under his direction by such person or persons as may be designated from time to time by the Chairman of the Commission), pursuant to Section 19(b)(3), 15 U.S.C. §78s(b)(3). *See* 15 U.S.C. § 78d-1, 78d-2; 17 C.F.R § 200.30-3(a)(58).[5] Because of this express delegation of authority, the staff has a duty to take appropriate action on behalf of the Commission.

Discussion

For the reasons that follow, the staff should exercise its authority to abrogate the "Interpretation" and require that it be refiled in accordance with Section 19(b)(1), 15 U.S.C. § 78s(b)(1), and reviewed in accordance with Section 19(b)(2), 15 U.S.C. §78s(b)(2), of the Act, as such action is necessary and appropriate in the public interest and would be otherwise in furtherance of the purposes of the Exchange Act.

I. The "Interpretation" Is Not Entitled To Immediate Effectiveness.

CBOE designated the "Interpretation" as effective upon filing under Section 19(b)(3)(A) of the Exchange Act, which provides:

> [A] proposed rule change may take effect upon filing with the Commission if designated by the self-regulatory organization as (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization, (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization, or (iii) concerned solely with the administration of the self-regulatory organization or other matters which the Commission, by rule,

[5] Rules 430 and 431 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.430 and 201.431, provide for Commission review of staff action taken by delegated authority upon request by, *inter alia*, a person aggrieved by the staff's action. In determining whether to grant review in response to a petition such as this one, the Commission looks to the standards set forth in Rule of Practice 411(b)(2), 17 C.F.R.§ 201.411(b)(2), *i.e.*, whether the decision embodies, *inter alia*, (a) a conclusion of law that is erroneous, or (b) an exercise of discretion or decision of law or policy that is important and that the Commission should review. (*See* Rule 431 of the Commission's Rules of Practice.)

> consistent with the public interest and the purposes of this subsection, may specify as without the provisions of such paragraph (2).

CBOE justified its action under the first prong, subsection (i), as "constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of [CBOE]." However, as discussed below, the "Interpretation" does not involve interpretation of the existing rule cited by CBOE, and in any event does not address the type of "housekeeping" or other insubstantial administrative matter these provisions are intended to address.[6] Because CBOE's summary adoption and enforcement of radical changes to its membership rules and the substantive rights of its members is improper under the guise of a purported interpretation that takes effect on filing under Exchange Act 19(b)(3)(A), the Commission should abrogate the "Interpretation."

A. The "Interpretation" Is Unrelated To CBOE Rule 3.19.

CBOE's claim that the "Interpretation" is merely an interpretation of Rule 3.19 is obvious subterfuge, as the "Interpretation" does not relate to anything contained in Rule 3.19 and is instead a new rule that immediately extinguishes the exercise rights and abrogates the corporate membership rights of Exerciser Members. Without re-casting this substantive rule change as an interpretation of Rule 3.19, CBOE would not have been able to claim that the "Interpretation" is immediately effective. Rule 3.19 provides:

> Termination from Membership
>
> The membership status of a member shall automatically terminate at such time that the member does not possess a membership through ownership, lease, or registration of a membership to the member. The membership of a member

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[6] "'House-keeping' and other rules which do not substantially affect the public interest or the protection of investors would take effect upon filing with the SEC, subject to the SEC's authority to abrogate them within 60 days of filing." *Summary of Principal Provisions of Securities Acts Amendments of 1975 (S.249)*, Senate Committee on Banking, Housing and Urban Affairs, 94th Cong, 1st Sess. (1975), at 7.

> organization shall also automatically terminate at such time that the member organization has no nominee or person who has registered his or her membership for the member organization. Notwithstanding the foregoing, if the Exchange determines that there are extenuating circumstances, *the Exchange may permit a member to retain the member's membership status for such period of time as the Exchange deems reasonably necessary to enable the member to obtain a membership, a substitute nominee, or a substitute person to register his or her membership for the member, as applicable.*

(emphasis supplied).

Rule 3.19 addresses extenuating circumstances that cause a member to lose his membership, and allows CBOE to *maintain the status quo* by permitting that member to retain membership status for the time "reasonably necessary to enable the member to obtain a membership." Rule 3.19 has no bearing on the issue of whether the recent merger between CME Holdings and CBOT Holdings extinguished the membership rights of the existing 221 CBOE Exerciser Members, or whether full members of CBOT retained their right to become Exerciser Members after the merger. Certainly it does not support an interpretation that purports to drastically alter, rather than maintain, the status quo. No "Interpretation" of Rule 3.19 would have been necessary to maintain the status quo here.[7]

CBOE's "Interpretation" of Rule 3.19 is in reality an attempt to immediately effectuate the changes contained in its December 2006 Proposed Rule Change without waiting for the Commission's review and approval of that filing. Specifically, in the Proposed Rule Change, CBOE seeks to obtain SEC approval for an interpretation that the exercise rights no longer exist,

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[7] The "Interpretation" is also inconsistent with Rule 3.19 because the period of temporary membership is tied to the SEC's final action on CBOE's Proposed Rule Change rather than on the time necessary to obtain a substitute membership as contemplated by Rule 3.19. CBOE had no legitimate expectation that the 221 Exerciser Members whose memberships were stripped could "obtain a membership, a substitute nominee, or a substitute person to register his or her membership for the member."

contrary to Delaware law and in the face of the pending Delaware case that will address this issue. CBOE also seeks Commission approval for a similar "temporary" membership status:

> 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 result would be accomplished by staying, for an interim period of time, the impact of the termination of the exercise right on the trading access of those individuals who were exercise members of CBOE on a designated cut-off date. This would permit those individuals to continue to trade on CBOE in the capacity of CBOE members during that interim period. For this purpose, CBOE proposes the close of business on December 11, 2006 as the cut-off date for determining whether exercise members would have the right, during the interim period, to continue to have trading access to CBOE. Individuals who were exercise members of CBOE in good standing on that date would continue to be able to trade as members of CBOE during the interim period, notwithstanding the above-described effect on the exercise right of the acquisition of CBOT, but individuals who were not effective exercise members on that date would not be permitted to exercise or have trading access to CBOE during the interim period without obtaining a separate CBOE membership. 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, which could involve CBOE adopting a plan to provide some form of trading access to such persons in the absence of the exercise right. Any such plan would be subject to the approval of CBOE members under Section 2.1 of the Exchange's Constitution, and to the approval of the Commission under Section 19(b) of the Act.

(Proposed Rule Change, at 14-15 (footnote omitted).)

Having admitted in the Proposed Rule Change that CBOE needs Commission approval to terminate the Exerciser Members' memberships and implement a similar temporary permit program, CBOE now seeks to do both of these things without Commission review. There is no basis to support CBOE's contention that the "Interpretation" is "a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of" Rule 3.19.

B. The "Interpretation" Has Significant Market and Financial Impacts.

In addition to the infirmity of CBOE's reliance on Rule 3.19, the "Interpretation" is also improper because it is not the type of housekeeping or administrative matter Section 19(b)(3)(A) is intended to address. These provisions clearly do not permit material changes to an exchange's

membership structure or member ownership rights, nor do they allow rule changes that completely alter the costs of exercising membership privileges. The "Interpretation," however, does exactly this. Indeed, the "Interpretation" radically changes CBOE's membership rules as they apply to a substantial number of members. Specifically, the "Interpretation" provides that Exerciser Members are no longer members by virtue of possessing a CBOT B-1 membership, and CBOT full members who formerly leased their CBOT B-1 memberships to Exerciser Members will no longer be able to do that. Instead, under the "Interpretation," Exerciser Members who qualify will pay a monthly access fee directly to CBOE for temporary trading permits.

To date, the "Interpretation" has had a significant impact on the market for both CBOT and CBOE memberships and membership leases. Specifically, (1) the lease market for CBOT Series B-1 memberships − which were inextricably tied with CBOE memberships under the CBOE Certificate of Incorporation and subsequent contracts between the exchanges −has been destroyed; (2) CBOT full members who leased their B-1 memberships to Exerciser Members are being denied the opportunity to collect lease payments; (3) the lease value of all CBOT B-1 memberships is being diminished; and (4) the sale value of all CBOT B-1 memberships is being diminished.[8] Such drastic changes would not result from a mere "interpretation" of an existing rule as contemplated by Section 19(b)(3)(A) of the Exchange Act.

The precise financial impact on the CBOT B-1 membership lease market will be difficult to quantify over a given period of time because multiple market factors can affect both the lease and market values of the B-1 memberships. These factors would include, among others,

[8] Although CBOE says otherwise, the "Interpretation" also necessarily eliminates the voting rights and other indicia of membership of the Exerciser Members even if they qualify for temporary trading permits.

the market activity or volatility of the product offerings on each exchange, the product trading volumes on each exchange, and the demand (*i.e.*, the number of willing buyers and sellers) for the leases or memberships on each exchange at any given point in time. In fact, in the Delaware action, CBOE conceded that CBOT members have suffered economic losses, that these losses are difficult to quantify, and that the trier of fact may have to "isolate and discount other factors" that might affect the lease and market values of the B-1 memberships in order to determine monetary damages. (CBOE Opp. to Mot. for Temp. Restr. Order, July 26, 2007, at 27.)

Meanwhile, regular CBOE members have been reaping huge financial gains from the CBOE Board's self-interested actions. The market value of a CBOE membership is based on the expectation that CBOE will demutualize and promptly conduct an initial public offering of the equity interests distributed during the demutualization. CBOE's declaration that CBOT members with exercise rights and the Exerciser Members will not share in the distribution of equity when CBOE demutualizes creates the expectation of a forced transfer (*i.e.*, confiscation) of over $1 billion in equity value away from the Exerciser Members to the other members of CBOE. Instead of the 931 regular CBOE members dividing approximately 41% of the securities distributed upon demutualization, CBOE seeks to create the expectation that regular members will divide 100% of the securities by cutting out the 1331 CBOT members entitled to share in the distribution under Delaware law. As a result, the price of a CBOE membership has been artificially inflated and CBOE lease rates have risen with the increase in membership prices. This information is causing profound market impact.[9]

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[9] Indeed, the CBOE membership should be deemed a security based on the fact that CBOE's well publicized efforts to demutualize and conduct an initial public offering have converted the membership from a trading permit to an option to purchase securities when and if issued. The term "security" means . . . any . . . option . . . on any security . . . or warrant or right to subscribe to or purchase, any of the foregoing. (Securities Act § 2(a)(1), 15 U.S.C.A § 77b(a)(1).) The filing and *(cont'd)*

As there is no basis for CBOE's "Interpretation" under Section 19(b)(3)(A), the Commission should summarily abrogate the "Interpretation" at its earliest convenience to prevent further harm that must have been foreseen and intended by CBOE when it chose this course of conduct. The conclusion is self-evident that CBOE is using the "Interpretation" as a plot to achieve the ends sought in its Proposed Rule Change without waiting for Commission action, and to avoid having the Delaware court apply Delaware law to protect the property rights of the Exerciser Members and the CBOT members with exercise rights.

II. The "Interpretation" Was Not Validly Adopted.

A. CBOE's Constitution Prohibits Rules Granting Temporary Memberships.

CBOE's "Interpretation" was adopted in contravention of its own membership rules and therefore in violation of applicable federal law.[10] Specifically, Article II, Section 2.1 of CBOE's Constitution expressly prohibits CBOE from creating any new memberships or permits for any purpose or with any characteristics, without the approval of the existing membership:

> Section 2.1. Number of Memberships
>
> (a) Membership in the Exchange shall be made available by the Exchange at such times, under such terms and in such number as shall be proposed by the Board and approved by the affirmative vote of the majority of voting members present in person or represented by proxy at a regular or special meeting of the membership. *Such an affirmative vote by the members shall be required for the issuance of all new memberships, whether regular or special, whether having expanded or limited rights, whether designated memberships or permits or as a classification using any other description, which grant the holders thereof the right to enter into securities transactions at the Exchange.*

(cont'd from previous page)

implementation of the Interpretation has operated as a device to inflate the price of that security interest.

[10] The Exchange Act provides that "[e]very self-regulatory organization shall comply with the provisions of this chapter, the rules and regulations thereunder, *and its own rules*." 15 U.S.C. 78s(g)(1) (emphasis added).

(emphasis supplied.)

Despite this unambiguous rule, the "Interpretation" adopted by CBOE Board purports to create 221 new permits for Exerciser Members or their delegates whose CBOE memberships the CBOE Board terminated a result of the merger. Affording the "former" Exerciser Members newly created, "temporary" permits is not permitted by the CBOE Constitution.

CBOE's clear violation of Rule 2.1 is not justified by Rule 3.19, for the reasons discussed above. Although Rule 3.19 allows CBOE temporarily to extend membership status under "extenuating circumstances," this is not what CBOE chose to do here. The Rule only affords CBOE authority to permit a member to retain the member's membership status "for such period of time as [CBOE] deems reasonably necessary to enable the member to obtain a membership, a substitute nominee, or a substitute person to register his or her membership for the member, as applicable." Nowhere does CBOE indicate that the purpose of the "Interpretation" is to "enable the member to obtain a membership." On the contrary, CBOE set up a temporary trading program based on payment of access fees rather than on maintaining or obtaining qualification as an Exerciser Member under Article Fifth(b) or otherwise obtaining a substitute membership. Accordingly, CBOE had no authority within its own rules or otherwise to enact the "Interpretation."

B. CBOE's Directors Violated Their Fiduciary Duties Because They Were Impermissibly Conflicted In Adopting the "Interpretation."

CBOT filed today the letter opinion of its Delaware counsel regarding the Proposed Rule Change. (*See* Letter from Morris, Nichols, Arsht & Tunnell LLP, dated August 20, 2007, attached hereto as Exhibit A (the "Morris Nichols Letter").) The Morris Nichols Letter opines

that the CBOE Board breached its fiduciary duties in determining to extinguish the rights of the Exerciser Members and the other holders of exercise rights. (*Id.* at 3.)[11]

As set forth in the Morris Nichols Letter, the CBOE Board owes fiduciary duties to all CBOE members, including the Exerciser Members. By CBOE's own admission, such fiduciary duties include the duty to act in good faith, in a manner consistent with the terms of Article Fifth(b), and not for any inequitable purpose. A majority of the directors serving on the CBOE Board have a direct financial interest in eliminating the rights of the Exerciser Members prior to CBOE's planned demutualization, which renders them incapable of making a disinterested decision regarding the effect of the CBOT Holdings/CME Holdings merger on the Exercise Rights. Thus, the same fiduciary duties that caused CBOE initially to form a special committee of disinterested directors to consider the treatment of Exerciser Members in the context of the demutualization should have compelled the formation of a special committee to consider the effect of the merger on Exerciser Members, including any related rule changes. In light of the direct financial interest of a majority of the directors, the CBOE Board is not entitled to rely on any presumption that its action was proper, but must demonstrate to the Delaware court that the Proposed Rule Change is fair to *all* members, including the Exerciser Members. As CBOE is unable to make this showing, the Proposed Rule Change is invalid.

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[11] This precise issue is pending before the Delaware court. (*See* Morris Nichols Letter at 2-3.) The court recently determined that it has jurisdiction to decide the state law fiduciary duty and contract issues implicated by CBOE's conduct. (*See* Mem. Op., dated August 3, 2007, at 29-30.) The court stated that:

> In sum, it is not immediately and conclusively obvious why a regulatory act voluntarily (and not necessarily) taken by the CBOE Board can be isolated from the reach of fiduciary duty law, especially when the consequences (great benefits to the [regular CBOE] members and great detriment to the CBOT Full Members) were so apparent at the time when the CBOE Board decided to act.

(*Id.* at 30 n.10.)

For all of these same reasons, the Board violated its fiduciary duties in adopting the "Interpretation." Accordingly, the "Interpretation" was null and void from inception and is not enforceable by CBOE.

C. The "Interpretation" Violates State Law.

Regardless of the infirmities surrounding the process by which CBOE's Board adopted the "Interpretation," CBOE's termination of the Exerciser Members' memberships and the exercise rights of CBOT full members, without amending its Certificate of Incorporation, is a clear violation of its state law obligation to govern itself in accordance with the terms of its Certificate and to honor its contractual obligations.[12] Article Fifth(b) provides: "In recognition of the special contribution made to the organization . . . by the members of the Board of Trade . . . *every present and future member of said Board of Trade* who applies for membership in the [CBOE] and who otherwise qualifies shall, s*o long as he remains a member of the said Board of Trade*, be entitled to be a member of the [CBOE]. . . ." (emphasis added). Article Fifth(b) further provides: "No amendment may be made with respect to [this paragraph] without prior approval of *not less than 80%* of (i) the [Exerciser Members] 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*. . . ."

There is no authority for ignoring the Certificate of Incorporation, regardless of whether the period during which the provision is suspended is called temporary, interim or provisional. CBOE's adoption of the "Interpretation," which is part of its by-laws, contravenes Delaware law. 8 Del. C. §109(b) ("[t]he bylaws may contain any provision, not *inconsistent with* law or with the

[12] Again, the Delaware court has determined that it has jurisdiction and will decide these state law issues. (*See* Mem. Op., dated August 3, 2007, at 7, 29-30.)

certificate of incorporation....") (emphasis added). This renders the "Interpretation" unenforceable under the Exchange Act, which states that any self-effectuating exchange rule may *only* be enforced to the extent that such rule is *not inconsistent with applicable with State law*. *See* Section 19(b)(3)(C), 15 U.S.C.A. § 78s(b)(3)(C) ("Any proposed rule change of a self-regulatory organization which has taken effect pursuant to subparagraph (A) or (B) of this paragraph may be enforced by such organization to the extent it is not *inconsistent* with the provisions of this chapter, the rules and regulations thereunder, and applicable Federal and *State law*.") (emphasis added). Accordingly, the Exchange Act forbids CBOE from enforcing the "Interpretation" because it plainly violates applicable Delaware law.[13]

To be sure, CBOE claims that it is merely interpreting Article Fifth(b) as it has done before, rather than amending it. The precedent of the prior interpretations, however, does not alter the requirement that the "Interpretation" be consistent with the language of the certificate that is being interpreted. Here, CBOE seeks to interpret a provision that guarantees "every" member of CBOT the right to become a member of CBOE to mean "no" member of CBOT has that right. In contrast, CBOE's prior interpretations of Article Fifth(b) were consistent with the rights granted in the Charter and were reflected in contracts negotiated with and agreed to by CBOT on behalf of its members. At the time of their approval by the SEC, none of those prior interpretations involved unresolved state law disputes. In any event, each of those prior

[13] In a press release announcing enactment of the recent Delaware constitutional amendment allowing the Commission to bring questions of Delaware law directly to the Delaware Supreme Court, the General Counsel of the Commission reiterated that "In our constitutional system, federal and state law coexist side-by-side, each with a distinctive role. As a result, the administration of the federal securities laws often requires interpretation of state law." (Del. S. Ct. Press Release, May 15, 2007, available at http://courts.delaware.gov/Courts/Supreme%20Court/pdf/?deconstamend051507pdf.pdf.)

interpretations was approved by the Commission, whereas CBOE is attempting to slip this "Interpretation" through with no review whatsoever.[14]

It is clear that CBOE used the summary effectiveness provision of Exchange Act Section 19(b)(3)(A)(i) to "jump the gun" on its efforts to get rid of Article Fifth(b) in any way possible, without waiting for the Commission to determine whether to approve the Proposed Rule Change is consistent with the Exchange Act, or for the Delaware court to determine whether CBOE's interpretation of Article Fifth(b) is valid under Delaware law. Thus, the Commission's abrogation of the "Interpretation" is appropriate in the public interest and in furtherance of the purposes of the Exchange Act because it was adopted in violation of applicable state law.

III. The "Interpretation" Can Be Unwound In An Orderly Fashion.

Abrogation of the "Interpretation" will not disrupt CBOE's market, because the Exerciser Members will continue to be members entitled to trade on CBOE. To the extent Exerciser Members have relinquished the indicia of membership in reliance on the "Interpretation," CBOE has the authority to avoid disruption, if it chooses, by continuing such memberships under existing Rule 3.19 for the period of time necessary for Exerciser Members to reassemble the indicia of membership. No further regulatory action would be required.

* * *

Counsel for Floodstrand and Ward, and on behalf of a class of all others similarly situated in the Delaware action, delivered a letter to counsel for CBOE proposing an alternative to the "Interpretation" that would return to the status quo as of July 1, 2007, without prejudicing

[14] Like the Proposed Rule Change, the "Interpretation" is also inconsistent with and in breach of these contracts, including the 1992 Agreement, as set forth in CBOT's February 27, 2007, comment letter regarding the Proposed Rule Change.

CBOE's position. (*See* Letter from Gordon B. Nash, Jr. to Paul E. Dengel, dated August 16, 2007, attached hereto as Exhibit B.)

Under this proposal, CBOE would withdraw the "Interpretation" and CBOE's Rule 3.16 would continue to govern the interpretation of the term "member of the Board of Trade of the City of Chicago" as used in Article Fifth(b). Any requirement in Rule 3.16 to hold shares of stock of CBOT Holdings would be interpreted to require that such person hold the number of shares of stock of CME Holdings exchanged for such CBOT Holdings stock in the merger. While CBOT believes that this occurs by operation of law, under the proposal CBOE would adopt this interpretation as a temporary "Interpretation and Policy" under Rule 3.16. The effect would be that Exerciser Members would continue to be members of CBOE, and CBOT full members would continue to have exercise rights, while the question regarding the effect of the merger remains pending before the Commission and the Court. The "Interpretation and Policy" would also provide a 30-day period for anyone who acted in reliance on the "Interpretation" to obtain the indicia of membership.

With the membership rights thus returned to the *status quo ante*, CBOE would be allowed to collect a monthly access fee from Exerciser Members to be held in escrow pending a resolution of both the court and SEC proceedings. The parties would stipulate that the agreement was without prejudice to their respective positions.

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August 20, 2007

Erik R. Sirri
Elizabeth K. King
Division of Market Regulation
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Proposed Rule Change: File No. SR-CBOE-2006-106

Dear Mr. Sirri and Ms. King:

I deliver this letter in connection with the proposed rule change submitted to the Securities and Exchange Commission (the "Commission") by the Chicago Board Options Exchange, Inc., a Delaware membership corporation ("CBOE"), on December 12, 2006, and amended on January 16, 2007, and June 28, 2007. The proposed rule change involves an interpretation of paragraph (b) of Article Fifth ("Article Fifth(b)") of CBOE's Certificate of Incorporation (the "Certificate") regarding the continued right of Full Members of the Board of Trade of the City of Chicago, Inc., a Delaware corporation ("CBOT"), to become members of CBOE in light of the recent merger (the "Merger") between Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings, Inc., CBOT's parent corporation.

I understand that Article Fifth(b) has been previously interpreted in accordance with agreements of CBOE and CBOT dated September 1, 1992, August 7, 2001 (as amended by letter agreements dated October 7, 2004, and February 14, 2005), and December 17, 2003 (collectively, the "Agreements"). The interpretations of Article Fifth(b) set forth in the Agreements were approved by the Commission under Section 19(b)(2) of the Securities Exchange Act of 1934, as amended, in Release Nos. 34-32430, 34-517333, and 34-51252. Additionally, I understand that CBOE has previously interpreted Article Fifth(b) and that the Commission approved such interpretation in Release No. 34-46719. In each of these instances, at the time of the final approval of the proposed rule submissions, there were no disputed state law issues between the CBOE and the CBOT. Here, of course, such disputed issues still exist and are pending in the Delaware Court of Chancery. *See CBOT Holdings, Inc. v. Chicago Board Options Exchange, Inc.,* C.A. No. 2369-VCN (Del. Ch. August 3, 2007).

With respect to the proposed rule change (SR-CBOE-2006-106), I understand that the interpretation of Article Fifth(b) was approved by CBOE's board of directors (the "CBOE Board"). I submit this letter because the CBOE Board's interpretation of Article Fifth(b) in connection with the proposed rule change implicated a number of principles of Delaware law that should be brought to the Commission's attention. These principles were not discussed in the letters submitted on behalf of CBOE to the Commission in support of the proposed rule change. More specifically, the letter submitted to the Commission on behalf of CBOE by Richards, Layton & Finger on January 16, 2007 (the "Richards Letter")[1] stated that "when questions arise as to the application of Article Fifth(b) in circumstances not directly addressed by that Article, it is within the general authority of the Board to interpret Article Fifth(b) so long as in doing so the Board acts in good faith, in a manner consistent with the terms of that Article and not for inequitable purposes." The CBOE Board's action does not meet any of these three prongs, and the Richards Letter does not address them or opine on whether the Board acted properly in light of the standard. Furthermore, the Richards Letter failed to explain the fiduciary duties that the CBOE Board owed to its members or potential members in connection with any such interpretation or the level of review that applies to such an interpretation.

This letter briefly explains certain important concepts of Delaware law and their application to the proposed rule change. First, the CBOE Board owes fiduciary duties to *all* members of CBOE, including the Full Members of CBOT who have exercised their right to become members of CBOE (the "Exerciser Members"), and may owe fiduciary duties to the Full Members of CBOT who hold the right ("Exercise Rights") to become Exerciser Members. These fiduciary duties include the duty to act in good faith, consistent with the terms of Article Fifth(b), and not for any inequitable purpose. Second, when examining whether directors have met their fiduciary duties under Delaware law, directors will not be entitled to the protection of the business judgment rule if a majority of directors have a personal financial interest in the decision. In such circumstances, the directors bear the burden of demonstrating the entire fairness of their decision.

Here, because a majority of the CBOE Board has a material, financial interest in the decision to interpret Article Fifth(b), the CBOE Board bears the burden, under Delaware law, of demonstrating the fairness of its decision.

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[1] Richards, Layton & Finger submitted a second letter to the Commission on June 28, 2007, in response to the Commission's request for an opinion that the change to Article Fifth(b) was not an amendment but an interpretation. This letter, like the January 16 Richards Letter, acknowledged that the CBOE Board's interpretation of Article Fifth(b) must be made "in good faith, consistent with the terms of Article Fifth(b) and not for inequitable purposes." Furthermore, the June 28 letter conceded that in "the event of a legal challenge to an interpretation, the reviewing authority would interpret Article Fifth(b) and would not be bound by the interpretation of the [CBOE] Board."

Fiduciary Duties to Exerciser Members and Holders of Exercise Rights. As noted above, the CBOE Board owes fiduciary duties to the Exerciser Members, and arguably owes fiduciary duties to the holders of Exercise Rights. The Delaware Court of Chancery, in a recent decision in the litigation between CBOT and CBOE, addressed the fiduciary issues raised by the proposed rule change:

> In addition, if the CBOE Board owed fiduciary duties to the Exerciser Members (and arguably others), those duties may well protect the interests of these CBOT members because those decisions which caused the claimed harm to them were made by the CBOE Board while, under any interpretation of the various documents, at least many of the CBOT members were Exerciser Members of the CBOE. In sum, it is not immediately and conclusively obvious why a regulatory act voluntarily (and not necessarily) taken by the CBOE Board can be isolated from the reach of fiduciary duty law, especially when the consequences (great benefits to the Seat Members and great detriment to the CBOT Full Members) were so apparent at the time when the CBOE Board decided to act.[2]

The fiduciary duties owed by the CBOE Board to the holders of Exercise Rights and the Exerciser Members include, by CBOE's own admission, the duty to act in good faith and in a manner that is consistent with the terms of Article Fifth(b), and not to act for any inequitable purpose. The CBOE Board failed to satisfy these fiduciary duties in determining to extinguish the rights of the Exerciser Members and all of the holders of Exercise Rights.

Entire Fairness Standard Applies Where A Majority Of The Directors Have An Interest In The Decision. In determining whether a board of directors has satisfied its fiduciary duties under Delaware law, a board is typically entitled to the presumption of the business judgment rule. If, however, a majority of the directors are not independent or have an interest in the transaction, the directors bear the burden of proving the entire fairness of the transaction or decision. *See, e.g, Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). Under Delaware law, a director is interested in a decision if the director will experience some benefit that is not shared by *all* of the stockholders or members. *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002).

A Majority Of The CBOE Directors Have A Material Interest In The Interpretation Of Article Fifth(b). A majority of the directors serving on the CBOE Board and interpreting Article Fifth(b) are either regular members of CBOE (who stand to benefit

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2 *CBOT Holdings, Inc. v. Chicago Board Options Exchange, Inc.*, C.A. No. 2369-VCN, slip op. at 30 n.48 (Del. Ch. August 3, 2007).

financially from the proposed rule change) or are affiliated with, or beholden to, such regular members. More specifically, 11 of the 23 members of the CBOE Board are CBOE regular members or are affiliated with or employed by regular members, such that they have a significant financial interest in eliminating the rights of the Exerciser Members and those holding Exercise Rights. In addition, CBOE's chairman and CEO is beholden to the regular members because his continued employment with CBOE rests in such members' hands. Thus, 12 of CBOE's 23 Board members are not independent with respect to the decision on how to treat Exerciser Members and holders of Exercise Rights in connection with the Merger.

The CBOE Board recognized that these conflicting personal interests prevented it from making a disinterested decision regarding the treatment of the holders of Exercise Rights in the CBOE demutualization. Because of that recognition and in an effort to satisfy its fiduciary duties, the CBOE appointed a special committee of independent directors to act in place of the CBOE Board in connection with the demutualization of CBOE. The same fiduciary duties that required the formation of the special committee of disinterested directors in the demutualization context should have compelled the formation of such a committee in these circumstances, where the CBOE Board has determined to extinguish the rights of the Exerciser Members and the Exercise Rights through regulatory action. Simply put, a majority of the CBOE directors stood to gain financially from a decision to extinguish those rights (or were beholden to such persons), and, thus, were not in a position to exercise business judgment on the treatment of all Exerciser Members and the holders of Exercise Rights.

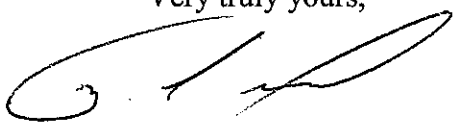
The CBOE Board did not appoint a special committee to interpret Article Fifth(b), nor did it seek independent financial and legal advice for purposes of making its decision. Accordingly, in determining whether the CBOE Board met its fiduciary duties with respect to its proposed interpretation of Article Fifth(b), the CBOE Board must demonstrate that its decision with respect to Article Fifth(b) is entirely fair to all of the members of CBOE, including the Exerciser Members, under Delaware law.

As noted above, Delaware law is clear that the board bears the burden of demonstrating the fairness of its decision in circumstances where the board makes a determination based on its own self-interest. Delaware law is also clear that this fairness requirement applies in circumstances where the Board's decision favors certain groups of stockholders or members with whom the particular directors' interests are aligned. *See, e.g., Oliver v. Boston University*, 2006 Del. Ch. LEXIS 75, at *119 (Del. Ch. Apr. 14, 2006) (holding that allocation of merger proceeds between various stakeholders was unfair and finding that "[m]ore disturbing is that, although representatives of all of the priority stakeholders were involved to some degree in the negotiations, no representative negotiated on behalf of the minority common stockholders"); *In re Tele-Communications, Inc. S'holders Litig.*, 2005 Del. Ch. LEXIS 206 (Del. Ch. Dec. 21, 2005) (stating that "because a clear and significant benefit of nearly $300 million accrued" to board members because of their holdings of Series B common stock "at the expense of another class of shareholders to whom was owed a fiduciary duty," the entire fairness test applies); *In re FLS Holdings, Inc. S'holders Litig.*, C.A. No. 12623, 1993 Del.

Ch. LEXIS 57 (Del. Ch. Apr. 2, 1993) (requiring a board comprised exclusively of directors owning large amounts of common stock or directors who were affiliates of the company's controlling stockholder to demonstrate the fairness of an allocation of consideration that clearly favored the common stock over the preferred stock). Accordingly, the CBOE Board must demonstrate to the Delaware court the fairness of its interpretation of Article Fifth(b) in connection with the proposed rule change in light of the direct financial interest of a majority of the directors serving on the CBOE Board.

This letter is solely for the benefit of CBOT in connection with the matters addressed herein and may not be relied upon for any purpose or by any other person or entity, other than the Commission, without my prior written consent. In the event that you have any questions with respect to this letter, please do not hesitate to contact me at (302) 351-9228.

Very truly yours,



Frederick H. Alexander

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August 16, 2007

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Via E-Mail and U.S. Mail

Paul E. Dengel, Esq.
Schiff Hardin LLP
233 South Wacker Drive
Suite 6600
Chicago, IL 60606

Re: ***CBOT Holdings, Inc. et al v. Chicago Board Options Exchange,*** **Case No. 2369-N**

Dear Paul:

In response to your August 14, 2007 letter, described below is an alternative to the Interim Access Rule that would avoid disrupting CBOE's markets, cover regulatory issues addressed by the Interim Access Rule, and not prejudice CBOE's position. This alternative could take either the form of a stand alone agreement or an agreed order before the Court. It would include a stipulation that the parties reserve all rights in the pending proceedings and two principal components.

First, CBOE would agree to immediately withdraw the Interim Access Rule. In its place, CBOE would simultaneously file an interpretation to CBOE Rule 3.16 in the form enclosed with this letter.

Second, the agreement or order would maintain the *status quo* as of July 1 with the exception that CBOE can collect a monthly access fee from Exerciser Members to be held in escrow pending a resolution of both the court and SEC proceedings and distributed to either CBOE or the Exercise Member (or his or her lessor as the case might be) if the plaintiffs prevail.

The plaintiffs are prepared to put this alternative in place as soon as possible.

Sincerely,

Gordon B. Nash, Jr.

Enclosure

CH01/ 12517156.1

Rule 3.16. Special Provisions Regarding Chicago Board of Trade Exerciser Memberships

(a) *Termination of Nontransferable Memberships.* A nontransferable membership acquired by a person pursuant to Paragraph (b) of Article Fifth of the Certificate of Incorporation shall terminate (i) upon receipt by the Membership Department of written notice from the person that the person is surrendering the membership or (ii) at such time that the person is no longer entitled to membership on the Exchange in accordance with Paragraph (b) of Article Fifth of the Certificate of Incorporation. Notice of each such termination shall be published in the Exchange Bulletin.

(b) *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 September 1, 1992 (the "1992 Agreement") between the CBOT and the Exchange, and in the Agreement entered into on December 17, 2003, ("the 2003 Agreement") between the CBOT and the Exchange, in the Agreement entered into on August 7, 2001, ("the 2001 Agreement") between the CBOT and the Exchange as amended and supplemented by the Letter Agreement among CBOT Holdings, Inc., CBOT and the Exchange entered into on October 7, 2004, and by the Letter Agreement among CBOT Holdings, Inc., CBOT and the Exchange entered into on February 14, 2005, as further interpreted in accordance with that certain proposed rule change filed with the Securities and Exchange Commission as File No. SR-CBOE-2002-41, 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 1992 Agreement, and solely for such purpose, the Exchange 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 the Exchange 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 the Exchange gives notice to the CBOT pursuant to Paragraph 3(b) of the 1992 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 1992 Agreement) for whom dues, fees and other charges and qualification requirements are waived in accordance with the foregoing shall have any rights as a member of the Exchange other than to participate in such offer, distribution or redemption, and (ii) the membership on the Exchange of each such Exerciser Member shall terminate immediately following the time such individual participates in such offer, distribution or redemption.

Amended October 8, 1976; April 23, 1978; December 12, 1978; June 2, 1980; October 28, 1987 (87-23); June 8, 1993 (92-42); July 19, 2000, effective August 18, 2000 (99-15); July 29, 2002 (02-41); July 15, 2004 (04-16); May 24, 2005 (05-19).

... Interpretations and Policies:

.01 This interpretation and policy is temporarily adopted to avoid any uncertainty respecting the membership status of a person who acquired a membership pursuant to Paragraph (b) of Article Fifth of the Certificate of Incorporation. The term "member of the Board of Trade of the City of Chicago" (the "CBOT"), as used in Article Fifth(b), will be interpreted as provided in this Rule 3.16, except any requirement that such person own shares of CBOT Holdings, Inc. shall be interpreted to require that such person hold the number of shares of Chicago Mercantile Exchange Holdings, Inc., exchanged for the 27,338 CBOT Holdings, Inc. shares previously required to be held by such person. If any such person took action in reliance on Interpretation.01 of Rule 3.19 and would be disqualified as a result of that good faith reliance on Interpretations and Policies .01 to Rule 3.19 (Amended August 3, 2007 (07-91)), such person may retain his membership status for thirty days to enable him to obtain a membership a substitute nominee, or a substitute person to register his or her membership for the member, as applicable, all in accordance with Rule 3.19.