March 8, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: File No. S7-40-04

Dear Mr. Katz:

The Chicago Board Options Exchange, Incorporated ("CBOE") is pleased to present its comments on issues raised in the Commission's Concept Release Concerning Self-Regulation (Release No. 34-50700, referred to herein as the "Concept Release"). As the Commission notes in the Concept Release, questions have arisen recently concerning the efficacy of self-regulation in response to the many major changes in the structure, ownership and operation of U.S. securities markets that have taken place. Some of the recent structural changes that have the potential to impact self-regulation are the result of the Commission's decisions to permit self-regulatory organizations ("SROs") to organize as for-profit corporations and to demutualize so as to be owned by stockholders who are not necessarily members of the SROs. Other changes to securities markets cited in the Concept Release as bearing upon self-regulation are that in recent years securities markets have become increasingly electronic and in some cases are now structured as electronic communications networks that are not SROs and that rely on other SROs for their regulation. Some of the regulatory issues that have recently been identified may be seen to raise a question whether the conflicts that have always been inherent in self-regulation are perhaps having a greater impact in light of these structural and operational changes affecting securities markets.

As described below, CBOE does not think a proper response to recent changes in the structure of SROs or to recent regulatory issues should be for the Commission to propose and adopt rules that would have the effect of eliminating self-regulation of securities markets entirely, or making radical changes to the way in which self-regulation operates. Rather, we strongly believe that the Commission should await the adoption of its proposed new rules concerning the governance, administration, ownership, structure and reporting requirements of SROs, and evaluate the impact of these new rules on SROs. Many SROs, including CBOE, also have implemented significant changes to their governance structure and practices in recent years to help assure that the SRO acts consistent with its self-regulatory obligations. We strongly believe that the SEC should evaluate the changes that SROs have made and assess their impact on self-regulation. Below in this letter we will present our reasons for believing that now is not the time for the Commission to discard or radically change the way in which self-regulation operates in U.S. securities markets. Following this, we will address several of the broad issues raised in the Concept Release. We will not respond to each of the separate questions identified in the Concept

Release, but we will present our views on those matters that most directly affect our exchange and where we believe our views may be helpful to the Commission.

The Commission Should Not Act to Discard or Radically Change Self-Regulation at this Time.

Preliminarily, we note that self-regulation is a cornerstone of securities markets regulation, and its removal or drastic alteration would impact the entire fabric of federal securities regulation. Given the extent to which self-regulation is embedded in the Securities Exchange Act of 1934, any attempt to alter substantially the SRO structure would necessitate a far-reaching statutory review by Congress as well as by the Commission. Recent structural changes to securities markets that may impact the conflicts of interests inherent in self-regulation do not alter this reality. Indeed, at the time the Exchange Act was adopted, Congress recognized that self-regulation inherently involved conflicts between the public interest in having honest and well-regulated securities markets and exchange members' self-interest in avoiding what some of them may characterize as excessive regulation. At the same time, by choosing self-regulation as the model for the regulation of securities markets, Congress demonstrated its belief that, with appropriate safeguards, self-regulation could lead to better regulation of securities markets by permitting the specialized knowledge and experience of those closest to the markets to be brought to bear on the complex problems of how best to regulate them.

Clearly, among the safeguards embedded in SRO regulation has always been the role of the Commission as overseer of SROs (the "well-oiled shotgun behind the door"). This includes the Commission's rule-making authority to adjust and fine-tune the process of self-regulation as needed in response to changes in markets and newly identified problems. In fact, in Release No. 34-51019 (the "Governance and Transparency Release") the Commission recently proposed a number of new or revised rules in response to some of the very same structural changes and issues that are cited in the Concept Release as reasons for considering more fundamental changes to self-regulation. We agree that it is appropriate for the Commission to adjust certain of its rules applicable to SROs in light of changed circumstances and needs, and for the most part, we support many of the rule changes recently proposed by the Commission in the Governance and Transparency Release for this purpose.[1] Such changes, however, are many steps removed from a paradigm shift in the way in which self-regulation applies to the securities markets.

This brings us to the second, and perhaps most important, reason why we believe now is not the time for the Commission to propose eliminating or radically changing the way in which self-regulation applies to securities markets. The SEC separately has proposed an extensive array of new or revised rules to address perceived shortcomings in SRO operation. While we have concerns with some of these proposed rules, overall, CBOE supports these proposed changes and believes they will enhance exchange governance structures and practices so that they serve to protect investors and the public interest and assure that exchanges act consistent with their self-regulatory obligations and be effective regulators. It is possible that many of these proposals will be adopted and implemented this year. Given this reality, we question the wisdom of making the kinds of major changes that are discussed in the various approaches of the Concept Release until after the Commission's newly adopted or revised rules governing the governance, ownership, structure and reporting requirements applicable to SROs have been in effect for a sufficiently long time to enable their impact on perceived regulatory problems to be evaluated, as well as the enhancements exchanges have made independently. Once these new rules have been evaluated, if further changes are deemed necessary, the Commission would be able to propose and adopt

[1] See letter from William J. Brodsky to Jonathan G. Katz, dated March 8, 2005, presenting CBOE's comments on rule proposals set forth in Release No. 34-51019.

additional rule changes within its authority or, if more radical changes are believed to be called for, it could suggest legislation for this purpose.

Many of the Perceived Problems of Self-Regulation May be Addressed in Ways that Permit the Benefits of Self-Regulation to be Preserved.

The fact that certain conflicts are inherent in self-regulation does not justify either eliminating self-regulation altogether or changing it in ways that significantly reduce its benefits. Instead, a better approach is to take steps to mitigate these conflicts in ways that permit the benefits of self-regulation to be preserved. We believe that the Commission's proposed rulemaking concerning the governance, administration, ownership and reporting of SROs is an appropriate step to address the conflicts inherent in self-regulation. CBOE agrees with the general proposition contained in the rules release that diversity of Board and committee representation is an appropriate way to address the conflicts presented by self-regulation. These proposed rules should have an opportunity to work before the more radical approaches in the Concept Release are pursued.

Another important factor in responding to the conflicts inherent in self-regulation while retaining its benefits is the oversight role that the Commission has always played as a critical element of self-regulation. The Commission's recent proposals intended to strengthen its oversight role, such as requiring greater transparency of SRO regulatory efforts by imposing new reporting requirements on SROs, should help to preserve self-regulation and the realization of its benefits in the face of its inherent conflicts. We must observe, however, that in the area of evaluating SRO regulatory expenditures, while the total amount of money spent by an SRO on regulation may be one of many factors that should be taken into account in evaluating whether the SRO has met its obligation to regulate its market and its members, this one factor should not be given undue emphasis over others, so that SROs lose all incentive to be more efficient in the way in which they regulate. The ultimate test should be the effectiveness of each SRO's regulatory program, and if an SRO is able to provide more effective regulation for less money, it should be credited, not criticized, for that accomplishment.

Beyond its important oversight role, we believe there are other steps the Commission could take in order to improve the quality of self-regulation. One such step would be for the Commission to make available to all SROs clear written statements of the standards and best practices that it believes should apply to specific regulatory matters across all markets whenever it concludes that such clarification is called for. In our view, too often there have been disparities in the way in which certain regulations are applied from one exchange to another because of the absence of clear guidance from the Commission. We believe that if the Commission were to make its views known on such matters to all SROs in a clear and consistent way, and to do so promptly upon a determination that a need for such guidance is needed, SROs would have a better understanding of what is required of them and would be in a better position to regulate their markets and their members accordingly.

Multiple SROs.

We believe that the existing model of multiple SRO's, each responsible for regulating its own market, has for the most part well served the objective of sound regulation. This model has permitted the specialized knowledge that each SRO has concerning its own unique rules and procedures to be brought to bear to the regulation of its market. It also fosters competition in the development of new, more efficient, regulatory systems, which also benefits the overall quality of regulation. On the other hand, we agree that the existence of multiple SROs can result in unequal

regulation across markets. CBOE also recognizes that requiring each SRO to build and maintain its own regulatory systems and programs may result in unnecessary duplicative costs and other inefficiencies.

Nonetheless, in balancing the pluses and minuses of multiple SROs, we believe that the best answer is not to delegate market regulation to a sole or "single member" self-regulator that would be independent of, and would not be involved in the operation of, any market. While the delegation of regulatory responsibilities to such a sole self-regulator might well avoid some of the problems cited in the Concept Release that result from the dual role of multiple SROs as regulators and operators of markets, the cost of following this approach would be to destroy the major advantage of self-regulation through multiple SROs. That is, to assure that persons involved in the regulation of securities markets are close to the markets they regulate and therefore have an in-depth understanding of their rules and the ways in which they and their members operate.

To address concerns relating to duplicative costs and operational inefficiencies, CBOE believes that there are a number of tools already in place which SROs can and do utilize to reduce costs and promote efficiency, such as SEC Rule 17d-2 agreements which are used by SROs to allocate regulatory responsibility with respect to common members. However, and as noted above, CBOE believes that one of the best tools to reduce the likelihood of unequal regulation from one SRO to another due to conflicting SRO rules and rule interpretations is for the Commission to provide clear and prompt guidance to SROs concerning how regulations should be applied and interpreted.

With respect to CBOE's experience with the development and use of the Consolidated Options Audit Trail System ("COATS") that it recently developed with the other options exchanges, CBOE believes that it is too early to assess its effectiveness in enhancing inter-market surveillance by SROs. However, CBOE believes that in developing and deploying such systems, care should be taken to avoid any unintentional impact of these systems on the competition among different types of markets.

<u>SROs Should be Free to Develop Their Own Fee Structure to Fund the Cost of Their Operations, Including Regulatory Costs.</u>

For the most part, we find no need for the Commission to be more involved in regulating the various fees and charges imposed by SROs upon their members and users of their markets than is currently required under the filing and approval requirements of Section 19(b) of the Exchange Act. Instead of greater Commission involvement in fee-settting, we believe existing vigorous competition among SROs may be relied upon to assure the reasonableness of SRO fees and charges. One exception to this is where there is no competition because SROs are permitted to act jointly to establish fees for access to specific SRO services, such as the market data fees charged by NMS facilities such as CTA/CQ and OPRA. Here, SROs, in effect, are permitted to act as lawful monopolies, and it is appropriate for the Commission to exercise greater oversight to assure that this monopoly power is not abused. However, in considering the reasonableness of market data fees charged jointly by SROs, we strongly believe the Commission should take into account not only the direct costs involved in the collection, consolidation and dissemination of market data, but also the costs of operating and regulating each SRO's respective market. Since the value of market data depends on the quality and integrity of the markets in which the data is generated, it is entirely fair and reasonable that a portion of the costs incurred in operating and regulating these markets should be borne by persons who benefit by having access to market data. Otherwise, these costs would have to be covered in their entirety by members and other users of

SRO markets, and users of market data would get a "free ride". Although new or newly demutualized for-profit SROs may have an incentive to look to market data fees as a source of profit, the enhanced transparency of the entire fee and expense structure of SROs proposed in the Governance and Transparency Proposal should provide the Commission with the tools it needs to assure that the misuse of market data fees does not take place.

In summary, CBOE does not believe that the SEC should fundamentally change the manner in which self-regulation applies to the securities markets. Rather, in light of the significant and comprehensive nature of the rules the SEC is proposing concerning the governance, administration, ownership and reporting obligations of SROs, CBOE strongly recommends that the appropriate course of action at this time is to await the adoption of these proposed rules and assess their impact on self-regulation, as well as the governance enhancements exchanges have made on their own initiative. Separately, the SEC should encourage SROs to establish joint and coordinated regulatory efforts where it makes sense to reduce unnecessary costs and inefficiencies. CBOE looks forward to working with the SEC Commissioners and SEC staff on these important issues of self-regulation. In the meantime, if you have any questions on points raised in CBOE's response, please contact Joanne Moffic-Silver, CBOE's General Counsel, at (312) 786-7462, or me.

Sincerely,

William J. Brodsky
Chairman and Chief Executive Officer

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation
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