

Information Circular IC04-110

August 6, 2004

Dear CBOE Member,

CBOE concluded its final July-to-June fiscal year on June 30. Going forward, CBOE will transition to a calendar year planning period with the fiscal year's end in December. For accounting purposes, the next six months will be treated as an abbreviated fiscal cycle in order to make the transition from the July to January cycle. The next complete fiscal year will begin January 1, 2005.

As we close the books on the 2004 fiscal year, we would like to take a moment to brief you on where that year has taken us, and more importantly, where CBOE will go from here.

Equity Options

Competition continues to grow in the options marketplace, where market share in equity options is increasingly determined by two factors: ease of access and payment for order flow. The rapid growth of the ISE is a vivid case in point. As of the end of July 2004, ISE's equity market share had climbed to 37 percent, while CBOE's market share in all equities traded stands at 25 percent.

CBOE's market share has begun to stabilize, however, after declining steadily since the suspension of payment for order flow (PFOF) fees in 2001 and the expansion of the ISE's listings in 2001. The headway we have made recently is a direct result of the efforts taken by CBOE members and staff to rebuild CBOE's competitive position.

Major initiatives included the implementation of HyTS terminals and the rollout of the Hybrid Trading System, which have provided users with the new tools to access our markets and liquidity, and the reinstatement of an exchange-wide plan for PFOF.

There are now 950 classes active on the Hybrid; about half of the volume in Hybrid classes is traded electronically and half is traded on the floor. We are pleased to report that the implementation of Hybrid trading, which began 14 months ago, has resulted in

generally tighter and deeper markets at CBOE. More importantly, we are now prepared to build upon the foundation provided by the Hybrid.

Despite significant steps forward, competitive vulnerabilities still remain between CBOE's trading platform and those of some competitors. Member committees are actively working to address these shortcomings in our market model.

CBOE recently took a major step forward in this ongoing initiative by making all options market makers, both here and away, eligible for access to automatic execution. For some time, CBOE members themselves have enjoyed similar access at the ISE. The development of a one-size-fits-all marketplace at CBOE, with increased access for members and non-members alike, makes it possible to repatriate some of that business to CBOE.

A new PFOF program was initiated in order to empower CBOE market makers to compete for order flow lost to our competitors. Although the CBOE has been extremely vocal in opposing the practice of PFOF, and we have petitioned the SEC on numerous occasions and in many forums, the practice continues to be sanctioned by the SEC. Absent any changes in SEC policy, implementation of a new payment plan at CBOE has become a competitive necessity. We will continue to modify the program to stay competitive.

It appears that the SEC will continue to allow internalization, as with PFOF, to continue in the options markets. Internalization became a more immediate competitive threat this year with the entrance of the BOX (Boston Options Exchange) into the options market. The BOX market share of 2% is not insignificant given it just began trading in February '04. BOX's price improvement program (PIP) and open trading model are designed to facilitate internalization. CBOE, through member committees, is in the midst of developing a response to internalization that will retain the integrity of the CBOE marketplace.

The importance of closing these competitive gaps cannot be overstated. Market share is not the end game, but it is a measure of how effective we are, relative to our competitors, in addressing the needs of our customers. It is also a tremendously significant benchmark for ranking the exchanges, which directly impacts order flow decisions. Volume represents opportunities for profit, and volume begets volume. We will continue to attract order flow so long as we respond to the needs of our customers. Our aim is to remain the marketplace of choice, for as many customers as possible, thereby creating more business and profit opportunities for more CBOE members. The rollout of Hybrid 2.0 is CBOE's next major initiative toward reaching that goal.

Hybrid 2.0

Hybrid 2.0 expands the benefits of the Hybrid Trading System by enabling a wider range of market participants to access the system. Hybrid 2.0 enables a new class of

membership -- electronic-Designated Primary Market Makers (e-DPMs) -- to stream quotes electronically from any location. The addition of this new membership class makes CBOE the first options exchange to employ competing electronic DPMs (i.e., specialists). The following firms were named e-DPMs by the Special Appointments Committee:

Citadel Derivatives Group LLC
Citigroup Global Markets
Knight Financial Products LLC
SLK-Hull Derivatives LLC

Susquehanna Investment Group
Timber Hill LLC
Wolverine Trading LLC

We have high expectations for these new partners. The added liquidity and business that the e-DPMs bring to CBOE will only serve to enhance the profit opportunities of our members.

In the next phase of Hybrid 2.0, CBOE will seek regulatory approval for our own members and member firms to become Remote Market Makers (RMMs), a designation created for those individuals and organizations wanting to operate as solely off-floor market makers. In its proposal to the SEC, CBOE will seek to consolidate the RMM quotes with those of CBOE's e-DPMs and in-crowd market participants to create a more robust marketplace with deep liquidity. The Hybrid format will continue to accommodate orders directed for open-outcry execution, thus providing our floor members with trading opportunities on the traditional platform. Implementation of the RMM phase of Hybrid 2.0 is subject to regulatory approval by the SEC.

The rollout of Hybrid 2.0 goes a long way toward addressing our competitive challenges, but we must be prepared to make further adjustments as we continue to move ahead. The Hybrid system was designed so that CBOE could respond to a rapidly changing environment, and we must be prepared to employ that flexibility when required.

Index Options

CBOE's index options complex has come under attack in a "war of words" waged by other exchanges. Our competitors have taken their grievance -- that exclusively licensed index options should be multiply listed -- to the press and to the SEC in the form of petitions.

These protests however, ignore the intellectual property rights of the *owners* of the indexes, such as Standard & Poor's and Dow Jones, as well as the fact that there is already strong competition within our own marketplace between CBOE members and other market participants who trade these products.

Furthermore, CBOE created the index option concept, nurtured and marketed these products and educated our customers; CBOE members took the risks and made markets when these products were still unknown. We are philosophically opposed to the type of "cherry picking" advocated by those who seek to capitalize on a successful product

offering without paying the price of innovation, and we will vigorously defend and protect our legal rights. Ultimately, we believe such piggybacking on the success of others is a disincentive to the type of innovation that best serves our customers and our markets.

While the SEC thus far has been reluctant to entertain this issue in a formal way, at this year's Options Industry Conference, Annette Nazareth, the SEC's Director of Market Regulation, stated it was "the strong preference of the SEC that all options be multiply listed." Notwithstanding the legal arguments as to whether the SEC is legally empowered to impose such a standard, we must be prepared for any eventualities.

If our competitors cannot successfully argue for multiple listing of exclusively licensed index option products, they could certainly attempt to launch options on so-called "copy cat" indexes in an effort to win order flow. Although index option customers would be reluctant to abandon the deep liquidity of CBOE's established index options markets, they have also expressed a clear preference for increased electronic access. We must respond to these customers by offering index options on our Hybrid platform, *before* a competitor offers them an electronic alternative.

Members and staff are working to determine the optimum course to introduce Hybrid trading of CBOE index products. Time is of the essence: if we do not provide index products designed to trade on the current market models preferred by our customers, someone else will.

While the Hybrid Trading System provides a base for this initiative, it does not necessarily mean that the current model used to trade equity options is readily transferable to the index products. We are examining all opportunities open to CBOE, including the introduction of new, specially constructed index products to the Hybrid. One fact is certain; to ignore this issue is not an option.

CBOE Futures Exchange

The CBOE launched its new all-electronic futures exchange, the CBOE Futures Exchange, LLC (CFE), on March 26, 2004 with futures on the VIX[®]. We are pleased with the early success of the new exchange. Currently, VIX futures are averaging approximately 425 contracts daily. Variance futures got off to a slower start, but are expected to gain traction through our marketing and educational efforts.

On August 4, 2004, CBOE filed a motion to dismiss the lawsuit previously filed in Chicago by the Chicago Mercantile Exchange (CME) alleging that the CFE's listing of VIX and Variance futures, pursuant to a license granted by S&P, violated a license that CME previously obtained from S&P. On August 3, 2004, S&P filed suit in New York seeking a court ruling that CME's license from S&P does not include the right to trade VIX and Variance futures and to prohibit CME from trading those products.

Seat Sales and Exercise Rights

The stabilization of CBOE's market share and the anticipated benefits of Hybrid 2.0 have contributed to a marked increase in the value of CBOE seat prices, now up over 100 percent from their lows in December 2002.

The SEC has approved our rule filing, which will allow CBOT to separate the exercise right from the full CBOT membership so that CBOE can implement its tender offer. In order to exercise and become a member of CBOE, a CBOT member will continue to be required to be in possession of a CBOT full membership and an associated exercise right privilege. We are preparing both the purchase offer and bank loan documents and expect to implement the offer later this month.

National Stock Exchange (NSX)

CBOE is currently engaged in discussions to reduce our two-thirds interest in the NSX. The details of the sale are nearly complete and we hope to complete the transaction in the near future.

Financials

A fiscal year-end audit is still in progress, but the preliminary totals are as follows. CBOE saw volume in excess of 1.3 million contracts per day this fiscal year. Member fee reductions were in excess of \$7 million. After these refunds, CBOE had a pre-tax profit of around \$3 million at the end of the fiscal year. CBOE had approximately \$38 million in working capital at the end of the fiscal year, up from \$30 million at the beginning of the fiscal year. There was no debt at fiscal year-end.

Regulatory Update

CBOE takes its regulatory obligations seriously, and we are committed to maintaining an effective regulatory program to protect our marketplace. Members should realize that CBOE must continue to meet considerable competitive pressures while operating in a challenging regulatory environment that demands increased automation, resources and structural changes.

Since the NYSE's regulatory problems and other high-profile regulatory matters were made public in 2003, we now face a totally different regulatory environment than we were in just one year ago. The SEC has pressed for all self-regulatory organizations (SROs) to review and update their systems and to implement new initiatives for more stringent regulation and enforcement.

Governance

Long before governance and regulatory issues surfaced at the NYSE, CBOE instituted policies and reforms to ensure that its governance structure meets the highest standards of ethical conduct and integrity. Significant steps were taken to institutionalize checks and balances, and to eliminate the potential for conflicts of interest. The SEC views these changes, which were approved by the CBOE membership, as very positive steps.

Based on a member vote in 2002, the composition of the CBOE Board of Directors is equally balanced between 11 public directors and 11 member directors, plus the chairman of the Exchange. Last year it was decided that a public director would be appointed Lead Director, and that the Board would meet at least once per quarter without Exchange management present.

CBOE also created a Regulatory Oversight Committee comprised solely of public directors, a Governance Committee, chaired by a public director, and a Nominating Committee that includes two public representatives. Public representation on the Business Conduct Committee was increased from one to three members, and an internal auditor was retained to perform regular audits of our regulatory activities. Public directors also chair CBOE's Audit Committee and Compensation Committee and these committees maintain a balance of at least 50 percent public directors.

The SEC continues to request more information about how exchanges operate and, in that regard, CBOE will make and issue an annual financial disclosure document similar to public companies. The disclosure will be issued in the fall, and will include compensation data for the top five executives at CBOE.

Market Structure

On the Washington front, CBOE continues to monitor congressional hearings on the need to reform the U.S. capital market structure. The hearings have focused on exchange governance and regulatory roles, reforms to promote competition, reform efforts at the NYSE and the role of the NYSE specialist system, changes in trade-through rules, market access fees, market data and sub-penny quoting. Not only do the stock market issues currently under review have obvious implications in terms of hedging for options traders, but also it is anticipated that a similar congressional review of the options markets will follow. We will continue to monitor these hearings for issues of interest to CBOE members and to prepare for subsequent reviews of the options industry.

Moving Forward

The past few years were marked by fierce competitive assaults on CBOE, and we were called upon to make important competitive decisions and implement difficult changes. Our membership, challenged like never before, responded by virtually reinventing the

way that options are traded at CBOE. The Hybrid system is transforming our market model into the most innovative trading platform in the industry. CBOE will continue to meet its challengers head on. Together, we can respond to the challenges of the day with the same innovative spirit that has defined the CBOE for the past 31 years.

We welcome your comments, questions and suggestions.

Sincerely,

Bill Brodsky

Ed Tilly

Ed Joyce

CBOE now has a weekly e-mail letter to members. Contact the Membership Department at members@cboe.com and register your e-mail address to receive *Member E-News*.