



Information Circular IC06-11

January 19, 2006

Dear CBOE Member,

On September 14, 2005, the Business Model Task Force formally recommended to the Board of Directors that CBOE transition to a for-profit model citing the need for the Exchange to operate more efficiently and with greater strategic agility. The Board endorsed the Task Force recommendation, effective January 1, 2006.

CBOE's conversion to a for-profit model ultimately will impact every aspect of our business, from how we make strategic decisions to how we conduct day-to-day operations at CBOE. We are not only embarking on a new business model, but on a new philosophy. The decision to go for-profit reaffirms the goal of unlocking value for seat *owners* and recognizes the importance of members who are not seat owners as *customers* who *choose* to bring their business to CBOE. In the near-term, revenue and expense budgets will reflect the move to a for-profit model, and organizational changes will be implemented to manage the transition.

As part of the preparation for CBOE's for-profit transition, the Floor Directors Committee and the Board of Directors reviewed CBOE's decision-making processes, including the committee structure. While member committees have made invaluable contributions to the Exchange throughout its history, it was determined that the overall number and size of committees should be reduced in order for CBOE to respond more quickly and effectively to increasingly agile competitors. As a result, the number of committees for 2006 will be reduced from 39 to 21, with the remaining committees, or in some cases, Exchange staff, assuming the duties of discontinued committees. Our goal is to preserve membership expertise and participation, while streamlining the size and focus of the committee structure.

The ability of CBOE as an institution – its members, staff and Board – to change and to compete has defined its success for more than 30 years. We ask now for your continued support as we embark on what will undoubtedly be an era of great historical significance for CBOE. The transformation to a for-profit entity will enable us to better focus

CBOE's resources and to operate more efficiently, but we cannot get there without a shared vision and a collective effort. More specific goals and objectives for CBOE as a for-profit entity will be presented at the January 26th Board meeting, and a meeting of the membership will follow on February 1st.

The remainder of this letter summarizes the progress made at CBOE in 2005. We anticipate more frequent member communications during our ongoing for-profit transition, and urge you to register your e-mail address at members@cboe.com if you have not already done so. Due to increased communications and the high costs associated with printing and mailing hard copies of letters, **CBOE will no longer mail hard copies of these letters to the membership.** This letter will be the last of its type to be mailed to CBOE members; **subsequent letters will be sent through e-mail only.**

2005 RESULTS

Seat Prices

CBOE's seat market rebounded strongly in 2005. The market for seats was very active -- 104 seats traded in 2005, up from 66 in 2004 -- and the price of seats rose dramatically. After the first transaction of the year, when a seat traded for \$299,000 on January 6th, seat prices began a rapid ascent and reached record levels midway through the year. A July 18th seat sale of \$755,000 established a new record price, surpassing the previous record price of \$750,000 set on March 11, 1998. Prices continued to set new record levels for the remainder of 2005, culminating with the year's final seat transaction on December 20th when a CBOE seat sold for an all-time record \$875,000.

Volume and Market Share

2005 was a year for the record books at CBOE. Exchange-wide volume was up 30 percent over 2004, the previous record year at CBOE, and dozens of records were set in individual products. Our index complex drove most of the overall gains.

On the market share front, after nearly two years in which CBOE and ISE were in a virtual tie for overall market share, CBOE pulled ahead in 2005 and ended the year leading the ISE by one percentage point. In a game now measured in inches, CBOE's single-point gain represents the sustained efforts of the entire membership and staff on a number of key competitive fronts.

Index and ETF Options

Trading in index and ETF options reached 192 million contracts, up 41 percent over 2004's record totals. Several of CBOE's individual index and ETF options also set new annual records, including SPX, NDX, RUT and IWM options.

The surging demand for SPX options, which averaged 285,000 contracts per day in 2005, up 45 percent from 2004, could not have been met without the deep liquid markets provided by the SPX trading crowd. While market conditions favored the growth of CBOE's premier index product, increased trading in SPX options also grew as a result of trading in VIX futures on the CBOE Futures Exchange. In 2005, hedging transactions

related to VIX futures generated volume of more than 3 million SPX contracts. (CBOE will begin trading VIX options on February 24, 2006.)

Also influencing SPX options volume in 2005 was the popularity of CBOE's S&P 500 BuyWrite Index (BXM). BXM is a benchmark index that measures the performance of a theoretical portfolio that writes covered SPX options each third Friday of the month against a portfolio of stocks in the S&P 500 Index.

While buy write, or covered call writing, strategies are not new, the BXM for the first time provided investors with a quantifiable benchmark for their performance. At the start of 2005, some \$9 billion had been raised by buy write funds that use the BXM strategy. By year's end, there were more than \$20 billion in 30 such funds. CBOE was the catalyst for the creation of this revolutionary index concept. The May 16th issue of *Pensions and Investments*, a leading publication for institutional investors, cited the BXM as fueling the growth of buy write strategies, and in particular, strategies that involve writing SPX call options against stocks included in the S&P 500. CBOE's role in the development of this index concept, and the subsequent popularity of the buy write strategy, was also noted.

Due to customer demand for similar performance benchmarks, CBOE and Dow Jones created the CBOE DJIA BuyWrite Index (BXD) to measure buy write strategies using the DJX and the CBOE DJIA Volatility Index (VXD) to measure the volatility of the widely followed DJIA Index. Both are based on Options on The Dow, traded exclusively at CBOE. (VXD futures are now offered on the CBOE Futures Exchange). CBOE also introduced the CBOE Nasdaq-100 BuyWrite Index (BXN) in 2005. We look forward to even greater growth in our index products with the introduction of these benchmarks.

In other index product developments, CBOE introduced two retail-friendly products in the form of reduced-value options in 2005. **Mini-Russell 2000 Index Options (RXN)**, based on 1/10th the value of the Russell 2000 Index (RUT), were introduced in January 2005; and **Mini S&P 500 Index Options (XSP)**, based on 1/10th the value of the S&P 500 Index were launched in October. Both products, which trade on the CBOE Hybrid Trading System, were formulated in response to investor demand for smaller index options that can be accessed electronically.

CBOE also witnessed dramatic growth in ETF options in 2005. In January, CBOE began trading options on the **S&P 500 Depositary Receipts (SPDRs)** and ended the year leading all other options exchanges with a 38 percent market share. Options on the **Russell 2000 ETF (IWM)** also experienced tremendous volume, growing by 229 percent in 2005. CBOE dominated trading in **Diamond (DIA) options** – which began trading on the Hybrid Trading System in June 2005, and were multi-listed in September – and narrowed the gap with the ISE in **Nasdaq-100 ETF (QQQQ) options** trading.

Equity Options

CBOE's equity business also thrived in 2005. Volume averaged 1,093,837 contracts per day, an increase of 23 percent over 2004's levels. Competition among options exchanges continued to intensify, but CBOE halted its decline in equity market share to ISE during

2005 with a series of trading enhancements, including the rollout of remote market makers, advanced spread order handling, directed order capability and a revised payment for order flow plan.

RMMs

On April 26, 2005, the Exchange's 32nd anniversary, CBOE launched its **Remote Market Maker (RMM) Program**. Currently a total of 606 classes, including QQQQs, SPDRs, XSP and DIA are open to RMMs; 65 firms are registered as RMMs, and 51 are actively quoting. RMMs currently use 219 memberships and account for 23 percent of Hybrid trading volume. The RMM program has greatly expanded CBOE's traditional user base, and the consolidation of off-floor RMM quotes with those of e-DPMs and in-crowd market participants has resulted in deeper, more liquid CBOE markets.

Directed Order Program

In October 2005, CBOE expanded its "Preferred DPM" program, which enabled DPM and e-DPM firms to participate in the order flow they brought to CBOE, to include any market maker quoting in a targeted class. The program now called "**Preferred Market Maker**" is available in all equity classes, plus all multiply listed index and ETF classes. Firms are increasingly using the program to concentrate their business at CBOE, and the program is credited with an uptick in customer market share in 2005.

Spreads and Complex Order Book

The growth of the complex order business in 2005 cannot be overstated. CBOE's business in complex orders increased from 17 percent of equity contracts in January to 20 percent of the equity contracts traded in December. CBOE has developed new trading technology to meet the needs of spread traders in the form of the Complex Order Book (COB), launched in 2005, and the Complex Order Auction (COA), which will be launched in early 2006, pending regulatory approval. These enhancements will provide complex orders with an electronic experience that reflects the virtues of the Hybrid – access to CBOE's liquidity with point-and-click functionality.

Payment for Order Flow

At its December 8th meeting, CBOE's Board of Directors approved a plan to revise CBOE's payment for order flow program in order to counter a PHLX plan, which had begun to win equity option business away from CBOE. Very preliminary results show CBOE beginning to recapture customer market share that had been rerouted to PHLX. We will continue to closely monitor the effectiveness of this program.

Update on Challenges to Proprietary Products

On September 1, 2005, the U.S. Court Southern District of New York dismissed claims that ETFs, or options on ETFs, were subject to a property right. The court also lifted a restraining order that had prevented ISE or any other exchange from listing or trading options on Diamonds without a license and denied Dow Jones' request for a preliminary injunction against such activities. In a related matter, Standard & Poor's sought to enjoin ISE from listing or trading options on S&P Depositary Receipts (SPDRs). The judge dismissed the complaint, finding that S&P did not have a protectible interest in those ETF

options. These two cases were consolidated by the court and heard as one. The rulings, however, do not apply to options on cash-settled indexes, which were not under consideration by the court.

Dow Jones and S&P/McGraw-Hill have appealed, and the appeals are currently pending before the U.S. Second Circuit Court of Appeals. CBOE filed an amicus brief in support of the appeals, and we remain vigorously committed to protecting our intellectual property, our licensing agreements, and our contract rights. We will keep you apprised of further developments.

CBOE Futures Exchange (CFE)

CFE launched 22 new contracts in 2005: Russell 1000, Mini-Russell 1000 and 2000 index futures, twelve PowerPack futures, Dow VIX futures and six Gas-at-the-Pump futures. Total volume at CFE was 177,046 contracts, up from 88,194 contracts traded in 2004. The bulk of CFE volume and open interest was generated by the VIX futures contract.

OneChicago

Volume at OneChicago, the single-stock futures joint venture of CBOE, CME and CBOT, increased throughout 2005, but is still falling short of breakeven. OneChicago continues to search for a strategic partner who will provide additional funds for the continued operation of the exchange and enhance its overall success.

National Stock Exchange (NSX) Update

NSX has entered into an agreement with CBOE to purchase most of CBOE's ownership in the NSX. NSX will ultimately buy back 153 of the 162 NSX certificates owned by the CBOE for \$11 million. CBOE will retain nine certificates representing 10 percent of the outstanding certificates. The transaction is scheduled to be completed over four years. At the initial closing on January 18, 2005, NSX purchased 69 of the 153 certificates for \$5 million. Over the next four years, NSX will pay CBOE \$1.5 million per year for an additional 21 certificates each year, providing NSX meets certain minimum working capital requirements. As CBOE's ownership of NSX is reduced, CBOE's representation on the NSX Board of Directors will be reduced as well.

Disaster Recovery

In December, CBOE completed the first phase of the creation of CBOE's all-electronic remote disaster recovery site. Phase one included the development and staffing of a site to provide next-day trading capability for CBOE exclusively-listed products.

Washington Update

On November 17th, CBOE Chairman and CEO Bill Brodsky testified on "Self Regulatory Organizations: Exploring the Need for Reform" at a hearing conducted by the U.S. House of Representatives Committee on Financial Services.

Throughout the past year, CBOE has worked closely with the U.S. Securities Markets Coalition, which represents the six U.S. options exchanges, to advocate for parity in

portfolio margining between single stock futures and options. We are pleased to report that in December the U.S. House of Representatives passed the CFTC Reauthorization Act of 2005, and the bill is now awaiting a Senate vote. Included in this bill is a provision strongly supported by CBOE to permit portfolio margining for single stock futures and options. In addition, both CBOE and the NYSE have submitted rule filings with the SEC to allow portfolio margining in all products at each exchange.

Financials

Financial results for 2005 have been favorable due to record trading volume of over 1.85 million contracts per day compared to budgeted volume of 1.1 million contracts per day. Pre-tax income for the year stands at \$19 million as of November 30, even after taking into account member fee reductions of \$15 million during the same period. We ended the month of December with working capital of \$60.7 million, up from \$42.9 million at the close of December 2004. CBOE continues to be debt free. Audited financials will be included in our annual report, scheduled for publication in April 2006.

Moving Forward

We thank the CBOE membership and staff for your continued support and hard work. Your collective efforts on a wide range of fronts enabled CBOE to make significant progress in 2005. We look forward to an exciting new year at CBOE, and wish each of you a happy and prosperous 2006.

Sincerely,

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