DRAFT

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Honorable Roderick M. Hills, Chairman
Honorable Philip A. Loomis, Jr.
Honorable John R. Evans
Honorable Irving M. Pollack
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Gentlemen:

Following our receipt of your letter dated July 7, 1976 indicating that the Commission would not make a decision respecting the initiation of exchange put trading on CBOE until after January 1, 1977, we have devoted considerable effort to the various areas of concern identified as needing resolution before put trading should commence. Since the new year is now upon us, we thought it would be appropriate and helpful to present a summary of our activities directly or indirectly related to CBOE's preparation for put trading.

We will begin this summary with some of the background of our put program and will then discuss in order the following areas of concern: Economic Impact, Industry Operational Readiness, Trading Floor Surveillance, Sales Practices, Industry and Public Education and Options-Related Regulatory Questions.

BACKGROUND

Although certain aspects of put trading have been discussed with the SEC staff since the very beginning of CBOE's options program, and many of the rules of CBOE and The Options Clearing Corporation were drafted from the start in contemplation of put trading, CBOE first presented to the SEC a complete description of a proposed CBOE listed put market somewhat over a year ago, in October, 1975. Proposed rules changes pertaining to the commencement of listed put trading were submitted in December, 1975, and appeared in the Federal Register on January 12, 1976. Shortly thereafter, a series of discussions with the Commission staff began concerning these rules changes and other aspects of CBOE's put program. During the course of these discussions, a few amendments to our proposed put rules were filed and a considerable number of descriptive papers, brochures and other written material was furnished to the staff, all in contemplation of a start-up date for put trading in 1976. The securities industry was also prepared to start puts trading in the late summer of 1976.

It was during the final stages of preparation that we received Chairman Hills' July 7 letter deferring Commission action on puts until January, 1977. As we illustrate ~~attempt to make clear~~ in the remainder of this letter, CBOE now believes that as a result of the steps it has taken over the past several months in addressing the identified areas of concern, the Commission should be able to adhere to the January, 1977 timetable in approving our put proposal. An early approval is particularly important because of the necessary lead time (we think 60 days is appropriate) between the time of Commission approval and the time trading can actually commence.

order of subjects

ECONOMIC IMPACT

One area of concern that has been expressed on numerous occasions by members of the Commission and others is whether options are likely to cause any negative impact in other areas of the securities markets. Questions in this area have ranged from whether options might influence the market in underlying securities to whether they might cause a diversion of capital away from other areas of investment.

CBOE had been studying the first question -- namely, whether listed options trading could affect the trading of underlying stocks -- since well before the inception of the Exchange, and, with the assistance of Robert R. Nathan Associates, has monitored this matter since the first day of options trading.

To date, our studies and those of Nathan Associates (all of which have been furnished to the Commission) have disclosed no adverse impact of call option trading on underlying stocks. Although we do not expect the result to be any different for put options, we intend to continue our monitoring after put trading commences, and we have conveyed our plans in this regard to appropriate staff members.

The second question -- whether listed options are diverting investor capital from other areas of investment, such as new issues and stocks of smaller companies -- is more difficult to measure, given the great number of independant variables that bear upon investment decisions. ~~Both we and~~ Nathan Associates have previously addressed this question conceptually and empirically, and concluded that there appeared to be no basis for concern. More recently, as this question has continued to be raised, we retained Professor Sidney Robbins of Columbia University and Professor Robert Stobaugh of the Harvard Business School, with the support of Management Analysis Center, Inc. of Cambridge, Massachusetts, to design and conduct a study of the new issue market for equity issues of small and medium-sized companies, giving special consideration to any effect of option trading on this market. Results of this study are expected by the end of January, 1977.

Invitation to hold off until completion of R-S

Apart from studies conducted by or on behalf of CBOE, the Commission has also conducted its own studies of the economic impact of option trading. We have assisted the staff in this endeavor, by collecting, organizing and describing to the staff every source of trading data which has come to our attention, including all data bases or statistical reports generated or assembled by CBOE, The Options Clearing Corporation or independent vendors. At the same time, we made available the methodology and results of our ongoing economic impact studies, beginning with the original Nathan studies completed prior to CBOE's inception.

Based upon our own experience, we believe that our ongoing system for the economic monitoring of option trading is well-founded, and that while not every question can be answered with certainty at this time ~~(especially the questions being examined in the Robbins-Stobaugh study)~~, concerns as to the economic impact of option trading have proved to be without foundation. We are confident that the Commission's own studies will confirm this. Thus, with the completion of the Robbins-Stobaugh study and continued monitoring of possible economic effects of option trading, including put trading, by CBOE in cooperation with SEC economists and staff members, economic ?

concerns should not interfere with a near-term CBOE put trading approval.

INDUSTRY OPERATIONAL READINESS

In addition to developing our own systems and procedures for put trading, another major objective of our planning, to which we have devoted considerable resources, has been the achievement of member firm operational readiness for puts. We began this effort in October, 1975, when the registered options principals of each firm were notified of the filing with the Commission of CBOE's intention to trade put options. At that time, it was recognized that certain functions associated with put trading would be subject to especially long lead times due to computer programming requirements. The areas of concern were wire order transmissions to the trading floor and customer margins. A wire order format manual, including puts and straddles, was published and distributed to all member firms in January, 1976, and firms were able to implement necessary changes in time for a spring 1976 start-up.

In the area of customer margins, CBOE coordinated the writing of comprehensive margin rules with the other major exchanges. Once these margin rules were agreed upon and informally approved by the SEC staff, CBOE was able to hold seminars for operations management personnel of member firms in January, 1976, at which time written margin rules, consistent for all exchanges trading options, were distributed. Thus, firms were able to begin programming at that moment. CBOE then prepared a new margin circular, including puts, and a new margin manual for use by margin clerks in non-automated firms. CBOE also worked with the various software vendors in helping them prepare for puts, and CBOE retained an outside consultant, Kenneth DeWitt, who has had considerable experience in setting up the options department of a major wire house, to work with individual member firms in order to help them prepare. As spelled out in more detail below, a series of margin seminars, in addition to the seminars for management personnel mentioned above, for operational personnel were conducted on a nationwide basis.

As a result of these efforts combined with those of other industry organizations, member firms' margin departments are prepared for listed puts, and the Credit Division, Operations Committee and Executive Committee of SIA have not only endorsed but urged rapid SEC clearances for listed put trading.

CBOE's clearing reports, margins and credit examinations, and all other pertinent segments of CBOE's member firm examination procedures have been modified in order to segregate, identify and analyze the operational impact of listed put trading.

These modifications were developed in consultation with the Operations Committee of SIA, so as to avoid operational difficulties for member firms. Because of this segregation of the monitoring of put trading during the pilot phase, it should cause no disruptions in CBOE's ongoing surveillance over call trading.

TRADING FLOOR SURVEILLANCE

Just prior to the Commission's initial consideration of CBOE's put trading proposal, and shortly after widespread publicity as to alleged "fictitious trades" on AMEX, CBOE commenced an exhaustive review of historical trading patterns and individual trades in its market in order to identify any similar problems on the CBOE floor. The SEC also commenced its own investigation of option trading on all exchanges. Although CBOE's unique trading and reporting system effectively precluded any instance of a reported trade that did not in fact exist, a few situations of apparently pre-arranged trades and reversals in connection with the determination of closing prices were discovered on CBOE. These cases have all been the subject of CBOE disciplinary proceedings, and at the date hereof, most of these proceedings have been settled.

Of course, as with any self-regulatory organization, there are other cases involving alleged trading irregularities that are in various stages of CBOE's investigatory or disciplinary process, while still other cases are the subject of SEC enforcement proceedings. However, we do not believe that the existence of these cases is a reason for concern or for any delay in the commencement of put trading. CBOE's cases, all of which are being pursued diligently, do not reflect any pattern or practice of widespread trading abuses.

As a result of the cases that were uncovered by CBOE and by the Commission, all of CBOE's surveillance procedures were thoroughly reviewed and evaluated by CBOE's staff working closely with members of the Commission's staff both in Washington and in Chicago. This review included preparation of a comprehensive surveillance mannuel, an on site inspection of CBOE's procedures, techniques and personnel made by the SEC staff, and a meeting in Washington with representatives of the Division of Market Regulation. During the course of this review, several suggestions for improvements in systems or procedures were made, including greater utilization of automated systems in analyzing trade data, consolidation and simplification of certain reports, improving the ~~correctness~~ computation of trade information and upgrading the training of surveillance personnel.

The systematic review and improvement of CBOE's surveillance function did more than respond to specific suggestions;

Cite [illegible] surveillance manual

Trout [illegible]

it has entailed a "ground-up" reappraisal of the entire surveillance operation, encompassing broad-scale modifications to existing procedures where appropriate. Thus CBOE has now adopted a total plan for incorporating into its surveillance operation maximum usage of automated data processing analysis, ~~and this~~ which in turn will permit a reduction in the overall paper work burden. Summary analyses of closing sale information and trading between market makers are already in production, and other ~~components~~ elements of the new automated plan will be ready before the end of January, 1977. In addition, trade checking personnel have been trained to review all transactions on a current basis, providing, in effect, "on-line" surveillance of options transactions.

Although the foregoing surveillance review encompassed all options transactions, special attention was given to put trading in order to build in from the start any systems needed to deal with potential trading abuses that might arise when puts are traded. The first stop was to systematically define what, if any, special problems might be associated with put trading, and for this purpose CBOE called upon panels of industry experts assembled as consultants. One panel consisted of persons, all from New York, that represent the broadest possible cross section of listed call and unlisted put and call experience and are familiar with options trading practices. A separate group consisted of CBOE floor members.

Both groups came up with similar findings. Most important, no "hidden" problems peculiar to puts were identified, and it was argued that the same general system of surveillance and enforcement would serve equally for puts and calls. However, two factors were identified as calling for special treatment. First, since puts require certain mental adjustments reflecting that put prices move inversely in relation to stock prices and call prices, individuals responsible for surveillance functions will require intensive training. That training is under way and will be completed this month.

Second, the added complexity of options positions involving both puts and calls makes analysis of such positions that much more difficult. However, we have developed techniques of computer analysis that break down all positions -- puts, calls and stocks -- into "same side" and "opposite side" segments that greatly simplifies the task of analysis for surveillance purposes, and this, too, will be operational this month.

Thus, prior to the commencement of listed put trading, CBOE will have a surveillance system that recognizes the special characteristics of puts, but benefits from our substantial experience with calls and takes advantage of previously unavailable automated techniques.

SALES PRACTICES

From the inception of the CBOE listed put trading program, our approach has been a most conservative one. We have taken cognizance of the fact that listed put trading is something new in the market, and we have devoted our efforts toward addressing the fact that puts are not understood by many investors. Reflecting this conservative approach, in addition to the enormous educational effort we have directed toward industry personnel and the public as described below, we have required that the higher standard of suitability presently applicable to uncovered call writing must also apply to all put writers (covered or uncovered), and we have tightened margin rules. We will require a separate put qualification and testing program for registered options principals and registered representatives not only to qualify for puts but also to retain previously earned call qualifications. We have worked with other exchanges trading options in creating this qualification program, so there will be uniform industry-wide practice in this regard. Other aspects of the put qualification program are covered in the educational preparation segment of this report. Also in the sales practices area, member firm routine and special examination forms and procedures have been revised to include puts. Revised educational circulars, including strengthened guidelines for advertising and sales literature, have been prepared and will be distributed once the time table for the commencement of put trading is fixed. ?

Finally, following a thorough review of compliance procedures, we recently approved a rule change requiring that at each firm one Senior Registered Options Principal, who is an executive officer or partner, must be responsible for supervision of the public customer options business. The new rule specifies that the Senior ROP must have written procedures for delegation of his supervisory duties. more than for delegation Reflecting this rule and other improvements in the area of sales practices, we have recently published a revised sales practices educational circular, including puts, that makes strong suggestions for provision of certain supervisory tools to branch managers. Both our new rule and the revised educational circular have been thoroughly reviewed and evaluated by the Compliance Division of the SIA.

These actions, combined with the educational program outlined in the following section, should serve to strengthen supervision over sales practices while maintaining and enhancing methods which have proven successful.

INDUSTRY & PUBLIC EDUCATION

The put educational program designed in 1975 was based on the perception that a well-prepared industry with knowledgeable representatives was necessary for the trouble-free implementation of put trading. Early in the planning stages it became clear that CBOE would have to lead the way and provide the majority of resources for what has become, to our knowledge, the most massive training effort ever undertaken in the securities industry. Each phase of the program has been designed to coincide with certain related events during the period of put development. Thus, while much of the program has now been completed, a few elements are appropriate for implementation only following SEC approval of put trading. In order to show the size and scope of this enormous educational effort, it is presented below in outline form. Elements that will take place after SEC approval of puts are marked by an asterisk. All others are complete or under way.

I INDUSTRY PREPARATION

A. Operations Management Seminars - Jan., 1976 (N.Y. & Chicago)

1. Purpose: Provide member firm operations management personnel with necessary details for put planning.

2. Publications: Special manual including put-related margin rules and a wire order format manual.

B. Margin Rules Update (publication) - March 12, 1976 (Revised per agreement with SEC staff).

C. Registered Options Principal Seminars - April, 1976 (7 U.S. cities) This series of seminars was jointly sponsored by CBOE, AMEX, PHLX and PSE.

   1. Purpose: Prepare Senior ROPs for put trading and provide framework for training member firm personnel.

   2. Publications: ROP training manual and ROP put qualification exam.

D. Compliance Seminars - May, 1976 (N.Y., L.A. & Chicago)

   1. Purpose: Prepare member firm compliance officers for put trading. Concentration on understanding of possible pitfalls and importance of RR training effort.

   2. Publication: Educational circular on sales practices, including put options.

E. Margins Seminars - May, 1976 (N.Y., L.A. & Chicago)

   1. Purpose: Provide margin clerks detailed explanations of margin rules with emphasis on problem-solving.

   2. Publications: Margin circular including puts and sample calculations and margins rules review.

F. CBOE-SIA Margins Seminars - July, 1976 (5 U.S. cities) Sponsored by CBOE, conducted by SIA Credit Division members.

   1. Purpose: Provide margin clerks with exposure to industry experts and their approach to put margining.

G. Branch Manager Seminars - October, 1976 (7 U.S. cities)

   1. Purpose: Strengthening options-related compliance and management abilities of branch managers prior to commencement of put trading.

   2. Publication: Branch manager options manual.

H. Registered Representative Seminars* - Will be conducted just prior to put trading commencement date (52 U.S. cities plus 2 Canadian cities).

   1. Purpose: Provide RRs with authoritative basic explanation of risk characteristics of puts. Highlight pitfalls.

   2. Publications: Registered personnel put trading manual and visual aid presentation.

II FLOOR PREPARATION

A. Member & Floor Managers Seminars - May, 1976 (20 seminars)

   1. Purpose: Prepare market-makers and floor brokers for put trading. Concentration on rules and procedures.

   2. Publication: Special manual.

B. Member Firm Personnel Seminars - May, 1976 (22 seminars)

   1. Purpose: Prepare member firm employees for put trading. Concentration on error avoidance.

   2. Publication: Special manual.

C. Board Broker Staff Seminars - May, 1976 (4 seminars)

   1. Purpose: Prepare board broker personnel for put trading. Concentration on rules, procedures and handling of the book.

   2. Publication: Board broker put manual.

D. Floor Preparation Refresher Courses* - Will be held for each function prior to simulated trading exercise.

E. Simulated Trading Exercise* - Will be held 2 weeks prior to put trading commencement date. Simulation will include not only trading but order transmission, clearing, trade matching and provision for tie-in to member firm internal systems.

In addition, a number of publications have been created in order to assure that accurate and adequate information will be available to securities industry sales personnel and their clients. They will, of course, be a secondary source of information relative to the current OCC Prospectus dated October 29, 1976, which discusses both listed puts and listed calls. These publications are listed below. Those with an asterisk are awaiting an official effective date for listed put registration before they will be released.

Options Reference Manual* - Complete detailed information covering every facet of options trading. Cross-indexed in order to provide immediate answers. Includes listed puts, listed calls and combinations of these positions. Designed as a guide for registered representatives in providing technical information and assessing suitability of certain strategies.

Tax Considerations In Using CBOE Options - Intended for both RRs and customers. Discusses in detail the tax implications of put and call options. Incorporates 1976 Tax Reform Act.

Understanding Options (including put options)* - Customer oriented basic explanation of put and call options. Avoids complicated strategies for better understanding. New version, revised for puts, of most widely distributed customer education piece.

Options Margin Manual* - Quick reference guide for margin clerks, includes puts, calls and combinations thereof. Created by CBOE, edited and approved by SIA Credit Division.

Educational circulars covering margins and sales practices with relation to put and call options have been written, and will be distributed prior to trading. These publications have been co-ordinated with the relevant division of the Securities Industry Association.

One additional comment should be made before closing this discussion of put option educational programs. That is, although there is much about puts that is new and will seem complicated until puts are better understood by most persons, there is also much that puts have in common with calls, where a much higher level of understanding has been built up over the past three years. Thus, most of the technical details, terminology, industry methods and associated descriptions applicable to puts are already in use with respect to call options. We have been able to take advantage of this in preparing our educational program for puts, since by not having to repeat what is already understood in the context of call options, we have been able to concentrate upon the very important investment characteristics and other distinctions of put options. This concentration upon the basic risks and suitable uses of put options has, from our seminar experience, greatly enhanced the effectiveness of the various programs and has served to emphasize the cautionary approach that we have taken.

OPTION-RELATED REGULATORY QUESTIONS

In Chairman Hills' October 4, 1976 letter to me, reference was made to a number of option-related regulatory matters to which the Commission has given attention and it was suggested that additional work was required on these matters before the Commission could be satisfied that appropriate regulatory safeguards have been provided and that expansion into puts would be proper. The letter identified NASD dual market-making, front-running and listing and maintenance standards as being some of these options-related regulatory issues.

Since the date of your letter, considerable progress has been made on each of these issues and they are all either resolved or well on the way to resolution. Specifically, the Commission has written the NASD giving a preliminary "green light " to the NASD proposal, subject to the development of adequate surveillance procedures. As to front-running, we understand that the Commission is close to acting on our long-pending rule proposal (Rule 4.18) that in concept is very close to a recently approved rule adopted in connection with the options program of the Midwest Stock Exchange (MSE Rule 8 - "Priority Information"). Finally, the Commission recently approved CBOE's listing and maintenance standards.

[Say anything about exempt credit?]

While undoubtedly there will continue to be other options-related regulatory matters on your agenda and ours, we do not think that these should affect the timetable for the introduction of put trading, so long as the basic safeguards necessary to regulate our market are in place. As mentioned elsewhere in this letter, we believe these safeguards are now either fully operational, or will be within the next several weeks. Thus, we are ready for put trading and we are hopeful that the Commission will soon act favorably on our put trading proposal.