The Chicago Board Options Exchange

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Mr. George A. Fitzsimmons, Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Re: <u>File No. S7-648</u>

Dear Mr. Fitzsimmons:

We are writing to present the comments of the Chicago Board Options Exchange, Incorporated in response to Release No. 34-13626 dated June 14, 1977. That release presents a revised version of proposed Rule 11Ac1-1 governing the dissemination of quotations for certain equity securities. As was the case with the earlier version, the revised rule is inapplicable to quotations relating to options, since the rule applies only to securities as to which last sale information is reported in the consolidated system under Rule 17a-15 (i.e., the CTA System), and options are not included in that system. (See Release No. 34-10851 exempting from the requirements of Rule 17a-15 securities that are ineligible for inclusion in the CTA System.)

CBOE submitted comments on the earlier version of the rule (Joseph W. Sullivan letter to George A. Fitzsimmons dated November 4, 1976) in which a number of reasons were given why a firm quotation rule should not be applied to listed options trading. Developments since the date of that letter (e.g., the advent of put trading and increased competition among exchanges trading the same classes of options) have, in our view, only added to the difficulties of imposing such a rule on options trading. As explained below, among the principal reasons why a firm quotation rule would be unworkable if applied to options trading are that (1) options are traded in a competing market-maker system on CBOE (as well as on most of the other exchanges trading options), (2) options are derivative securities, and are traded in a number of series varying as to exercise price, expiration or both, and (3) options are often traded in combination with other options, as spreads, straddles or other combinations. We also discuss below why the Commission's proposed exemptions from the rule would be inadequate to deal with the special problems presented by options trading.

Following the discussion of options trading, we will briefly present our reasons for believing that certain features of the proposed rule would cause problems in their application to stock trading, and could have the effect of reducing market-making competition in stocks. These problems would be particularly acute with respect to CBOE's pending proposal to commence stock trading, which was filed in response to the proposals of others to trade stocks and options together.

WHY A FIRM QUOTATION RULE SHOULD NOT APPLY TO OPTIONS

Competing Market-Maker System. CBOE's options market differs from the traditional stock exchange market in that CBOE has replaced the traditional exchange specialist who has combined brokerage and market-making functions with (i) a single Board Broker who holds the book of agency limit orders and (ii) a group of competing market-makers who, in competition with each other, collectively perform the market-making function of the traditional specialist. There are also floor brokers on CBOE, but here, too, the broker and dealer functions are separated, since no CBOE member may on the same day execute orders as agent and as principal in options relating to the same underlying security. This market-making system, which was first introduced by CBOE when it began trading options in 1973, has to a large degree served as the model for the options programs of other exchanges that have subsequently begun to trade options.

Perhaps the most obvious difference between CBOE's competing market-maker system and the unitary specialist system is that under the former system there are many more individual market-makers entering bids and offers in each security. Further, since these market-makers may not represent agency orders, and because many types of options orders cannot be held in the Board Broker's book, there are also a great number of brokers in each trading crowd bidding and offering on behalf of customers. Typical trading crowds on CBOE include 8—10 market-makers, 4—6 floor brokers, plus the Board Broker, and considerably larger trading crowds are not uncommon. Reflecting these large and busy trading crowds, and the great number of persons entering bids and offers in each security, CBOE has developed a unique system for collecting and disseminating current quotations. In each crowd there is an exchange employee whose sole task is to monitor the quotations that are made from moment to moment by market-makers, floor brokers and the Board Broker, and to publish a representative bid and offer with respect to each security traded in the crowd at any time. During an average trading day, this system results in approximately 20,000 separate quotations being published for the 95 call and 5 put classes of options traded on CBOE. Each of these quotations represents a bona fide bid or offer entered by a person willing to buy or sell at the quoted price, although these quotations would not meet the firmness requirement of the proposed rule. However, we do not think that these quotations are any the less useful for not being firm, since the usefulness of these quotations is not dependent upon how long a time after their entry they remain good, but rather is that they provide a "sense" of the current state of the market that is not otherwise obtainable away from the floor. In fact, a likely result of imposing a firmness requirement on these kinds of quotations would be to detract from their usefulness, since under a firm quotation rule many quotations will not be entered at all, reflecting the reluctance of options market-makers to enter bids and offers into a system that does not provide the capability of quickly adjusting them in response to changing market conditions.

Turning to the cost side of the cost-benefit equation, in a competing market-maker system the costs of implementing a firm quotation system would be enormous. In order to collect and publish current quotations under its present system, CBOE employs 46 quotation reporters for its 100 option classes, and this number will expand as more put classes are added. Yet expensive as this is, it could not begin to meet the requirements of a firm quote rule under which each quotation, including size, would have to be identified with the particular market-maker, floor broker or Board Broker that was responsible for it. In addition, under a firm quote rule there would have to be the capability of permitting each member who had previously submitted a quote to withdraw or modify that quote on an immediate basis so as to terminate his responsibility for a quote that is no longer current. Any system that might be developed to accomplish this would, we believe, necessarily result in each market-maker, floor broker and Board Broker being literally tied to his own computer terminal. Apart from the enormous financial costs of such a system, its implementation would undoubtedly result in radical changes in the nature of any competing market-maker system operating under it.* Reflecting these enormous costs and other burdens, we believe that as a practical matter it would be impossible for an exchange to provide meaningful market-making competition on its floor and at the same time comply with the proposed rule.

In fact, given the number of persons that are constantly entering quotes in CBOE's options market, the inclusion of size information alone, apart from any firmness requirement, gives rise to technical difficulties almost as great as those presented by a firm quote rule. The problem is much like that discussed above: namely, that without a system to identify particular quotes with the persons making them, specific size information is meaningless. We are studying the possibility of including in published quotation information under our present system some indication of approximate size based upon the quote reporter's sense of the number of options being bid or offered at the published price, but even this raises technical questions of capacity with respect to our equipment and that of quote vendors.

Finally, we would point out that as a result of the foregoing, the imposition of a firm quote rule in respect of options would mean that those exchanges such as CBOE that trade options under a competing market-maker system would probably have to abandon that system, resulting in an overall decline in the level of competition. Even if these exchanges could somehow adapt their competing market-maker systems to function under a firm quotation rule, the systems costs necessary to effectuate such an adaptation would place these exchanges at a serious competitive disadvantage compared to those options exchanges that operate under a unitary specialist system.

<u>Options are Derivative Securities and are Traded in Several Different Series</u>. The price of an option is largely dependent on the price of the underlying security, and for certain "in-the-money" options this dependence is virtually absolute. This means that bids or offers that may be made for an option at any time cannot hold once the market for the underlying security has changed. Thus, unlike stocks,

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* Operating difficulties aside, our preliminary estimates are that the investment in computer equipment alone to support such a system could range from five to eight million dollars, depending upon the functions to be performed.

in the case of options one must monitor one's quotations not only against transactions in the quoted security, but also against transactions in the underlying security. And, as if this were not enough, there is the added complicating fact that options are traded in a number of different series, varying as to expiration price, expiration date or both, and here, too, price relations must be kept in line.

In the average option class traded on CBOE, there are 8 to 10 different series available at any time, and in certain classes the number has been much higher, reflecting that additional series have been opened on account of price movements in the underlying security or on account of stock splits or distributions. In those underlying securities where puts as well as calls are available, the number of series is double those stated above. Since options that relate to three underlying securities are traded at each post on the CBOE floor, each market-maker (and, potentially, each floor broker) in the crowd must monitor the market in 24–30 different securities at the same time (48–60 securities whose puts are traded), and must be prepared to modify or withdraw his quotes on account of changes in the market for any of these securities. Plainly if the bids and offers of brokers or dealers were firm under these circumstances, the market could not function. And, as discussed below, the notion that this problem could be solved through the application of a limited time grace period falls of its own weight.

Combination Orders. As previously noted, options are often traded as spreads, straddles or other combinations. Commonly these are bid or offered at net prices, leaving it to the broker or dealer to fill the separate components of the order at whatever prices net to a price as good as or better than that stated in the order. Thus an order to "buy" a particular spread involving the purchase of one option and the concurrent sale of another at a net price of 3 could be filled by buying the first option at 7-1/2 and selling the other option at 4-1/2 or buying the first at 7-3/8 and selling the second at 4-3/8. Often a broker or dealer holding such a combination order will enter a bid or offer for one "leg" of the combination, provided he is able to fill the other leg at a price that will permit the entire order to be filled at the net price. But no broker or dealer would enter quotes for one leg only if it meant they were firm until withdrawn. Either such contingent quotes would have to be excluded from the operation of the rule, or they would just not be entered. Yet given the importance of these kinds of orders in the options market, their exclusion would significantly reduce the usefulness of published quotation information and would result in a non-published market-within-the-market available only to certain professionals but not to the public.

Proposed Exemptions. The Commission recognizes that there are circumstances when the firmness requirement of the rule should not apply, for the rule provides a number of exceptions to this requirement. As we understand the rule, the firmness requirement would not apply to: (i) bids or offers by brokers or dealers (other than exchange market-makers) that are "cancelled or withdrawn if not executed immediately after communication" [these quotations are not required to be collected and published], (ii) quotations made when the level of trading activity or other unusual conditions make it impossible for an exchange to make quotations available currently, (iii) quotations that have been followed by a subsequent transaction in the reported security, except that these quotations again become firm if not revised within three minutes after the subsequent transaction, and except that certain quotations made on exchanges are not relieved of the firmness requirement by reason of subsequent transactions on the same exchange at the same price that do not complete a single order.

While in theory these exemptions seem well founded, in practice we believe they are likely to prove unworkable in any competing market-maker system, and so far as options are concerned, neither these exemptions nor any others we have been able to identify could possibly be implemented. Thus, for example, while we agree with the appropriateness of excluding immediate or cancel orders from quotations published under the rule, the fact that this exclusion would not apply to exchange market-makers would pose serious problems insofar as options are concerned. Further, immediate or cancel orders are only one of the many kinds of special or contingency orders found in the options market (others include spreads, straddles and other combinations where one component of the order is contingent on the execution of the other component). Since none of these could be reflected in published firm bids or offers, there would have to be some sort of express exemption for all such contingent quotes.

Of course, it is an inherent limitation of any quotation system that there will always be some bids and offers that are not shown, but this is only a further reason why quotation information should be viewed only as providing a general sense of an exchange market such as CBOE's. Making quotations firm will not make them any more meaningful, but instead, the firmness requirement will likely result in published quotations being even less representative of the "true" market, since there will be more reluctance to announce firm bids or offers than non-firm ones.

The three-minute grace period exemption is simply unworkable if applied to options. As noted above, option prices relate to the market in the underlying security as well as in each series of option on the same underlying security. Thus in order for a competing market-maker or other broker or dealer to know the precise status of each of his options bids and offers at any particular time, he will have to closely monitor precisely when any transaction in not less than 25 different securities has been "effected" on his own exchange or "reported in the consolidated system" if effected elsewhere. Apart from the technical difficulties of divising a system that would permit even a unitary specialist to keep current as to the status of all such transactions under a "three-minute rule," when it comes to extending such a system to each competing market-maker on CBOE's floor, we are unable to even imagine what such a system would involve. If only considerations of cost were involved, this would be reason enough not to proceed down this path, but beyond the cost of the system (if such a system could even be designed) there is the further problem that no competing market-maker could possibly be able to make markets and monitor all of these other transactions and their impact on his quotes at the same time. The likely result would be to lessen greatly the incentive for any market-maker to remain on an exchange floor under such circumstances.

The Commission in its release announcing the proposed rule asks commentators to consider whether potential problems with the exemptions from the firmness requirement make it appropriate that bids and offers be firm under all circumstances. Having considered this with respect to options, and in light of our general objections to the firmness requirement as stated above, it is our strong belief that the only rule worse than one with unworkable exemptions would be a rule with no exemptions at all.

IMPACT OF THE PROPOSED RULE ON STOCK TRADING

Thus far, our comments have been directed at the difficulties of applying a firm quotation rule to options trading. However, we believe that there are also problems associated with applying the rule to stock trading, centering around certain potentially anticompetitive consequences of the rule. Our concern relates to the difficulty noted above in applying the rule to a competing market-maker system. In our judgment, these difficulties are so substantial that, as a practical matter, the rule can only function under a unitary specialist system. While this may not present any immediate difficulties for existing stock exchanges, it is likely to mean that the unitary specialist system will be frozen in place on all stock exchanges, and the move toward greater market-making competition on exchange floors that is just beginning to appear will have been arrested in its infancy.

In our view, this likely result is inconsistent with the Commission's stated goal in proposing Rule 11Ac1-1; namely, to enhance competition by fostering the development of a national market system. Of course, we share this goal, which is mandated by the Securities Acts Amendments of 1975. However, because we think that the rule is likely to impair and not enhance competition, and because we do not believe that a firm quotation rule is a necessary prerequisite to the development of a national market system (this point will be discussed in our comments in response to Release No. 34-13662, to be filed shortly), we do not agree that the adoption of such a rule can be justified in the name of competition.

The anticompetitive impact of a firm quotation rule in its application to stock trading will be especially troublesome for CBOE if, for competitive reasons, we find it necessary to commence stock trading in accordance with our pending proposal. Our proposal contemplates that if other markets can combine the trading of options and stocks, then CBOE would also trade stocks under its competing market-maker system. For reasons already discussed, we are not sure that it is possible to trade stocks in this way under the proposed quotation rule, and if it is not, CBOE will be under an obvious competitive disadvantage. The requirement that the published quotations of an exchange must represent an aggregation of all bids and offers of market-makers at the published price would be extremely difficult for CBOE to meet under its proposal to trade stocks in a competing market-maker system. Even if we are able to devise a system for complying with the rule, it will undoubtedly be more expensive to develop and operate than a comparable system under a unitary specialist system, and this, too, would place CBOE at a competitive disadvantage.

We can identify two possible answers to this problem. The most obvious solution would be to reconsider the need for any firm quotation rule in respect of stocks. For all of the reasons stated above, we think this would be the better approach for all concerned. Alternatively, if the Commission does impose a firm quotation rule for stocks, then CBOE would have to apply for appropriate exemptions in order to be able to initiate stock trading utilizing a competing market-maker system.

Very truly yours,

Joseph W. Sullivan

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