



October 14, 1971

TO THE BOARD OF DIRECTORS:

The attached formal expression of the Securities and Exchange Commission, (see Attachment #1), provides us with a basis for making fundamental judgments regarding implementation of a securities options market.

It would be an overstatement to characterize this expression as assuring that all of our options market plans will be approved in a form that is completely satisfactory. But in the considered judgment of your Executive Committee, drawing upon the opinions of our special securities counsel, the Securities Committee of the Board and others, we now have reasonable assurance that our basic concepts will prove acceptable from a regulatory standpoint. It is therefore prudent, in the committee's judgment, to proceed with the formal submissions to the SEC and other steps necessary to put our options market concept into operation.

The Board has also, accompanying this report, a report of the Securities Committee recommending that the concept be implemented from a market potential standpoint, a judgment in which the Executive Committee concurs. The Securities Committee has overseen the development of a comprehensive set of plans for conducting options trading. These include rules drafts, trading and clearing procedures, specifications for facilities and equipment, and data processing arrangements. The Committee further advises the Board of its belief that these operational plans are sound and ready to be implemented.

If the judgments of the Executive and Securities Committees are accepted on regulatory and operational questions, the difficult question to which the Board must address itself is how should the options market be organized and financed. While there are several aspects to this question, the fundamental consideration is, as always, the long-term best interests of the membership as a whole. Once these are established, organizational and financing arrangements can be developed to achieve them.

If options trading could be conducted on the same basis as the other new markets the Board has introduced in recent years, your Executive Committee believes these interests would seem as clear today as they did when the options research and development program was undertaken three years ago. The basic objective of the options R&D work was, of course, to further the diversification effort that brought the broiler, plywood and silver futures markets into being. The additional opportunities for members, the stabilizing influence on the level of exchange activity, the broadening of the Board of Trade's sphere of economic service and the other objectives underlying this diversification effort need no elaboration.

During the course of the options development effort, however, the many distinctions between conducting a commodity futures market and conducting a securities market have come to occupy our attention. Not only will different regulatory standards and industry practices come into play, but formation of a separate securities exchange with its own membership will also be required in order to draw a clear line between the jurisdictions of the Commodity Exchange Authority and the Securities and Exchange Commission.

These differences have seemed so great that, even granting the enormous potential of our options concept, it has been questioned whether a sufficiently large proportion of the membership would participate to justify the continuing large development expenses and prospective start-up costs of making an options exchange operational. The proposition has been put forward that those members interested in options should assume all further financial responsibility for the undertaking and, in effect, set up their own exchange. Under this approach, as outlined to the membership in a brochure distributed this past June, financing for such an exchange would come from the purchase of memberships by perhaps 250 to 300 Board of Trade members at a price of perhaps \$3000. One consequence of this approach is, of course, that the vast majority of Board of Trade members as such would lose, both now and for all time in the future, the privilege of participation in the options market. However, through what was described in the June brochure as a "royalty" arrangement, the Board of Trade would receive monetary compensation for its options R&D investment, with royalties based on options trading volume.

The time for definitive decisions is now at hand, and your Executive Committee has redirected its attention to the question of whether monetary compensation is what the Board of Trade as an institution should be seeking from this undertaking, in lieu of participation rights for all its members.

This is the critical question, and its answer turns on an evaluation of the right of participation in the options exchange to the membership as a whole. This evaluation cannot be made just in terms of participation in the immediate or even the foreseeable future but rather in terms of participation under all future circumstances and also in terms of the enhancement of the privileges of Board of Trade membership that a perpetual right to participate in options will provide.

It is the sense of the Executive Committee that participation in the options market at the outset may well be limited to a relatively few members. It is also recognized that some members cannot foresee participating at any time and that the qualification and orientation process involved in becoming an options exchange member may inhibit others. However, if our options concept meets with the success that we envision, the opportunities will be very great indeed and the orientation process well worth the effort on the part of a great many members, present and prospective.

It is, therefore, the conclusion of the Executive Committee that the permanent right to qualify as an options exchange member without payment is worth a great deal more to the membership than monetary compensation of the Board of Trade Treasury in the form of royalty payments. This conclusion appears valid whether the options exchange succeeds or fails. If it succeeds, the additional opportunities for members and other benefits of diversification that were sought at the outset of this undertaking will have been achieved. Should the venture prove a failure, these benefits will not be realized, but neither will any royalties be collected under the monetary compensation approach.

One further question that needs to be answered as a prerequisite to developing an organization and financing plan is whether the potential benefits justify the further costs of making the options exchange operational.

Attached to this report (Attachment #2) are start-up time and cost projections developed by the Department of Planning and Market Development in conjunction with the Treasurer and our special securities counsel. The estimate is that costs of \$600,000 to \$700,000 will be incurred over a period of 8 to 11 months prior to the date operations commence, the exact figures depending on the length of time required to accomplish formal registration of the options exchange with the SEC and whether certain other commitments (i. e. construction of floor facilities, educational programs, etc.) are made prior to the date registration is accomplished.

The Executive Committee believes the prospective benefits fully justify a start-up commitment of this order. And if the Board of Trade membership as a whole is to share in these benefits, it is clear that the Board of Trade must be prepared to make this commitment. Your committee has reservations, however, about making it on the same basis as the funds committed to date to options R&D.

Because the options exchange must be organized as a separate entity with separate membership for regulatory purposes and because only a portion of the Board of Trade membership can be expected to become members, it has long been accepted that the options exchange should operate on a financially self-sustaining basis. Once its SEC registration is accomplished and a membership enrolled, the options exchange will have its own membership dues;

once it becomes operational, a charge on net commissions comparable to that of other securities exchanges is contemplated as well. From this date forward, the Board of Trade will not be committed to provide further financial support (though it may well want to do so, particularly where capital expenditures for expansion of options exchange facilities are concerned).

In providing pre-operational funding, the question is whether the Board of Trade funds committed should be treated as an extension of its R&D investment or as an advance which the options exchange should be expected to repay. A good case can be made for either approach, or for treating certain of these expenditures (e.g. construction of facilities and educational programs) as a loan and others (e.g. the legal expenses involved in obtaining SEC registration) as an extension of the Board's R&D commitment. Everything considered, the Executive Committee believes the preferred approach is to view all Board of Trade funds committed from the date of the options exchange's organization forward as a draw down (by the options exchange) of a line of credit. Legal considerations dictate that the options exchange be incorporated, an interim board of directors named and other organizational steps taken prior to the date formal submissions are made to the SEC for registration of the exchange. Hence, the date of the exchange's organization and of transition to line of credit financing is near at hand.

The amount of this line of credit and the terms of any loan that results under it are best discussed as part of the description that follows of an organizational and financing plan that the Executive Committee believes will accomplish the basic objectives set forth above. This plan must also take into account, of course, regulatory and other legal considerations as well as the capital and personnel (member and staff) needs of the options exchange to maximize its chances for fulfilling its potential.

A summary description of the Executive Committee's organizational and financing recommendations follows.

#### A. Options Exchange Organization

1. Formation - - The options exchange will be formed as a Delaware membership corporation with the name Chicago Board Options Exchange (CBOE); the Board of Trade (CBT) will act as its incorporator. Upon the CBOE's incorporation, the CBT will transfer to it the CBT's options research and development work product pursuant to a transfer agreement (for a draft of this agreement, see Attachment #3). The transfer agreement will guarantee the right of every CBT member, in perpetuity, to become a member of the CBOE upon qualification. A CBT mem-

ber applying for CBOE membership will, however, be required to pay registration fees for certain forms of participation that are described in Attachment #5 and may be required to pay the amount of any capital assessment that has been made on CBOE members during the five years prior to the CBT member's application.

The transfer agreement will, among numerous other protective features, also commit the CBOE to use its best efforts to exploit the options R & D work product, and it will require CBT approval before the CBOE may sell, license or otherwise dispose of or permit the use of any of the CBT's options R & D work product. Any movement of CBOE trading facilities to a location other than 141 W. Jackson Blvd. or its immediate environs will also require CBT approval.

2. Membership - - - Every CBT member will have the right to qualify as a CBOE member, but only those CBT members who do so will assume any of the obligations of CBOE membership or come under the regulatory purview of the SEC. A CBT member's right to CBOE membership is not transferable, nor is his CBOE membership transferable or severable from his CBT membership. When a CBT member who is also a CBOE member ceases to be a CBT member, his CBOE membership will be terminated also; but the purchaser of a CBT membership may apply for CBOE membership on the same basis as its prior owner. To restate it, the CBOE membership right goes with the CBT membership.

In addition to as many CBT members as may elect to qualify, there will also be a limited number (on the order of 100 to 200) of CBOE-only memberships offered for sale when the CBOE has obtained its SEC registration. The anti-trust considerations, the need for outside participation and other factors necessitating this "outside" membership offering have long been recognized. The financing benefits of this offering, as well as its terms, will be described in the financing section of this report. CBOE-only members will hold a Class B membership that is identical in almost every respect with the Class A memberships held by CBT members. One exception is that Class B memberships are separately transferable.

For a discussion of membership qualifications, privileges, obligations, and categories of participation see Attachment #5.

3. Government and Administration - - - As the incorporator of the CBOE, the CBT will appoint an interim Board of Directors to serve until an options exchange membership exists and elections can be held. This interim Board can be expected, in all probability, to remain in office until December, 1972, the time provided

in the exchange's draft bylaws for annual elections. Once elections are held, these bylaws provide for a 17-man Board consisting of 11 members elected by the CBOE membership (a chairman and vice-chairman elected annually and three classes of three directors each elected for three year terms), the CBOE's president, three public directors, and two directors appointed by the CBT's Board of Directors. The Class B membership will be assured of representation on the Board through a provision that at least one of the three directors elected annually be a Class B member. In addition to its own elected Board of Directors, the CBOE will also have an elected nominating committee.

It is presently envisioned that the CBOE will have only a small staff of its own and will contract with the CBT for professional and technical services such as accounting and finance, public relations and surveillance on a full cost reimbursement basis. (A draft service agreement is included as Attachment #4.)

#### B. Options Exchange Financing

1. Capital Needs - - - Detailed studies have been made of the capital requirements for the start-up phase and for the first two operating years of the CBOE. Two operating years have been included in the initial capital requirements because it was judged that the character and potential of the exchange would be discernible during that period of time permitting determination of future courses of action.

Budgets for the start-up phase involve expenditure of \$600,000. This is detailed in Attachment #2. Following conservative assumptions, the first operating year is estimated to require working capital of approximately \$300,000 in excess of operating revenues (principally dues and net commission charges) for the period. In addition, a basic cash balance of \$200,000 should be available for operating safety. Allowance is also made, again following conservative assumptions, for a further funding requirement of \$300,000 in the second operating year. Said another way, the CBOE ought to have at the end of the first year cash resources of \$500,000 either on hand or on call. In summary, cash requirements look something like this:

Start-up requirements	\$ 600,000
Basic working capital balance	200,000
First year operations requirement	300,000
Second year operations requirement	300,000
	<u>\$1,400,000</u>

2. Capital Sources --- Funding of these requirements can come from the proceeds of membership sales to non-CBT members and from loans extended to the CBOE by the Board of Trade. It is suggested that this latter arrangement take the form of a revolving line of credit up to \$700,000. Draw downs on these funds would occur as start-up expenditures are made to effect registration with the SEC and to provide the physical facilities required in conducting trading.

As soon as registration is obtained, the CBOE would proceed to sell outside memberships. Present plans are to offer 100 to 200 such memberships at a price of \$5,000 to \$10,000. An estimate of at least \$750,000 in proceeds from these sales is believed to be entirely realistic. These funds, too, would be used during start-up and to provide the working capital for the first two operating years. If surplus funds developed, they could be used to pay off part of the borrowed balance drawn down under the revolving credit which would have the effect of restoring borrowing limits for the remainder of the initial period.

At the end of the second operating year, the total amount drawn down under the revolving credit arrangement could be converted into a note having a maturity of ten years and bearing interest at applicable rates. Consideration could also be given to the establishment of a sinking fund based on volume for loan authorization.

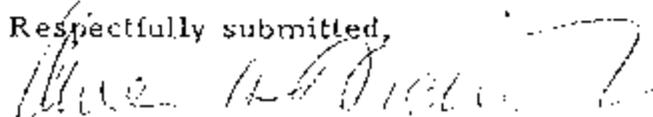
The Board of Trade has no surplus on hand with which to provide funds for underwriting the revolving line of credit. It, therefore, is faced with either borrowing the funds or looking to its members to agree on special assessments for this purpose. No banking arrangements for borrowed funds have been made.

It should be pointed out that under the terms of our present interim loan agreement, we are required to discuss this subject with our lending banks.

The anticipated expenditures for the first three months of the start-up phase are quite modest --- on the order of \$100,000. Significantly more funds would be needed for the fourth, fifth and sixth months of the start-up phase --- totaling approximately \$230,000.

Subsequent requirements for start-up activities and operating capital would be merged with the availability of proceeds of sale of outside memberships and draw downs on the line of credit taken only as necessary. It should be anticipated, however, for planning purposes, that the total of \$700,000 would be called upon at some time or another before the end of the second operating year.

Respectfully submitted,

  
OWEN H. NICHOLS, CHAIRMAN  
EXECUTIVE COMMITTEE