

# **American Stock Exchange Inc.**

86 Trinity Place  
New York NY 10006  
212/938 2401

**Paul Kolton**  
Chairman

September 27, 1973

Mr. Lee A. Pickard, Director  
Division of Market Regulation  
Securities and Exchange Commission  
500 North Capitol Street  
Washington, D. C. 20549

Dear Mr. Pickard:

The purpose of this letter is twofold. First, we wish to express the American Stock Exchange's views as to the desirability of implementing the Amex pilot project for options trading as promptly as possible, as well as to outline the procedures which we believe should be followed for its implementation, including procedures for soliciting the views of interested parties.

Second, we wish to provide the Commission with our comments on the letters of September 10, 1973 from Milton H. Cohen, counsel to the Chicago Board Options Exchange, in which Mr. Cohen requests the Commission not to permit any pilot program for options trading other than that of the CBOE in the near future.

As you know, the AMEX has been developing its pilot program on a high-priority basis for a number of months. In May, we met with Commission staff members to discuss the program and in early August, following the Board of Governors' approval of

Mr. Lee A. Pickard, Director  
Page 2  
September 27, 1973

the pilot project, we submitted to the Commission a written report outlining the basic operational and regulatory aspects of the program and the public purposes that would be served by it.

Further, we were afforded the opportunity to make an oral presentation to the full Commission earlier this month and responded to questions raised by the Commission and its staff. At that time we indicated that we were proceeding with the development of the pilot project as rapidly as possible, in order to meet our target date for its commencement on December 10, 1973. Meanwhile, as you know, we have submitted to the Commission staff, on an informal basis, a major portion of the extensive rule and Constitutional changes which will be necessary to implement the project.

The Amex fully understands the Commission's determination to ensure that investors who write or purchase options receive all necessary regulatory protections, and that organized markets for trading in options are structured in a way consistent with the public interest. To this end, we have kept the Commission and the staff apprised of our plans and progress, and we certainly will continue to do so.

Recently, the Commission staff has indicated it believes the first question to be addressed is whether it would be in the public interest for the Amex to commence a pilot project before the CBOE pilot project is completed -- and that the Commission has not yet resolved this question. Further, the staff has suggested it might be advisable to solicit the comments of interested parties on this "threshold" question prior to review by the Commission of the amendments to the Exchange Constitution and rules and the By-Laws and rules of the proposed Options Clearing Corporation, which have also been submitted to the Commission staff during the past few weeks.

Mr. Lee A. Pickard, Director

Page 3

September 27, 1973

We have little doubt that the additional information which would be made available through an Amex pilot program for options trading, to operate concurrently with the remaining life of the CBOE pilot project, would add significantly to the bank of knowledge necessary to evaluate broad-scale options trading; and that such data, not otherwise available, will be of great importance to the SEC, the public, and the securities industry.

For example, the Amex pilot project will enable the Commission and the Exchange to analyze in detail the role of the specialist in an options market and the relative merits of combining the broker and dealer functions, as opposed to splitting these functions as is done under the CBOE system. In this area, we believe that two pilot programs can be expected to provide useful data as to which system works most effectively. Further, it will be possible to evaluate the significance of the specialist's "book" and to check the capability of the specialist or the market maker to make tighter and more orderly markets and to provide better continuity and depth. Such an analysis will be facilitated by the Amex's existing floor surveillance system, which includes a trade-by-trade review of every specialist transaction.

Moreover, to the extent that competing markets are made in options in the same underlying stock, it will be possible to measure the likely effects of competition between markets. More broadly, we believe that an Amex pilot project will provide a valuable step, at an early stage, toward linking markets for trading in options in a central market system.

A key area in which the Amex pilot also will provide additional data lies in the Exchange's market surveillance procedures. The demonstrated capability of these

Mr. Lee A. Pickard, Director

Page 4

September 27, 1973

automated programs to analyze market activity -- some of them on a real-time basis -- will be applied from the outset to options trading.

Furthermore, with appropriate coordination, these surveillance procedures can help measure the impact of options trading on the underlying securities. To this end, the Amex will produce a daily "transaction journal" showing every trade and every quotation in each listed option; it is feasible to combine this surveillance tool promptly with corresponding data concerning the underlying stock, and thus, together with other procedures, to provide valuable insight, on a current basis, into the relationship between the options market and that for the underlying security.

Apart from this capability to monitor the market, the Amex as a major institution has the floor space, the trained personnel, the nationwide communications network and the linkage to brokerage firms around the country, to assure that an options trading test is conducted in a measured and orderly way. Further, the Exchange's long experience in trading warrants will help focus on an aspect of options trading in which it is essential that the machinery to assure efficient and fair treatment of customers is in place. By way of illustration, the Exchange has developed over the years procedures for assuring orderly closing out of positions in warrants prior to their expiration date, including such procedures as regularly scheduled follow-ups with firms with large short positions.

Finally, we believe that the continuous disclosure of options market transactions through the facilities of the Exchange's ticker network is of enormous importance to the public and the securities industry. It seems axiomatic that an options market which provides this kind of disclosure will provide the SEC with a substantial amount of useful data with respect to the potential public interest and possible inherent in options trading.

Mr. Lee A. Pickard, Director

Page 5

September 27, 1973

Aside from these factors, which involve obtaining as much empirical data as possible from the Amex pilot, there are competitive considerations which cannot be ignored. We emphasize this point out of a deep concern that delays in implementing the Amex project, while the CBOE continues to expand and develop its ongoing program, will have the effect of giving the CBOE a de facto monopoly of exchange options trading in the United States. Such a result, though not intended by the Commission, would not only damage the Amex and its membership but would be completely contrary to the move toward maximum competition in the securities markets which the Commission and the Congress have repeatedly stressed.

To dramatize this point, we understand that the CBOE will shortly, with SEC approval, significantly expand its number of posts and market makers and will at the same time add options in five new underlying securities. This also underscores the fact that the CBOE pilot project, by its terms, contains no limits as to the number of securities traded or the expansion of its options during the pilot, and no indication as to when the pilot itself is to be completed.

While we believe the Commission will determine that an Amex pilot project is desirable, we are nevertheless concerned with the impact on the Exchange's efforts if the SEC decides to solicit comments on the question of whether there should be a second pilot project, even before it reviews the proposed Amex rules which are designed to implement the Exchange's options project.

The delay which could be caused by such a procedure would certainly encompass weeks or even months. During this period, the Amex's carefully programmed effort, which is now entering the recruiting, training, and final design stages, would grind to an expensive halt. And during this period, the CBOE would presumably continue to

Mr. Lee A. Pickard, Director

Page 6

September 27, 1973

implement plans to increase the number of underlying stocks whose options are traded -- a number which, according to the CBOE's report on the first three months of trading, is expected to reach 50 by year-end.

Further, a large number of broker-dealers who are clearly anxious to participate in the Amex options project in order to service customers more effectively would be thwarted, and might assume the SEC wished to discourage options trading on the Amex. Thus, the impact of a delay would radiate beyond the Exchange -- to its members and their plans and commitments, and to their customers.

In view of these considerations, we believe it would be productive to begin discussions promptly with the Commission staff of any questions which the staff may have regarding the proposed rules package, in order to resolve such questions expeditiously. We would then plan to solicit comments of all interested parties under the Amex's stated policy requiring such solicitation with respect to important rule or policy changes. In this connection, we would hope to reach agreement with the Commission on a mutually satisfactory method of soliciting and reviewing such comments, which would accommodate the regulatory purposes of both the SEC and the Exchange and which is consistent with proposed Rule 9b-1.

If the Commission still believes it is also necessary to solicit comments on the question of whether a second pilot project is in the public interest, we strongly urge that this be done at the same time as comments are solicited on the proposed rule changes, so that there need be only one such solicitation, in view of the amount of time this procedure necessarily takes. In that way, it may be possible for the Amex program to be implemented without unnecessary and costly delay, and for the Amex to meet its target date of December 10, 1973, for commencing the pilot project.

Mr. Lee A. Pickard, Director  
Page 7  
September 27, 1973

We would like to comment, at this point, on Mr. Cohen's letter of September 10 in which he requests, on behalf of the CBOE, that the Commission not give a "green light" to any pilot program other than that of the CBOE in the near future, and in any event not to do so without fully considering the objections outlined in his letter. Most of the CBOE's objections to the Amex proceeding with its own options program have been considered above. We believe, also, that the key points now raised by the CBOE -- other than the fact that the CBOE would understandably prefer a field with no competitors -- have been covered in our August report and September 11th presentation to the Commission. In that material we answered the questions: "Why should the Amex develop a pilot program for trading in options?" and, "What public purposes will be served?" Nevertheless, we would like to comment on each of the CBOE's specific objections.

1. Burdens on Members – Mr. Cohen's letter states that the CBOE pilot program has imposed "significant burdens" on CBOE members and that additional pilot programs would accentuate these burdens on members "since they would be required to bear the costs of additional memberships and duplicative and inconsistent systems and procedures."

Other than as an urgent plea for total protection from competition by other securities exchanges, this argument is difficult to understand. Approximately two-thirds of CBOE member firms are also Amex member firms and, in general, the responses of such firms to the Amex proposal to initiate its own pilot program have been enthusiastic. In fact, a number of such dual member firms have urged this Exchange to develop its program as quickly as possible because of the services which the Amex can provide: greater trading and processing facilities, more experienced market-making capability,

Mr. Lee A. Pickard, Director  
Page 8  
September 27, 1973

prompt availability of a nationwide ticker system, etc. Moreover, it cannot be ignored that Amex member firms throughout the country which are not members of the CBOE, and their customers, would benefit as a result of the entry of the Amex into the options market.

The CBOE's contention that its members would be required to bear the costs of "duplicative or inconsistent systems and procedures" requires special comment. For one thing, Amex forms, procedures, options contracts and rules as they apply to member firm operations will largely and deliberately parallel those of the CBOE, so that confusion and duplicate costs can be avoided wherever possible. More important, from the beginning of its plans to establish an options market, the Amex attempted to open discussions with the CBOE with a view towards developing a clearing system that would interface, and perhaps by fully interchangeable, with the CBOE system. These attempts were based on our belief that both the public and the membership would benefit from such coordination, and that duplication would be minimized. Furthermore, we recognized that coordination at this early stage would facilitate and make less expensive the eventual development of a central market system for options trading.

Although the Amex has suggested this approach on a number of occasions, the CBOE thus far has been reluctant to enter into meaningful discussions regarding the clearing process. In June and early July, exploratory meetings were held with the CBOE, but the Amex was informed in mid-July that the CBOE Board of Governors had decided that, while it was willing to continue discussions pertaining to coordination of options trading (involving forms, standardized contracts, an electronic book, etc.), any discussions regarding the clearing of options should be deferred and were not authorized. It was only against this background that the Amex set about to establish the Options



Mr. Lee A. Pickard, Director  
Page 9  
September 27, 1973

Clearing Corporation of New York in order to meet its timetable for commencement of a pilot project.

In view of these efforts -- and the CBOE's unwillingness to this date to discuss the development of a common clearing facility -- it is anomalous for the CBOE now to complain that an Amex pilot project would result in "duplicative or inconsistent systems and procedures."

2. Confusion Among Investors -- CBOE's letter also states that a number of pilot systems might cause confusion among investors. While the basis for this concern is not fully explained, it is presumably that investors might be confused if the two exchanges have options with different terms and different rules and procedures.

We do not believe that confusion among investors is likely, since the options to be traded on the Amex will be standardized as to exercise price and expiration date, in the same way as those traded on the CBOE. Furthermore, far from being confused, investors will benefit from the Amex's regulatory and disclosure requirements, its facilities, and its surveillance program, as discussed above.

3. Surveillance and Regulation -- The CBOE also expresses concern that enforcement of its rules would be complicated unless there is coordination of rules, such as position and exercise limits, and unless there is integration of responsibility for their enforcement.

We are in agreement with the thrust of this point and we see no reason why there should not be close coordination between the surveillance and regulatory programs of the two exchanges. It should be pointed out, moreover, that one of the major benefits of a second pilot project will be the opportunity to test different regulatory measures or approaches, such as defining market-making responsibilities.

Mr. Lee A. Pickard, Director  
Page 10  
September 27, 1973

With respect to the rules specifically mentioned in the CBOE letter (Rules 4.11, 4.12, and 4.15), it should be noted that the corresponding Amex requirements (proposed Rules 905, 906 and 909) are substantially similar. Since these rules deal with numerical limits on positions and on exercise of options, it will be necessary, in situations where both exchanges trade in options for the same underlying stock, to determine whether these restrictions should be based on overall positions and exercises, rather than being applicable only to a single exchange. This is one of the matters that lends itself to effective cooperation between self-regulatory organizations and which we would expect to discuss with the Commission staff in the context of its review of the Amex proposed rule changes.

4. Market-Making – The CBOE states that if other exchanges are permitted to have pilot programs in which noncompeting specialists have access to a “book” of public orders, “an unequal situation would result in which CBOE’s system could not be fairly tested.”

The CBOE does not indicate any reason why its market-making system could not be fairly tested if another exchange has a concurrent pilot program using the traditional specialist system. In fact, as we indicated above, it would seem that this is precisely the area where two pilot programs can be expected to provide useful data as to which system works most effectively in attracting orders and in maintaining orderly markets.

5. National Market System – The CBOE states that, if other exchanges are to commence options trading, it would be better to develop a national market system at the outset rather than having different pilot programs develop separately.

We agree with this comment. As indicated above, we expect that by initiating the Amex pilot program at this time, the Amex will be able to contribute materially to a

Mr. Lee A. Pickard, Director  
Page 11  
September 27, 1973

national market system for options trading, with extensive automation and communication facilities, which would be available to the CBOE, as well as to a wider public.

We believe, therefore, that the commencement of an Amex pilot program is entirely consistent with the ultimate development of a central system. It seems unreasonable, however, while such a system is being developed and evaluated, to permit one exchange to continue to expand its market, while all others are required to remain on the sidelines and not participate in the system's development.

6. Interface or Centralization of Clearing Systems – The CBOE states that a true national market system will necessarily involve interface or centralization of the clearing systems of the various exchanges which trade in options. We agree with this comment but, as described above, we have thus far been blocked by the decision of the CBOE board, communicated to the Amex last July, that it was unwilling for the CBOE to have any further discussions with the Amex in the foreseeable future on this important subject. The Amex for its part remains willing to develop promptly with the CBOE a completely compatible system for clearing, or a single system.

7. Ability to Conduct a Sound and Fair Test of CBOE's New Market – Finally, the CBOE states that additional pilot programs by other exchanges would add nothing to the test of an exchange options market but “would impose burdens that the CBOE should not fairly be expected to sustain until its roots are more firmly planted.” As we have outlined earlier in detail, the Amex can provide invaluable data and make significant contributions to an options test as a result of its facilities, experience and regulatory capabilities.

Mr. Lee A. Pickard, Director  
Page 12  
September 27, 1973

In essence, it appears that the concern of the CBOE narrows down to a fear of possible competing markets. While this fear may be understandable, it would not seem appropriate for the Commission to invoke its procedures to provide protection against competition particularly when the public interest will be served through an additional pilot program that will develop data essential to the Commission in reaching a final decision.

Finally, we wish to comment on the suggestion by the CBOE that the Commission treat the filing by any other exchange looking to a pilot program as an original application for registration as a national securities exchange under Section 6 of the Exchange Act. In short, the CBOE wants the American Stock Exchange -- a registered national securities exchange for the past 39 years -- to go through the expense and time-consuming procedures of preparing and filing an entirely new application for registration under the Act in order to trade an additional group of securities. Since there is no basis for this suggestion under the Act, or even from a policy viewpoint, it seems clear that the purpose of the CBOE suggestion is to create as many difficulties and obstacles as it can for any other exchange which intends to commence trading in options.

As stated above, the Amex intends to work closely with the Commission and welcomes the careful scrutiny which its plan deserves and will receive from the Commission and others. We believe, in short, that the SEC's review of this material, and the comments to be received from interested parties, including the CBOE, will be helpful to the Exchange in initiating its pilot program.

We therefore respectfully request the Commission and its staff to avoid unnecessary delay in performing its statutory review function, and to take those prudent

**AMERICAN STOCK EXCHANGE INC.**

Mr. Lee A. Pickard, Director  
Page 13  
September 27, 1973

steps necessary so that the pilot program can be initiated by the Exchange's target date of December 10, 1973.

We are sending copies of this letter to each of the Commissioners and to the CBOE and PBW Stock Exchange.

Sincerely,

Paul Kolton

cc: (See Distribution List Attached)

Mr. Lee A. Pickard, Director

Page 14

September 27, 1973

Distribution List

The Honorable Ray Garrett, Jr., Chairman

The Honorable Philip A. Loomis, Jr., Commissioner

The Honorable Hugh F. Owens, Commissioner

The Honorable A. A. Sommer, Jr., Commissioner

The Honorable John R. Evans, Commissioner

Mr. Sheldon Rappaport, Associate Director, Division  
of Market Regulation

Chicago Board Options Exchange

Mr. Joseph W. Sullivan, President

Milton H. Cohen, Esq., Counsel

Philadelphia-Baltimore-Washington Stock Exchange

Mr. Elkins Wetherill, President