The Chicago Board Options Exchange

Joseph W. Sullivan
President

LaSalle at Jackson
Chicago, Illinois 60604 312 431-5701

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

Re: File No. S7-613

Dear Mr. Fitzsimmons:

We are writing to present the comments of the Chicago Board Options Exchange, Incorporated in response to Release No. 13388, dated March 18, 1977. That release presented three proposed rules under Section 11(a) of the Securities Exchange Act of 1934, as amended (the "Act"), dealing with the subject of securities transactions by members of national securities exchanges. Our comments will be focused on proposed Rule 11a2-1, Transactions for the Account of a Member, and proposed Rule 11a2-2, Member's Transactions Effected Through Other Members. Both proposed rules include a requirement that exchanges develop an access plan, which we believe to be inappropriate; our comments on access follow our discussion of the rules.

Rule 11a2-1

Under the proposed rule, members of registered national securities exchanges would be permitted to effect exchange transactions for their own account only if their orders yield priority in execution to orders for the account of persons who are not members or associated persons of members of the exchanges at the same price. Further, subject to members yielding priority, all orders at the same price must be granted priority solely on the basis of time of entry; the size of an order could not be a factor. Finally, in order for a member to effect any such transactions, the exchange would be required to adopt a plan with respect to membership, access to exchange and member services, and the scope of exchange jurisdiction to be exercised over associated persons.

Proposed Rule 11a2-1 would negate the statutory exceptions from the prohibition on members' trading, as set forth in Section 11(a)(1), and (except for odd-lot dealers) require all members' trading to yield priority, regardless of the type of member or transaction. We are opposed to the adoption of proposed Rule 11a2-1 because we believe it to be an unwarranted departure from the expressed intention of Congress in

revising Section 11(a). Insofar as proposed Rule 11a2-1 applies to transactions of a member acting in the capacity of a market-maker, we believe the rule exceeds the power of the Commission. Further, at least as applied to a system of competing market-makers, we believe the proposed rule to be unworkable.

Proposed Rule 11a2-1 is inconsistent with the 1975 amendments to the Act and is a departure from the clear intent of the amendments because it writes out of the statute the exceptions to the Section 11(a) prohibition on members' trading that were placed there by Congress. Each type of transaction listed in Section 11(a)(1), subparagraphs (A) through (F), has been determined to be beneficial to the marketplace, and no justification is offered for abridging the Congressionally-granted authority for such transactions. The Senate Report accompanying S.249 indicates that the Commission's power to regulate or prohibit one of the excepted categories of transactions was intended for circumstances where the exception was abused or exerted an undesirable influence on exchange trading. (Senate Report No. 94-75, p. 68.) Before such a wholesale rewriting of the statute occurs, the Commission should make appropriate findings. The Release accompanying the proposed rule does not even argue the presence of such abuse or undesirable influence.

To the extent that proposed Rule 11a2-1 applies to members acting in the capacity of market-makers, we believe it exceeds the power of the Commission. By Section 11(a)(2), Congress granted to the Commission the power to prohibit "transactions on a national securities exchange not unlawful under (Section 11(a)(1)) effected by any member thereof for its own account (unless such member is acting in the capacity of market-maker or odd-lot dealer) ...;" (emphasis supplied). That parenthetical clause is an express limitation on the Commission's authority to modify Section 11(a)(1), and cannot be overcome by reference to other parts of the Act. The clear intent of the statute is to preserve for the benefit of the marketplace the contributions of market-makers.

The proposed rule is wholly unworkable because it fails to take account of the realities of a trading crowd in a competing market-maker environment like that of the CBOE. On the CBOE, there is no single repository of bids and offers. Instead, there are numerous individual market-makers entering bids and offers in each security plus a Board Broker handling a book of non-member limit orders. Further, because these market-makers are not permitted to 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. These numerous market participants may be bidding and offering simultaneously, some on behalf of members' orders (which must yield priority), some on behalf of associated persons' orders (which may have to yield priority - the effect of proposed Rule 11a2-1 is unclear) and some on behalf of non-member orders. It would wreak havoc on an auction market to have to stop the action each time a trade was proposed to be executed in order to determine the priority of the would-be participants, taking account of the status of the initiating parties and the times of order entry. Such a trading procedure would be cumbersome enough on an exchange with a unitary specialist. Carried over to the CBOE's system of multiple, competing market-makers with a separate individual handling the limit order book, the requirements of proposed Rule 11a2-1 may well grind the market to a halt. There are simply too many participants and too many transactions to be able to classify and rank each order represented in a crowd. The Commission itself has recognized the difficulty of establishing a system capable of making the necessary distinctions among large numbers of brokers and dealers without impeding trading. (Release at page 52.)

CBOE does have in place a workable system for affording meaningful priority to non-member orders. We believe that the system is the most practical for CBOE's trading environment and that it goes further toward establishing public order priority than those of other exchanges. With limited exceptions in the case of single price openings and combination orders, limit orders displayed by CBOE's Board Brokers have priority over other bids and offers in the crowd at the same price, regardless of time of entry; size is not a factor. No member is permitted to place an order with a Board Broker for an account of that member or any other member of the Exchange.* The system works because attention need be focused on only one place: If a Board Broker is displaying the highest bid or lowest offer at the post, that bid or offer has priority over other orders at the same price, and reference need not be made to other orders in the crowd. Priority of orders at the same price within the book is afforded solely by time of entry; size is not a factor.

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* As a means of further strengthening public order priority, on December 21, 1976 CBOE filed with the Commission under Rule 19b-4 an amendment to its Rule 7.4(SR-CBOE-76-26). The proposed rule change would prohibit Board Brokers from accepting limit orders for the account of any broker-dealer, regardless of its membership status. The purpose of the proposed amendment was further explained in the letter from Scott L. Lager to Sheldon Rappaport, dated July 15, 1977. The filing is awaiting Commission action.

We note that proposed Rule 11a2-1 applies only to members of national securities exchanges and that no comparable rule requiring non-member broker-dealers to yield priority on orders effected for their own account has been proposed. We believe that, given the severe restrictions imposed on members' trading by proposed Rule 11a2-1, adoption of the rule will establish a strong disincentive to exchange membership, with a number of consequences.

First, the Commission's avowed goal of redressing the "undue professional advantage accruing to members" may be circumvented. With the sophisticated communication facilities utilized by market professionals today, the historical on-floor/off-floor distinction no longer has the significance it once had. Non-member broker-dealers, having the same communications facilities and access to the marketplace as members, would be able to effect transactions for their own account without regard to the necessity of yielding priority to public orders. Second, the viability of the exchanges would be impaired because of the erosion of the capital and floor capability necessary to maintain a fair and orderly market. Third, an abrupt exodus by members from exchanges would raise serious problems of self-governance and surveillance for those broker-dealers no longer a member of any exchange. Finally, those members who remain as members would be placed at a serious competitive disadvantage vis-a-vis the ex-members, who would be able to trade unfettered by the proscriptions of the rule.

Rule 11a2-2

Proposed Rule 11a2-2 would prohibit a member from effecting a transaction on an exchange for its own account, an account of an associated person or an account as to which the member or an associated person exercises investment discretion unless the transaction either fits one of the statutory exemptions under Section 11(a)(1)(A) through (H) or is effected pursuant to an order transmitted from off the floor and is executed by a member other than the member or an associated person of the member who initiated the order. The initiating member or associated person may do no more than transmit the order to the floor. Further, the exchange on which the latter transaction occurs must have filed an access plan identical to the one described above under Rule 11a2-1.

We would support this effort by the Commission to alleviate the blanket prohibition of Section 11(a) on members' exchange trading that does not otherwise qualify for the exemptions of Section 11(a)(1)(A) through (F), assuming some redress of the perceived imbalance of professional presence on exchange floors is deemed necessary. We note, again, however, that

such trading restrictions are not imposed on non-member broker-dealers. We are therefore concerned that such restrictions could serve as a disincentive to exchange membership, with the attendant problems discussed above, and we would recommend that any such restrictions be equally applicable to all broker-dealers, regardless of exchange membership, for the reasons set forth above and in our previous filing, SR-CBOE-76-26, and supporting comments.

Access

Both proposed Rules 11a2-1 and 11a2-2 include a provision requiring an exchange to adopt an appropriate access plan before members can trade under the rules' provisions. It does not appear necessary or appropriate to link members' proprietary trading to an exchange's developing a specific plan with regard to membership and access to exchange and member services. The access problem is one more properly addressed in a separate proceeding dealing with issues specifically arising under Section 6(f) of the Act. In addition, the Commission has the authority and ability to review and eliminate those exchange rules which the Commission believes to be a burden on competition and which are not reasonably necessary to further the purposes of the Act.

Very truly yours,

Joseph W. Sullivan