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United States Senate

COMMITTEE ON FINANCE
WASHINGTON, DC 20510

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SEC. & EXCH. COMM.

February 5, 1988

The Honorable David S. Ruder, Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Ruder:

We are deeply concerned about the Securities and Exchange Commission's decision to hold public hearings on February 11, 1988, regarding the multiple trading of options on exchange-listed securities. In our view there are several compelling reasons to conclude that this is not the appropriate time to conduct those hearings.

As an initial matter, we understand that the Pacific Stock Exchange ("PSE") has recently released a study regarding the incidence of trade-throughs in an option on an-over-the-counter stock, Microsoft, that is dually-traded on the PSE and the American Stock Exchange ("Amex"). That study found that, during a four-day period last September, trade-throughs occurred with respect to approximately 5% of all transactions in Microsoft options. The study found that the weighted average price discrepancy of those trade-throughs was 1/8 point, and that price discrepancies tended to be larger, and to occur most frequently, in the case of smaller orders (of the sort that are typically placed by public investors). By extrapolation, the study concluded that the annual additional cost to investors of trade-throughs in Microsoft options alone would be approximately $700,000. Indeed, PSE data from a five-day period in late July and early August suggested that the annualized cost of trade-throughs in that option would be more than $1 million. The PSE study noted that, based on these findings, the aggregate cost associated with trade-throughs could be significant if multiple trading occurred on a much larger scale and encompassed option series that are traded more actively than are Microsoft options, as well as option series that are more volatile.

The PSE study consequently raises serious questions about the reliability of the Commission's assertion that "[t]he trading experience of options on OTC stock has not shown significant price disparities in the markets for these multiply-traded options." See SEC Release No. 34-24613 (June 25, 1987). Rather, the PSE study strongly suggests that, if multiple trading is instituted in the absence of effective linkages, significant price disparities are, in fact, likely to occur, and that public investors are likely to bear the brunt of those disparities.

This study also casts further doubt upon the Commission staff's "contestable markets" theory. In each of the instances reflected in the PSE study, superior price quotations were available on the PSE; however, customer orders were routinely filled at the less favorable Amex price. The study consequently helps to document a point the exchanges have been making for some time; i.e., that genuine competition will not be possible in a multiple trading environment unless effective linkages are in place.

Because this study raises serious questions about two of the fundamental predicates for the Commission's decision to reopen the multiple trading debate, we believe the February 11 hearing should be postponed until the Commission has conducted a thorough and in-depth study of the trade-through problem. Until the Commission has collected more data on this subject, interested parties will be unable to fully assess the market ramifications of multiple trading and hearings on that topic will do little to advance the decision-making process. As the Commission would surely agree, the market consequences of instituting multiple trading are likely to be too far-reaching and too profound to be left to chance or assumption. Rather, any decision to proceed in that direction should be based upon hard data regarding the costs of fragmenting the markets and hard data regarding the competitive benefits that will flow therefrom. Because the PSE study strongly suggests that those costs may be much higher than the Commission has assumed and those benefits may be essentially nonexistent, we believe it would be premature to hold a public colloquy on multiple trading until the trade-through problem has been more thoroughly explored.

In addition to our belief that the factual record must be more complete before meaningful hearings can be held on multiple trading, we believe that the market events of the last two months raise serious questions about the wisdom of focusing Commission resources on this subject at this time. In my view, the market melt-down of mid-October and the continuing volatility of the markets make clear that the Commission should have other priorities. As the Brady Commission Report makes clear, recent events have exposed significant structural and operational weaknesses in the markets that must be addressed to prevent similar (or even more serious) market cataclysms from occurring and to restore investor confidence. In light of the urgency of addressing those problems, it would be a serious mistake to allocate Commission resources to a matter that everyone concedes has not involved any market problems.

Indeed, the events of mid-October and the persistent instability of the securities markets demonstrate that the Commission should currently be attempting to strengthen the securities markets, rather than to fragment and disrupt them. There is a distinct "cart before the horse" quality to focusing on multiple trading before the Commission has had the opportunity to identify the structural changes that are necessary to prevent a repetition of the October 19 crash and to bring greater stability to the markets. Multiple trading is clearly ancillary to those more pressing issues, and we seriously doubt that the desirability of instituting across-the-board multiple trading can be productively considered until those overriding market structure issues are resolved. We should note, in this regard, that the Brady Commission Report repeatedly sounded the theme that the markets are really one market and should be regulated accordingly. In our view, the Commission should be heeding that theme, rather than taking action that would Balkanize and upend the securities markets.

In short, we believe there are two key reasons to defer Commission consideration of multiple trading. As an initial matter, hearings on this subject will be of questionable value unless more empirical data is collected on the trade-through problem and the related market problems. In the absence of such data, hearings on this topic will essentially be occurring in a vacuum. Even more significant, the Commission should be reordering its priorities and allocating its limited resources to addressing the problems flagged by the October 19 crash. Until the Commission has had the opportunity to focus upon those problems and formulate appropriate responses, we believe it would be inappropriate to divert Commission resources to a matter that is, by no stretch of the imagination, a priority.

Sincerely,

Timothy E. Wirth
United States Senate

John Heinz
United States Senate