The ChicagoBoard
Options
Exchange

Joseph W. Sullivan
President

LaSalle at Jackson
Chicago, Illinois 60604 312 431-5701

January 5, 1977

Honorable Roderick M. Hills, Chairman
Honorable Philip A. Loomis, Jr.
Honorable John R. Evans
Honorable Irving M. Pollack
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Gentlemen:

Following our receipt of Chairman Hills' letter dated July 7, 1976 indicating that the Commission would not make a decision respecting the initiation of put trading on CBOE until after January 1, 1977, we have devoted considerable effort to the various areas of concern identified as needing resolution before put trading should commence. Since the new year has now arrived, we thought it would be appropriate to present a summary of our activities directly or indirectly related to CBOE's preparation for put trading.

We will begin with some of the background of our put program and will then discuss in order the following areas: Economic Impact, Trading Floor Surveillance, Industry Operational Readiness, Sales Practices, Industry and Public Education and Options-Related Regulatory Questions.

BACKGROUND

Although certain aspects of put trading have been discussed with the SEC staff since the very beginning of CBOE's options program, and many of the rules of CBOE and The Options Clearing Corporation (then Chicago Board Options Exchange Clearing Corporation) were drafted from the start in contemplation of put trading, CBOE first presented to the Commission a complete description of a proposed CBOE listed put market somewhat over a year ago, in October, 1975. Proposed rules changes pertaining to listed put trading were submitted in December, 1975, and appeared in the Federal Register on January 12, 1976. Shortly thereafter, a series of discussions with the staff began concerning these rules changes and other aspects of CBOE's put program. During the course of these discussions, a few amendments to our proposed rules were filed and a considerable number of descriptive papers, brochures and other written material were furnished to the staff, all in contemplation of a start-up date for put trading in 1976.

During the final stages of preparation we received Chairman Hills' July 7 letter. As spelled out in the remainder of this letter, CBOE believes that, as a result of the steps it has taken over the past several months in addressing the identified areas of concern, the Commission should be able to act favorably on our put proposal promptly after January 1, 1977. An early approval is particularly important because of the necessary lead time (a period on the order of 60 days would be appropriate) between the time of Commission approval and the time trading can actually commence.

ECONOMIC IMPACT

One area of concern that has been expressed by members of the Commission and others is whether listed options trading can cause any negative impacts in other areas of the securities markets. Questions in this area have included whether options trading might influence the market in underlying securities and whether it might cause a diversion of capital from other areas of investment.

CBOE had been studying the first of these questions since well before the inception of the Exchange and, with the assistance of Robert R. Nathan Associates, has monitored this matter since the first day of call option trading. To date, our studies and those of Nathan Associates (all of which have been furnished to the Commission) have disclosed no adverse impact of call option trading on underlying stocks. Although we do not expect the result to be any different for put options, we intend to continue our monitoring after put trading commences, and we have conveyed our plans in this regard to appropriate staff members.

The second question – whether listed options are diverting capital from other areas of investment, such as new issues and stocks of smaller companies – is more difficult to measure, given the great number of independent variables that bear upon investment decisions. Both we and Nathan Associates have previously addressed this question and concluded that there appeared to be no basis for concern. More recently, as this question has continued to be raised, we retained Professor Sidney Robbins of Columbia University (who served as Chief Economist to the Commission's Special Study of Securities Markets) and Professor Robert Stobaugh of the Harvard Business School, with the support of Management Analysis Center, Inc. of Cambridge, Massachusetts, to design and conduct a study of the new issue market for equity issues of small and medium-sized companies, giving special consideration to any effect of option trading on this market. Results of this study are expected by the end of January, 1977.

The Commission has also been conducting its own studies of possible economic impacts of options trading. We have assisted the staff in this endeavor, by collecting, organizing and describing to the staff every source of trading data which has come to our attention, including all data bases or statistical reports generated or assembled by CBOE, The Options Clearing Corporation or independent vendors. We have also made available the methodology and results of our prior and ongoing economic impact studies.

Based upon our own experience, we believe that our present system for the economic monitoring of option trading is well-founded and that, while not every question can be answered with certainty, concerns as to the economic impact of option trading are proving to be without foundation. Even if the Robbins-Stobaugh study should show any impact of options trading on the new issue market (which we do not anticipate, based on the preliminary results of a survey of leading underwriters, done as a part of that study), we seriously question whether this would provide any basis for regulatory action by the Commission as to options trading in general or for deferral of the commencement of put trading in particular. Thus, assuming continued monitoring of possible economic effects of option trading, including put trading, economic concerns should not interfere with an early commencement of CBOE put trading.

TRADING FLOOR SURVEILLANCE

Just prior to the Commission's initial consideration of CBOE's put trading proposal, and shortly after widespread publicity as to alleged "fictitious trades" on the American Stock Exchange, CBOE commenced an exhaustive review of historical trading patterns and individual trades in its market in order to identify any similar problems on the CBOE floor. The Commission also commenced its own investigation of option trading on all exchanges. Although CBOE's unique trading and reporting system effectively precluded any instance of a reported trade that did not in fact exist, a few situations of apparently pre-arranged trades and reversals in connection with the determination of closing prices were discovered on CBOE. These cases have all been the subject of CBOE disciplinary proceedings, and they have all been settled.

Of course, as with any self-regulatory organization, there are other cases involving alleged trading irregularities that are in various stages of CBOE's investigatory or disciplinary process, while still other cases are the subject of SEC enforcement proceedings. CBOE's cases, all of which are being diligently pursued, may show individual misconduct of various kinds, but do not reflect widespread trading abuses. We believe that the existence of these cases shows the self-regulatory system at work, rather than the reverse, and should not lead to any delay in commencement of put trading.

As a result of the cases that were uncovered by CBOE and by the Commission, CBOE's entire surveillance system has been thoroughly reviewed and evaluated by CBOE's staff. Members of the Commission's staff both in Washington and in Chicago worked closely with us in this endeavor. As a part of this review, the staff conducted an on-site inspection of CBOE's surveillance procedures, techniques and personnel. In addition, a series of meetings was held in Washington with representatives of the Division of Market Regulation and the Division of Enforcement, during the course of which several suggestions for improvements were made. These included: (1) greater utilization of automated systems in analyzing trade data, (2) consolidation and simplification of certain procedures for reporting and analyzing trade information, (3) provision for same day monitoring of trade data, (4) greater diligence in the conduct of ongoing investigations, and (5) upgrading of training of surveillance personnel.

Responding to each of these five suggestions, CBOE has accomplished the following: (1) Incorporated into its surveillance operation maximum usage of automated data processing analysis, including a recently installed automated screening system that, based upon pre-determined parameters in transactions involving closing prices and trades between market makers, identifies certain trades for further inquiry, (2) simplified the overall paperwork burden, in large part as a result of replacing manual screening of trade reports by automated techniques, (3) trained operations monitoring personnel to review all transactions on a current basis, providing, in effect, “on-line” surveillance of options transactions, (4) instituted stronger control procedures for handling investigations in progress, and (5) instituted a number of improvements in the training of surveillance personnel, including the preparation of a revised and strengthened surveillance manual.

The review and improvement of CBOE’s surveillance system did more than respond to specific suggestions; it has entailed a systematic “from the ground up” reappraisal of the entire surveillance operation, with special attention given to put trading. As a result, we have been able to incorporate from the start those systems needed to deal with potential trading abuses that might arise when puts are traded. The first step of this process was to define what, if any, special problems might be associated with put trading. For assistance in this task, CBOE assembled two groups of industry experts as consultants. One group consisted of persons associated with retail-oriented firms who represent a broad cross section of listed call and unlisted put and call experience and who are thoroughly familiar with options trading practices. A separate group consisted of CBOE floor members.

Both groups came up with similar findings. Most important, no “hidden” problems peculiar to puts were identified, and it was agreed that the same general system of surveillance and enforcement would serve for both puts and calls. However, two factors were identified as calling for special treatment. First, since puts require certain mental adjustments reflecting that put prices move inversely in relation to stock prices and call prices, individuals responsible for surveillance functions will require intensive training. That training is under way and will be completed this month.

Second, the added complexity of options positions involving both puts and calls makes analysis of such positions for surveillance purposes more difficult. However, we have developed techniques of computer analysis that break down all positions -- puts, calls and stocks -- into “same side” and “opposite side” segments and greatly simplify the task of analysis.

Thus, prior to the commencement of listed put trading, CBOE will have a floor surveillance system that recognizes the special characteristics of puts but benefits from our substantial experience with calls and takes advantage of previously unavailable automated techniques.

INDUSTRY OPERATIONAL READINESS

In addition to developing our own systems and procedures for put trading, another major objective of our planning, to which we have devoted considerable resources, has been the achievement of member firm operational readiness for puts. We began this effort in October, 1975, when the registered options principals (ROPs) of each firm were notified of the filing with the Commission of CBOE’s intention to trade put options. At that time it was recognized that certain functions associated with put trading would be subject to especially long lead times due to computer programming requirements, particularly for wire order transmissions to the trading floor and customer margins. A wire order format manual, including puts and straddles, was published and distributed to all member firms in January, 1976, and firms were able to implement necessary changes in time for a spring 1976 start-up.

In the area of customer margins, CBOE coordinated the writing of comprehensive margin rules with the other major exchanges. Once these margin rules were agreed upon and reviewed by the Commission's staff, CBOE was able to hold seminars for operations management personnel of member firms in January, 1976, at which time written margin rules, consistent for all exchanges trading options, were distributed. Thus, firms were able to begin programming at that moment. (The recently adopted amendment to the Federal Reserve Board's Regulation T instituting initial margin requirements in connection with option writing is compatible with the customer margin rules of CBOE and the other exchanges, so existing programming will not need to be changed.) CBOE then prepared a new margin circular, including puts, and a new margin manual for use by margin clerks in non-automated firms. CBOE also worked with the various software vendors to help them prepare for puts, and CBOE retained an outside consultant, Kenneth DeWitt, who had considerable experience in setting up the options department of a major wire house, to work with individual member firms. As spelled out in more detail below, a series of margin seminars for operational personnel, in addition to the seminars for management personnel mentioned above, were conducted on a nationwide basis. As a result of these efforts, combined with those of other industry organizations, member firms' margin departments are prepared for listed puts, and the Credit Division, Operations Committee and Executive Committee of SIA have not only endorsed but urged rapid SEC clearance for listed put trading.

For purposes of monitoring the readiness of member firms to handle puts, CBOE's clearing reports, margins and credit examinations, and all other pertinent segments of CBOE's member firm examination procedures have been modified in order to segregate, identify and analyze the operational impact of listed put trading. Because of this segregation of the monitoring of put trading, it should cause no disruptions in CBOE's ongoing monitoring of operational aspects of call trading.

SALES PRACTICES

From the inception of the CBOE listed put trading program, our approach has been a conservative one. We have taken cognizance of the fact that listed put trading is something new for investors and we have devoted major efforts toward addressing this fact. We have directed a large educational effort toward industry personnel and the public, as described below, and we have required that the higher standard of suitability presently applicable to uncovered call writing must also apply to all put writers (covered or uncovered). Further, we are requiring a separate put qualification and testing program for ROPs and RRs, not only to qualify for puts but also to retain previously earned call qualifications. (We have worked with other exchanges that trade options in creating this qualification program, so there will be uniform industry-wide practice in this regard. Other aspects of the put qualification program are covered in the "Education" segment of this letter.) Also, member firm routine and special examination forms and procedures have been revised to include puts. Revised educational circulars, including strengthened guidelines for advertising and sales literature, have been prepared and will be distributed when the timetable for the commencement of put trading is fixed.

Finally, following a thorough review of compliance procedures, we recently approved a rule change requiring that at each firm one Senior Registered Options Principal (Senior ROP), who must be an executive officer or partner, be assigned overall responsibility for supervision of the public customer options business. The new rule also introduces a requirement that the firm must have written procedures governing the supervision of its options customer accounts, and any delegation of the Senior ROP's supervisory duties must be in accordance with these procedures. Reflecting this rule and other improvements mentioned above, we have recently prepared a revised sales practices educational circular, including puts, that places strong emphasis upon providing supervisory tools to branch managers, and illustrates what some of these tools might be. Both our new rule and the revised educational circular have been thoroughly reviewed and evaluated by the Compliance Division of the SIA.

These actions, combined with the educational program outlined in the following section, should serve to strengthen supervision over sales practices while maintaining and enhancing methods which have proven successful.

<u>INDUSTRY & PUBLIC EDUCATION</u>

The put educational program designed in 1975 was based on the perception that a well-prepared industry, with well-trained and knowledgeable member-firm personnel, was necessary for the orderly implementation of put trading. Early in the planning stages it became clear that CBOE would have to lead the way and provide the majority of resources for what has become, to our knowledge, the most massive training effort ever undertaken in the securities industry. Each phase of the program has been designed to coincide with certain related events during the period of put development. Thus, while much of the program has now been completed, or is presently underway, a few elements remain for implementation following Commission approval of put trading. In order to show the size and scope of this educational effort, it is presented below in outline form. Elements that will take place after SEC approval of puts are marked by an asterisk. All others are complete or under way.

I INDUSTRY PREPARATION

A. Operations Management Seminars – Jan., 1976
(N.Y. & Chicago)

1. Purpose: Provide member firm operations management personnel with necessary details for put planning.

2. Publications: Special manual including put-related margin rules and a wire order format manual.

B. Margin Rules Update (publication) – March 12, 1976
(Revised per agreement with SEC staff).

C. Registered Options Principal Seminars – April, 1976
(7 U.S. cities) This series of seminars was jointly sponsored by CBOE, AMEX, PHLX and PSE.

1. Purpose: Prepare Senior ROPs for put trading and provide framework for training member firm personnel.

2. Publications: ROP training manual and ROP put qualification exam.

D. Compliance Seminars – May, 1976 (N.Y., L.A. & Chicago)

1. Purpose: Prepare member firm compliance officers for put trading. Concentration on understanding of possible pitfalls and importance of RR training effort.

2. Publication: Educational circular on sales practices, including put options.

E. Margins Seminars – May, 1976 (N.Y., L.A. & Chicago)

1. Purpose: Provide margin clerks detailed explanations of margin rules with emphasis on problem-solving.

2. Publications: Margin circular including puts and same calculations and margins rules review.

F. CBOE-SIA Margins Seminars – July, 1976 (5 U.S. cities)
Sponsored by CBOE, conducted by SIA Credit Division members.

1. Purpose: Provide margin clerks with exposure to industry experts and their approach to put margining.

G. Branch Manager Seminars – October, 1976 (7 U.S. cities)

1. Purpose: Strengthening options-related compliance and management abilities of branch managers prior to commencement of put trading.

2. Publication: Branch manager options manual.

H. Registered Representative Seminars* – Will be conducted just prior to put trading commencement date (52 U.S. cities plus 2 Canadian cities).

1. Purpose: Provide RRs with authoritative basic explanation of risk characteristics of puts. Highlight pitfalls.

2. Publications: Registered personnel put trading manual and visual aid presentation.

II FLOOR PREPARATION

A. Member & Floor Managers Seminars – May, 1976
(20 seminars)

1. Purpose: Prepare market-makers and floor brokers for put trading. Concentration on rules and procedures.

2. Publication: Special manual.

C. Board Broker Staff Seminars – May, 1976 (4 seminars)

1. Purpose: Prepare board broker personnel for put trading. Concentration on rules, procedures and handling of the book.

2. Publication: Board broker put manual.

D. Floor Preparation Refresher Courses* – Will be held for each function prior to simulated trading exercise.

E. Simulated Trading Exercise* – Will be held 2 weeks prior to put trading commencement date. Simulation will include not only trading but order transmission, clearing, trade matching and provision for tie-in to member firm internal systems.

In addition, a number of publications have been created in order to assure that accurate and adequate information will be available to securities industry sales personnel and their customers. (They will, of course, be a secondary source of information relative to the current OCC Prospectus dated October 29, 1976, which covers both listed puts and listed calls.) These publications are listed below. Those with an asterisk are awaiting Commission approval of puts before they will be released.

<u>Options Reference Manual</u>* – Complete detailed information covering every facet of options trading. Cross-indexed in order to provide immediate answers. Includes listed puts, listed calls and combinations of these positions. Designed as a guide for RRs in providing technical information and assessing suitability of certain strategies.

<u>Tax Considerations In Using CBOE Options</u> – Intended for both RRs and customers. Discusses in detail the tax implications of put and call options. Incorporates 1976 Tax Reform Act.

Understanding Options* (including put options) – Customer oriented basic explanation of put and call options. Avoids complicated strategies for better understanding. New version, revised for puts, of this most widely distributed customer education piece.

Options Margin Manual* – Quick reference guide for margin clerks, includes puts, calls and combinations thereof. Created by CBOE, edited and approved by SIA Credit Division.

Educational circulars covering margins and sales practices with relation to put and call options have been written, and will be distributed prior to trading. These publications have been prepared in coordination with the relevant division of SIA.

One additional comment should be made before closing this discussion of put option educational programs. That is, although there is much about puts that is new and will seem complicated until puts are better understood, there is also much that puts have in common with calls, where a much higher level of understanding has been built up over the past three years. Thus, most of the technical details, terminology, industry methods and associated descriptions applicable to puts are already in use with respect to call options. We have been able to take advantage of this in preparing our educational program for puts, since, by not having to repeat what is already understood in the context of call options, we have been able to concentrate upon the special investment characteristics, risks and suitable uses of put options. This concentration is in line with the generally cautionary approach that we have taken and, judged by our seminar experience, has greatly enhanced the effectiveness of the various programs.

OPTION-RELATED REGULATORY QUESTIONS

In Chairman Hills' October 4, 1976 letter, reference was made to a number of option-related regulatory matters to which the Commission has given attention, and it was indicated that additional work was required on these matters before the Commission could be satisfied that expansion into puts would be proper. The letter identified NASD dual market-making, front-running and listing and maintenance standards as being some of these options-related regulatory issues.

Since the date of your letter, considerable progress has been made on the first and third of these issues and, as to front-running, we understand that the Commission is close to acting on our long-pending rule proposal (Rule 4.18) that in concept is very close to a recently approved rule adopted in connection with the options program of the Midwest Stock Exchange (MSE Rule 8 – "Priority Information"). A further issue that has been of great concern to the Commission and to CBOE since Chairman Hills' October 4 letter, namely, exempt credit for market makers, is also well on the way to resolution. In this connection we would point out that to the extent revised rules of the Federal Reserve Board might limit the ability of market makers to utilize underlying stocks for hedging purposes, the availability of puts will provide market makers with an alternative means of hedging.

- - - -

We believe that the foregoing summary of progress that has been made on numerous fronts in recent months shows clearly that CBOE and its member firms are ready for put trading. We urge the Commission to act favorably on our put trading proposal in the very near future.

Puts and calls have always been traded together in the over-the-counter market and we believe they should now be traded together on exchange markets; as Chairman Hills has put it, they are "the other half of the horse." CBOE did not start trading puts and calls together in 1973 because, given the many innovations that its new market entailed, we thought that prudence required moving in small steps. Since 1973 CBOE has grown from approximately 400 members and 16 classes of options to 1,300 members and 86 classes of options; and four other exchanges have been permitted to create options markets following our basic innovations. With all this expansion of options trading in the past four years, the commencement of put trading, which was somewhat artificially separated from the commencement of call trading as part of CBOE's cautionary approach in 1973, has been deferred for one reason or another. As a result, investors in listed options have not been able to avail themselves of the many uses of put options. We believe that these uses of puts should be made available in exchange markets, and that additional delay will seriously disadvantage CBOE in an increasingly competitive environment. We hope the Commission will now agree that there is no further reason for deferral.

Very truly yours,

Joseph W. Sullivan