The ChicagoBoard Options Exchange

Joseph W. Sullivan
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Chicago, Illinois 60604 312 431-5701

October 20, 1977

TO: Board of Directors

FROM: Joe Sullivan

Attached is a set of the SEC options releases of Tuesday, October 18, 1977.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 14057/October 17, 1977

In the Matter of

American Stock Exchange, Inc.
86 Trinity Place
New York, New York 10006

Chicago Board Options Exchange, Incorporated
LaSalle at Jackson
Chicago, Illinois 60604

Midwest Stock Exchange, Incorporated
120 South LaSalle Street
Chicago, Illinois 60603

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

New York Stock Exchange, Inc.
11 Wall Street
New York, New York 10005

Pacific Stock Exchange Incorporated
301 Pine Street
San Francisco, California 94104

Philadelphia Stock Exchange, Inc.
17th Street & Stock Exchange Place
Philadelphia, Pennsylvania 19103

File Nos.

SR-Amex-76-12	SR-MSE-77-28
SR-Amex-76-23	SR-NASD-77-2
SR-Amex-77-8	SR-NYSE-77-17
SR-Amex-77-9	SR-NYSE-77-21
SR-CBOE-76-16	SR-PHLX-76-18
SR-CBOE-76-27	SR-PHLX-77-5
SR-CBOE-77-5	SR-PHLX-77-6
SR-CBOE-77-14	SR-PSE-76-17
SR-CBOE-77-15	SR-PSE-76-40

SR-CBOE-77-16	SR-PSE-77-9
SR-MSE-77-2	SR-PSE-77-13
SR-MSE-77-4	SR-PSE-77-15
SR-MSE-77-6	SR-PSE-77-17

ORDER INSTITUTING CONSOLIDATED PROCEEDINGS TO DETERMINE WHETHER THE FOREGOING PROPOSED RULE CHANGES SHOULD BE DISAPPROVED

The self-regulatory organizations listed above have each filed with the Commission, pursuant to Section 19(b) (1) of the Securities Exchange Act of 1934 (the "Act"), 15 U.S.C. 78(a)(b)(1), and Rule 19b-4 thereunder, 17 CFR 240.19b-4, rule or rule change proposals which would expand existing programs for trading standardized options or initiate new programs for such trading (the "Expansion Proposals"). Notice of each proposal, together with the respective terms of substance thereof, was given by the publication of a Commission release and by publication in the Federal Register as follows:

To expand the number of call option classes which may be listed on the American Stock Exchange, Inc. ("Amex") from 80 to 100 classes, SR-Amex-76-12, Securities Exchange Act ("SEA") Release No. 12334; April 12, 1976, 41 FR 16523, April 19, 1976;

To permit the trading on Amex of options on underlying securities that are solely traded in the over-the-counter market, SR-Amex-76-28, SEA Release No. 13095, December 22, 1976, 42 FR 2146, January 10, 1976;

To permit trading on Amex of options on Government guaranteed debt securities, SR-Amex-77-8, SEA Release No. 13559, June 20, 1977, 42 FR 2734, May 27, 1977;

To permit the Amex to institute strike price intervals of 5 points for option series on underlying stocks priced up to $100, and 10 point intervals for option series on stocks above $100, SR-Amex-77-9, SEA Release No. 13518, May 6, 1977, 42 FR 24779, May 16, 1977;

To permit the trading on the Chicago Board Options Exchange, Incorporated ("CBOE") of options on underlying securities that are solely traded in the over-the-counter market, SR-CBOE-76-16, SEA Release No. 12703, August 12, 1976, 41 FR 35884, August 23, 1976;

To expand the number of call option classes which may be listed on the CBOE from 100 to 125 classes, SR-CBOE-76-27, SEA Release No. 13160, January 13, 1977, 42 FR 3911, January 21, 1977.

To permit the CBOE to institute strike price intervals of 5 points for option series on underlying stocks priced up to $80, and 10 point intervals for option series on stocks above $80, SR-CBOE-77-5, SEA Release No. 13429, April 4, 1977, 42 FR 19194, April 12, 1977;

To trade equity securities on the CBOE floor, SR-CBOE-77-14, SEA Release No. 13672, June 24, 1977, 42 FR 33825, July 1, 1977;

To permit the trading on CBOE of options on Government guaranteed debt securities, SR-CBOE-77-15, SEA Release No. 13698, June 29, 1977, 42 FR 35236, July 8, 1977;

To provide increased position limits for CBOE member options positions which are offset by related positions on the opposite side of the market, SR-CBOE-77-16, SEA Release No. 13883, July 25, 1977, 42 FR 38949, August 1, 1977;

To permit the Midwest Stock Exchange, Incorporated ("MSE") to institute strike price intervals of 2 1/2 points for option series on underlying stocks priced up to $25 and 5 point intervals for option series on stocks between $25 and $100, SR-MSE-77-2, SEA Release No. 13369, March 14, 1977, 42 FR 16005, March 24, 1977;

To permit the trading on MSE of options on underlying securities that are solely traded in the over-the-counter market, SR-MSE-77-4, SEA Release No. 13406, March 25, 1977, 42 FR 19200, April 12, 1977;

To expand the number of call option classes that may be listed on the MSE from 20 to 40 classes, SR-MSE-77-6, SEA Release No. 13431, April 5, 1977, 42 FR 19202, April 12, 1977;

To allow MSE option and equity members to hold simultaneous market maker appointments in both an option and its underlying stock, SR-MSE-77-28, SEA Release No. 13707, June 30, 1977, 42 FR 35718, July 11, 1977;

To permit the National Association of Securities Dealers, Inc. to display standardized options quotations on the NASDAQ system under a pilot program, SR-NASD-77-2, SEA Release No. 13230, February 1, 1977, 42 FR 8244, February 9, 1977;

To permit the trading of standardized options on the New York Stock Exchange, Inc. ("NYSE") under a pilot program, SR-NYSE-77-17, SEA Release No. 13674, June 24, 1977, 42 FR 33829, July 1, 1977;

To enable the NYSE to offer for sale options market maker annual memberships, SR-NYSE-77-21, SEA Release No. 13882, August 22, 1977, 42 FR 44052, September 1, 1977;

To increase the number of call option classes which may be listed on the Philadelphia Stock Exchange, Inc. ("PHLX") from 40 to 70 classes, SR-PHLX-76-18, SEA Release No. 13071, December 14, 1976, 41 FR 55758, December 22, 1976;

To permit PHLX to institute strike price intervals of 5 points for option series on underlying stocks priced below $100, and 10 point intervals for option series on stocks at

or above $100, SR-PHLX-77-5, SEA Release No. 13517, May 6, 1977, 42 FR 24790, May 16, 1977;

To eliminate the requirement that a wall or physical barrier separate option and stock trading activities on the PHLX, SR-PHLX-77-6, SEA Release No. 13689, June 28, 1977, 42 FR 34561, July 6, 1977;

To permit the trading on the Pacific Stock Exchange Incorporated ("PSE") of options on underlying securities that are solely traded in the over-the-counter market, SR-PSE-76-17, SEA Release No. 12539, June 11, 1976, 41 FR 24787, June 18, 1976;

To expand the number of call option classes which may be listed on the PSE from 30 to 50 classes, SR-PSE-76-40, SEA Release No. 13161, January 13, 1977, 42 FR 3914, January 21, 1977;

To permit the PSE to institute strike price intervals of 2 1/2 points for option series on underlying stocks priced below $25, 5 point intervals for option series on stocks between $25 and $60, and 10 point intervals for option series on stocks above $80, SR-PSE-77-9, SEA Release No. 13485, April 28, 1977, 42 FR 23901, May 11, 1977;

To eliminate the requirement that a wall or physical barrier separate option and stock trading activities on the PSE, SR-PSE-77-13, SEA Release No. 13567, May 23, 1977, 42 FR 28178, June 2, 1977;

To expand the number of call option classes which may be listed on the PSE to 80 classes, SR-PSE-77-15, SEA Release No. 13795, July 22, 1977, 42 FR 38952, August 1, 1977;

To allow PSE members to hold simultaneous market maker appointments in both an option and its underlying stock, SR-PSE-77-17, SEA Release No. 13725, July 7, 1977, 42 FR 37083, July 19, 1977.

GROUNDS FOR DISAPPROVAL UNDER CONSIDERATION

The Expansion Proposals of the respective self-regulatory organizations listed above have one feature in common. Each appears to provide for an expansion of options trading activities in the trading market for which those respective organizations have self-regulatory responsibility, either by providing for the expansion of an existing program for the trading of standardized options or by initiating a new program for the trading of such options. Under Section 19(b)(2) of the Act, the Commission may approve a proposed rule change of a self-regulatory organization only if it finds that such proposed rule change is consistent with the requirements of the Act and applicable rules and regulations thereunder; the Commission is required to disapprove a proposed rule change if it does not make that finding.

The Commission, for reasons set forth in Securities Exchange Act Release No. 14056 (October 17, 1977) (the "Release") has determined that it is necessary to initiate an investigation and study pursuant to Sections 2, 3, 6, 9(b), 10(b), 11A, 15(c), 15A, 19(b), 19(c), 19(g), 19(h), 21(a) and 23 of the Act to evaluate, among other things, (i) whether the several self-regulatory organizations' regulatory and surveillance programs are adequate to prevent fraudulent, deceptive and manipulative acts, practices, devices and contrivances, to maintain fair and orderly markets in options and in their underlying securities, to protect investors and to enforce the Act, rules adopted thereunder and the rules of such self-regulatory organizations; (ii) whether those self-regulatory programs have adequately kept pace with the dramatic expansion of standardized options trading, or are capable of absorbing the additional burdens that might be occasioned by further expansion of such trading; (iii) whether there are adequate criteria for evaluating, among other things, whether particular options expiration cycles, exercise price intervals and other standardized terms are consistent with the purposes of the Act; and (iv) whether the rapid expansion of standardized options trading has been, and whether expansions such as those contemplated by the Expansion Proposals are, consistent with the public interest in ensuring that securities trading does not adversely affect the financing of trade, industry and transportation in interstate commerce and in perfecting the mechanisms of a national market system for securities.

The Proposals raise, in an ad hoc, piecemeal fashion, concerns that are the subject of the Commission's investigation and study. As an administrative and regulatory matter, fragmented, case-by-case consideration of these important issues appears unsound, and potentially damaging to investor protection and the public interest. In addition, it appears to the Commission that, in order to approve any of the Expansion Proposals, the Commission would have to answer many of the same questions that are the subject of the options investigation and study it has authorized and announced in the Release. Thus, it appears that, until the study and investigation are completed, the Commission may not be able to make the required findings for approval of the Expansion Proposals. For these very reasons, in order to preserve the status quo pending a resolution of the Commission's investigation and study, the Commission has today proposed for adoption in the Release, Rule 9b-1(T) under the Act. That rule would make it unlawful to expand any existing program for the trading of standardized options, or for any exchange or association to initiate any new programs for the trading of such options.

Each of the self-regulatory organizations bears a burden under Section 19(b) of the Act to demonstrate that each of its proposed rule changes is consistent with the requirements of the Act and the rules and regulations thereunder. But, in light of the nature and complexity of the questions that have been raised, the self-regulatory organizations have not yet sustained (and may not at this time be able to sustain) their statutory burden with respect to the Expansion Proposals. Accordingly, for the reasons set forth above and in the Release, the Commission has determined to give notice at this time that the pending Expansion Proposals are the subject of disapproval proceedings. In particular, in view of the considerations described above, the following specific grounds for disapproval of the Expansion Proposals are now under consideration:

A. Section 6(b)(1) of the Act requires that a national securities exchange be organized and have the capacity to be able to carry out the purposes of the Act and to comply, and to enforce compliance by its members and persons associated with its members, with the

provisions of the Act, the rules and regulations thereunder, and the rules of the exchange. Section 15A(b)(2) of the Act imposes similar requirements upon registered securities associations. The Commission is unable to find at this time that implementation of the Expansion Proposals, under current circumstances, would not result in violations of the requirements of Sections 6(b)(1) or 15A(b)(2) of the Act by each of the self-regulatory organizations listed above.

B. Section 6(b)(5) of the Act requires that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Section 15A(b)(6) of the Act imposes similar requirements on registered securities associations. The Commission is unable to find at this time that implementation of the Expansion Proposals, under current circumstances, would not result in violations of the requirements of Sections 6(b)(5) or 15A(b)(6) of the Act by each of the self-regulatory organizations listed above.

C. Section 6(b)(6) of the Act requires that the rules of a national securities exchange provide that its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of the Act, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction. Section 15A(b)(7) of the Act imposes similar requirements on registered securities associations. The Commission is unable to find at this time that implementation of the Expansion Proposals, under current circumstances, would not result in violations of the requirements of Sections 6(b)(6) or 15A(b)(7) of the Act by each of the self-regulatory organizations listed above.

D. Section 6(b)(8) of the Act requires that the rules of a national securities exchange not impose any burden on competition not necessary or appropriate in furtherance of the Act. Section 15A(b)(9) of the Act imposes a similar requirement on registered securities associations. The Commission is unable to find at this time that implementation of the Expansion Proposals, under current circumstances, would not result in violations of the requirements of Sections 6(b)(8) or 15A(b)(9) of the Act by each of the self-regulatory organizations listed above.

The instant consolidated disapproval proceedings are not intended to deal comprehensively with every potential basis for considering disapproval of the various Expansion Proposals; rather, the Commission is of the view that the particular concerns it has articulated above, considered alone, presently preclude it from making the findings which are a prerequisite under Section 19(b) of the Act to approval of the Expansions Proposals. Should the Commission remain unable to make those findings, in light of the matters described above, it must disapprove the Expansion Proposals. But if it should prove necessary to take such action, such disapproval should not be construed to bar further consideration of the Expansion Proposals at some time in the future, under other circumstances, assuming satisfactory resolution of those issues which now

prevent the Commission from finding that the Expansion Proposals are consistent with the requirements of the Act and the rules and regulations thereunder.

Procedure

The Commission has determined to provide an opportunity for the written presentation of views, data and arguments, as part of these proceedings. Interested persons are invited to submit written views, data and arguments within 30 days from the date hereof as to the Expansion Proposals. Copies of all submissions will be available for inspection at the Commission's Public Reference Room, 1100 L Street, N. W., Washington, D. C. Copies of the submissions are also available at the principal office of the self-regulatory organization which has made a particular filing. Persons desiring to make written statements should file six copies thereof with the Secretary of the Commission, Securities and Exchange Commission, 500 North Capitol Street, Washington, D. C. 20549 by November 16, 1977.

By the Commission.

George A. Fitzsimmons
Secretary

SECURITIES AND EXCHANGE COMMISSION

[17 CFR Part 240]

[Release No. 34-14056 ; File No. S7-722]

INVESTIGATION OF STANDARDIZED OPTIONS TRADING AND REGULATION OF SUCH TRADING; PROPOSED RESTRICTION OF FURTHER EXPANSION OF PILOT OPTIONS TRADING PROGRAMS; AND COMMISSION DISAPPROVAL PROCEEDINGS

AGENCY: Securities and Exchange Commission

ACTION: Announcement of investigative proceeding concerning trading of standardized options and regulation of such trading; proposal of temporary rule to restrict expansion of options trading; announcement of commencement of disapproval proceedings with respect to certain proposed rule changes of self-regulatory organizations concerning expansion of options trading

SUMMARY: This release announces commencement of an investigative proceeding concerning trading of standardized options and regulation of such trading. In addition, as a consequence of the nature of the questions to be addressed in the investigation, this release invites public comment concerning proposed Temporary Rule 9b-1(T) (the "Rule"), which, if adopted, would prevent any exchange or association from expanding any existing program for the trading of standardized options or initiating any new program for the trading of such options at this time. Finally, this release announces commencement of disapproval proceedings with respect to various self-regulatory organizations' proposed rule changes which would expand existing pilot options trading programs or initiate new programs for options trading.

DATES: Comments by November 30, 1977

ADDRESSES: All comments should refer to File No. S7-722 and should be sent with three copies to George A. Fitzsimmons, Secretary, Securities and Exchange Commission,

Washington, D.C. 20549. All submissions will be made available for public inspection at the Commission's Public Reference Room, Room 6101, 1100 L Street, N.W., Washington, D.C.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION: The Commission announced today the initiation of an investigation and study pursuant to Sections 2, 3, 6, 9, 10, 11A, 15, 15A, 19(b), 19(c), 19(g), 19(h), 21 and 23 of the Securities Exchange Act of 1934 (the "Act"),[1] to determine what action is necessary to aid in the enforcement of the Act,[2] and whether additional rules thereunder should be proposed to protect investors and the public interest and to maintain fair and orderly markets in connection with the trading of standardized options and underlying securities. The investigation and study have been initiated because of Commission concern regarding: (1) the present ability of the self-regulatory organizations' surveillance systems to detect and prevent fraudulent, deceptive, and manipulative activity, both in options and in underlying securities, in a manner which is consistent with the maintenance of fair and orderly markets and the protection of investors and that complies with the requirements of the Act; (2) the adequacy of existing Commission and self-regulatory organization rules to prevent fraudulent, deceptive and manipulative acts, practices, devices and contrivances in connection with options trading; (3) the development of the standardized options markets in a manner which is consistent with the public

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1 15 U.S.C. §§ 78b, 78c, 78f, 78i, 78j, 78k-1, 78o, 78o-3, 78s(b), 78s(c), 78s(g), 78s(h), 78u and 78w.

2 15 U.S.C. §78a, et seq.

interest in perfection of the mechanisms of a national market system for securities and prevention of securities trading which adversely affects the financing of trade, industry and transportation in interstate commerce; and (4) the development of appropriate standards, formulated with reference to the purposes of the Act, by which to measure the appropriateness of particular programs which would have the effect of expanding or altering existing pilot options trading programs.

The Commission also announced and invited public comment on proposed Temporary Rule 9b-1(T) under the Act, which, if adopted, would temporarily defer the expansion of existing pilot options trading programs and the initiation of new programs, pending completion of the study and investigation.

Finally, because of the Commission's concerns regarding the development of existing pilot options trading programs, and its present inability to find that pending self-regulatory organization rule change proposals designed to expand the options trading pilot programs are consistent with the requirements of the Act and rules thereunder, the Commission announced initiation of disapproval proceedings for all such rule change proposals.

BACKGROUND AND PURPOSE

Section 9(b) of the Act prohibits the trading of options, by use of any facility of a national securities exchange, "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[3] This broad, plenary authority with respect to options trading was conferred on the Commission

3 15 U.S.C. §78i (1970).

because of the unique threat which the Congress believed options trading posed to the integrity of the securities markets.

In the early 1930's, a series of Congressional and private studies exposed widespread manipulative and fraudulent practices in the securities industry involving options and the trading of underlying securities.[4] Consequently, the Congress proposed, in the early drafts of Section 9(b) of the Act, simply to prohibit all forms of options contracts.[5] Financial authorities[6] and securities industry representatives,[7] however, suggested that, while options had been employed conspicuously for manipulative purposes, legitimate financial ends might be served by the use of such securities. Consequently, the Congress entrusted the Commission in Section 9(b) of the Act with discretion as to whether, and how, to "experiment" with options trading under regulatory circumstances which would eliminate the manipulative and fraudulent uses of options.[8]

Initiation of standardized options trading. In light of this history, particularly the clear intent of Congress to permit options trading, if at all, only under carefully controlled circumstances, the Commission has proceeded cautiously in permitting exchanges to initiate pilot

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4 Senate Comm. on Banking and Currency, "Stock Exchange Practices," S. Rep. No. 1455, 73d Cong., 2d Sess. (1934) (hereinafter cited as "Pecora Commission Report"); Twentieth Century Fund, Inc., The Security Markets (1935) (hereinafter cited as "Twentieth Century Fund Report"). See Tracy and MacChesney, The Securities Exchange Act of 1934, 32 Mich. L. Rev. 1025 (1934); See also Comment, Market Manipulation and The Securities Exchange Act, 46 Yale L. J. 624 (1937).

5 Subsection 8(a)(9), H.R. 7852 (February 10, 1934).

6 See, e.g., Twentieth Century Fund Report, supra note 4 at 251, 447-8.

7 See e.g., Testimony of Richard C. Whitney, President, New York Stock Exchange, regarding H.R. 7852, Hearings on Stock Exchange Practices of the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6632 (1934).

8 H. R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934).

programs for the trading of standardized options, and has maintained the pilot status of such programs because of the Commission's continuing concern that experience might indicate a need to eliminate these tentative options trading programs altogether. The Commission's caution in that regard has been dictated, in part, by its awareness that standardized options trading, absent appropriate surveillance safeguards, might re-establish, and indeed magnify, dangers to the marketplace which the Act was intended to erradicate.

These same concerns persuaded the Commission, prior to authorizing standardized options trading, that competent primary regulation by the self-regulatory organizations and effective oversight of trading in options would be necessary prerequisites to the initiation and continuance of any such trading.[9] In view of arguments to the effect that the economic benefits

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9 Experience has strengthened this conviction, particularly since options-related manipulations appear to be more easily affected today than once was the case.

For example, options-related manipulation of stocks in connection with the former non-standardized over-the-counter options market was a difficult undertaking. Typically, pools of individuals obtained options on blocks of stock at bargain prices, then artificially inflated the price of the underlying stock (over wide price ranges) for weeks or even months, and eventually exercised their options and distributed the stock so obtained into the market at the inflated prices. See, e.g., Twentieth Century Fund Report, supra note 4, at 443-508; the Pecora Commission Report, supra note 4; and Stock Market Control (D. Appleton-Century Co., Inc., 1934), at p. 107-26.

Under current circumstances, however, even minor price movements in underlying stocks are generally accompanied by continuous price adjustments by market makers and other participants in the standardized options markets. Experience has shown that, as individual near-term series reach the "at-the-money" stage, for example, these price adjustments occur on close to a dollar-for-dollar basis with parallel changes in the price of the underlying securities. Accordingly, it is possible, in standardized options markets, to accrue relatively large manipulative profits, through the purchase and resale of options on an options exchange, by affecting, for a relatively short time period, only a small price movement in the underlying stock. Alternatively, manipulative operations in the options markets may be undertaken with a view to capping or pegging price movements in the underlying stock in order to profit from related options positions. In contemporary options markets, it appears also that manipulative activity can occur faster, with greater frequency, and with a relatively smaller commitment of capital and personnel to the

of options ownership in connection with ownership of underlying securities could outweigh the dangers of options trading if the securities markets are adequately regulated, but only on the basis of assurances that effective regulation would, in fact, be present, the Commission authorized establishment of "pilot" programs for the trading of standardized options on national securities exchanges in 1973.[10]

In particular, on February 1, 1973, the Commission granted the application of the Chicago Board Options Exchange, Incorporated (the "CBOE") to register as a national securities exchange pursuant to former Section 6 of the Act,[11] in order to permit it to "test the market" for the trading of standardized call options "within a controlled environment."[12] The Commission specifically noted in its approval order that it intended "to maintain a close surveillance over the progress of the CBOE's 'pilot project'" and "to maintain flexibility in regulating this new type of exchange market."[13] In adopting former Rule 9b-1 on December 13, 1973,[14] the Commission reiterated the particular need for close surveillance of pilot options programs which "may

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manipulative purpose than was formerly possible with non-standardized over-the-counter options.

10 Securities Exchange Act Release No. 10552 (December 13, 1973).

11 15 U.S.C. §78f (1970).

12 Securities Exchange Act Release No. 9985 (Feb. 1, 1973).

13 Id.

14 17 CFR §240.9b-1 (1974). That rule prohibited transactions on exchanges in puts, calls, straddles and other options or privileges of buying or selling a security except in accordance with plans established by the exchanges that the Commission declared effective as being necessary or appropriate in the public interest or for the protection of investors. Rule 9b-1 was rescinded by the Commission upon the adoption of Rule 19b-4 under the Act, 17 CFR §240.19b-4. Securities Exchange Act Release No. 11604 (Aug. 19, 1975), 40 FR 40512 (1975).

involve complex problems and special risks to investors and to the integrity of the marketplace."[15] With that in mind, it further stated its intention to use its broad rulemaking powers under Sections 9 and 23 of the Act to provide itself with substantial flexibility in carrying out its regulatory responsibilities with respect to options trading on exchanges.

Since 1973, the Commission has approved pilot options trading programs proposed by the American Stock Exchange, Inc. (the "Amex"),[16] the Philadelphia Stock Exchange, Inc. (the "Phlx"),[17] the Pacific Stock Exchange Incorporated (the "PSE"),[18] and the Midwest Stock Exchange, Incorporated (the "MSE").[19] In approving each of those options programs, the Commission emphasized, as it had in the case of the CBOE, that options trading was being permitted only on an experimental basis and that ongoing surveillance of the exchanges' programs might result in significant alterations in their options-related activities.

From 1973 to date, the Commission has approved proposals by each options exchange to expand its respective pilot program to some extent. Approximately six months ago, the Commission authorized a further expansion of each pilot options program by permitting the limited trading of put options on an experimental basis.[20] Again, the Commission emphasized

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15 Securities Exchange Act Release No. 10552 (Dec. 13, 1973). In the same release, the Commission approved the CBOE's plan to trade standardized options on a pilot basis pursuant to former rule 9b-1.

16 Securities Exchange Act Release No. 11144 (Dec. 19, 1974).

17 Securities Exchange Act Release No. 11423 (May 15, 1975).

18 Securities Exchange Act Release No. 12283 (Mar. 30, 1976), 41 FR 14454 (1976).

19 Securities Exchange Act Release No. 13045 (Dec. 8, 1976), 41 FR 54783 (1976).

the pilot nature of these programs and that close surveillance of options trading programs both by the self-regulatory organizations and by the Commission would be needed.

Currently, there are pending before the Commission a number of self-regulatory organization rule proposals that would permit further expansions of existing pilot options trading programs and, in two instances, rule proposals by other self-regulatory organizations to initiate new pilot options programs.[21] The proposals include, among other things, plans to multiply existing expiration cycles and strike price intervals for the trading of standardized options. In addition, some existing options trading programs have not, thus far, listed the maximum number of classes which have been authorized for trading by the Commission.

The Commission believes that the proposed expansions of existing pilot options trading programs raise significant issues concerning whether such expansions would be consistent with the Commission's and the self-regulatory organizations' responsibilities to assure the maintenance of fair and orderly markets; and to prevent fraudulent, deceptive and manipulative acts, practices, devices and contrivances in the securities markets. The Commission is also concerned that, more broadly, experience with existing pilot options trading programs has not yielded answers to certain general questions bearing upon the future of standardized options trading. These questions include: (i) how to develop standards by which to gauge, on a case-by-

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20 Securities Exchange Act Release No. 13401 (Mar. 23, 1977), 42 FR 17547 (1977). In that connection, each options exchange was permitted to initiate trading in no more than five put options classes.

21 File Nos. SR-Amex-76-12; SR-Amex-76-28; SR-Amex-77-8; SR-Amex-77-9; SR-CBOE-76-16; SR-CBOE-76-27; SR-CBOE-77-5; SR-CBOE-77-14; SR-CBOE-77-15; SR-CBOE-77-16; SR-MSE-77-2; SR-MSE-77-4; SR-MSE-77-6; SR-MSE-77-28; SR-NASD-77-2; SR-NYSE-77-17; SR-NYSE-77-21; SR-Phlx-76-18; SR-Phlx-77-5; SR-Phlx-77-6; SR-PSE-76-17; SR-PSE-76-40; SR-PSE-77-9; SR-PSE-77-13; SR-PSE-77-15; and SR-PSE-77-17.

case basis, the appropriateness of particular self-regulatory organization proposals to expand options trading;[21a] (ii) whether standardized options trading represents a threat to the integrity of the capital-raising functions of the securities markets; and (iii) how such trading can or should be comprehended within the national market system for securities contemplated by the Act.

The Commission intends to investigate, and wishes to receive comment on, the foregoing questions in the context of experience by self-regulatory organizations, brokers, dealers, and public investors with existing pilot options trading programs. While some of the foregoing questions may not be amenable to definitive resolution, others (particularly those concerning the existing capabilities of self-regulatory organizations to comply with the Act's requirements in connection with pilot options trading programs and the adequacy of existing regulation of options trading) must be resolved, in the Commission's view, because of recent problems in those areas, before further expansion of pilot options trading programs can be determined to be consistent with the requirements of the Act. The Commission, however, does not wish commencement of this investigation, or the concerns expressed herein, to be interpreted as a determination that current options trading is inherently improper or incapable of appropriate regulation or is inconsistent with the maintenance of fair and orderly markets and the protection of investors.

21a The problem of articulating standards for expansion proposals arises, for example, in connection with rule changes which would alter currently employed strike price intervals or trading cycles for the various authorized classes of options because, at least theoretically, there is no limit on the extent to which such expansion could occur.

Recent problems. During the nearly four years since the initiation of standardized options trading, the volume of such trading has grown beyond initial expectations.[22] Accompanying that burgeoning trading activity have been instances of alleged and admitted violations of the federal securities laws and exchange and Commission rules. Viewed in isolation, those particular instances did not, at first, appear to be unusual in nature or severity. In part, the Commission was persuaded initially by the options exchanges that, as they gained experience in regulating options trading, their systems for surveillance and enforcement would be revised as necessary to detect and prevent such violations.

On the basis of the Commission's experience over recent months, however, the Commission has serious questions as to whether existing self-regulatory programs are adequate to insure the maintenance of fair and orderly markets and the protection of investors. In addition, the Commission is particularly concerned that the regulatory and surveillance capabilities of the existing self-regulatory programs would be unacceptably strained if the options pilot programs were to be allowed, at this time, to expand. In the Commission's view, all available resources, both those of the self-regulators and those of the Commission, should be directed for the present at determining the nature and extent of the current regulatory deficiencies in the pilot options

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22 The significant increase in options trading is reflected by the yearly options contract volume statistics for all options exchanges from 1973 through August 1977:

1973	1974	1975	1976
1,119,177	5,682,907	18,102,569	32,373,927

1977 (Jan. – Aug.)
25,732,585

See Securities and Exchange Commission Statistical Bulletin, Volume 35, No. 5 – Volume 36, No. 8 (May 1976 – August 1977), reported monthly on table M-10 (A-10 until Volume 36, No. 3 (Mar. 19, 1977)), Value and Volume on U.S. Exchanges.

programs and at finding solutions to such deficiencies. Some of the events which have led the Commission to this conclusion are summarized below.

In early 1976, the Commission learned of widespread fictitious trading by option specialists on an exchange which had occurred over a period of several months. The exchange took disciplinary action against those involved, but the Commission judged those sanctions to be inadequate and instituted its own actions in 1977, resulting in the imposition of additional sanctions.[23]

Also, this year the Commission became aware of patterns of trading on options exchanges which suggested that floor members of those exchanges were increasing substantially their proprietary trading in certain dually traded options solely for the purpose of attracting order flow from major brokerage firms doing business with the public. In that regard, the Commission issued a general warning that the use of exchange facilities for that purpose may operate as a fraud upon public customers as well as upon other markets.[24]

Further, the Commission has also learned of, and is investigating, other situations indicating the occurrence of other abusive practices in the trading of options, including: (1) prearranged trades on the floor of an options exchange, for tax or other purposes, which result in the reporting of trades on the transaction tape although the parties have agreed that, after the tax year, the transactions will be reversed; (2) options transactions which amount to wash sales, matched orders, or other forms of prearranged trades entered into in order to, among other things, give the appearance of increased trading volume; (3) manipulation of the price of an underlying

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23 See Securities Exchange Act Release No. 13453 (April 9, 1977), Securities Exchange Act Release No. 13797 (July 22, 1977), and Securities Exchange Act Release No. 13798 (July 22, 1977).

24 Securities Exchange Act Release No. 13433 (April 5, 1977).

security for the purpose of pegging or depressing the value of its related option and preventing exercise; and, (4) options transactions made on the basis of undisclosed market information that a block of the underlying stock has been or is about to be traded. The Commission has also become aware of conduct by broker-dealers in the selling of standardized options which indicates transmittal of deceptive sales literature, churning of customers' options accounts, effecting of options transactions unsuited to customers' financial means and investment objectives, and extensions of credit to customers in violation of applicable federal regulations.

The facts uncovered by these ongoing investigations appear to indicate that the options exchanges may not have fulfilled their obligations in certain areas to maintain fair and orderly markets and to enforce compliance with the Act, the rules thereunder, and exchange rules.

During April of this year, the Commission's staff conducted a series of inspections of all of the existing options trading programs.[25] Those inspections were focused largely on the market surveillance and floor regulation capabilities of the individual options exchanges, and a variety of problems were identified. For example, the Commission's staff found that it is possible for options market makers and member firms to effect, for themselves or on behalf of their customers, "transactions" in listed options through clearing firm members, away from the options floor, and entirely outside of most existing market surveillance programs. Such transactions are possible because clearing firm members are able to "adjust" options positions

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25 On April 4 and 5, 1977, the staff conducted an inspection of the CBOE in Chicago, Illinois. On April 6, 1977 the staff conducted an inspection of the options trading program of the Midwest Stock Exchange, Incorporated in Chicago, Illinois. On April 7, 1977, the staff conducted an inspection of the options trading program of the Pacific Stock Exchange Incorporated in San Francisco, California. On April 11, 1977, the staff conducted an inspection of the options trading program of the Philadelphia Stock Exchange, Inc., in Philadelphia, Pennsylvania. On April 12 and 13, 1977, the staff conducted an inspection of the options trading program of the American Stock Exchange, Inc., in New York City.

directly with the Options Clearing Corporation after individual trades have cleared an exchange's market surveillance system. Under those circumstances, substantial violations of both exchange rules and the Act could be occurring without the knowledge and effective surveillance of either the Commission or the various self-regulatory organizations. Perhaps more importantly, it has become apparent that some surveillance procedures previously instituted by self-regulatory organizations to cure specific regulatory problems can no longer be considered effective, because of the exchanges' inability to relate position adjustments to particular transactions. The Commission's concern in this area is heightened by the fact that during a sample one-week period in April of this year, these so-called "adjusted trades" accounted for between 11.3% and 30.1% of all cleared options trading volume throughout the nation; and moreover, the self-regulatory organizations have not yet taken any effective action to resolve this problem.

A variety of other situations have been uncovered on various exchanges. On one major options exchange, the Commission's staff has found that no adequate surveillance program capable of identifying the members effecting particular options transactions exists, despite several earlier representations to the Commission by that exchange that such a program would quickly be instituted. On some exchanges, apparent misuse of market maker exceptions from the credit limits under Regulation T[26] were uncovered. On at least one exchange the staff has also uncovered disturbing discrepancies between reported and cleared trading volume.

The Act requires that exchanges have adequate programs to provide for the maintenance of fair and orderly markets. Unless certain market surveillance and regulatory capabilities in the options markets are improved, however, it does not appear that the Commission will be able to

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26 12 C.F.R. §§ 220.1-220.8.

insure that, in these markets, the federal securities laws and self-regulatory organization rules are adequately being enforced or that the public interest and investors are being properly protected.

The July request. On the basis of the results of the recent inspections and the facts uncovered by the ongoing investigations, and in view of numerous pending proposals to expand or initiate trading of standardized options, the Commission determined on July 18, 1977,[26] to begin a comprehensive review of standardized options generally and also of the operation of each existing pilot options program. At the same time, the Commission requested each options exchange to refrain from initiating trading in any class of options not listed for trading on that exchange on July 15, 1977.[27] The Commission further indicated that, pending its review of options trading and the regulation thereof, proposed rule changes designed to initiate new programs for the trading of options or to expand existing ones would be inconsistent with its general review, and should be deferred. That action was taken so that the Commission could, among other things, more accurately, and in a more orderly fashion, assess the sufficiency of the regulatory programs of the options exchanges and of other self-regulatory organizations for maintaining fair and orderly markets in options and in the securities underlying those options. The Commission stated that its review would reconsider, among other things, (i) the implications

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26 Securities Exchange Act Release No. 13760 (July 18, 1977), 42 FR 38035 (1977).

27 Pursuant to Rule 19b-4 under the Act (17 CFR § 240.19b-4), the Commission, at various times, has authorized a certain maximum number of options classes which may be traded on each options exchange respectively. See Securities Exchange Act Release No. 13104 (Dec. 27, 1976). 42 FR 88 (1976), (SR-Amex-76-12); Securities Exchange Act Release No. 12976 (Nov. 22, 1976), 41 FR 51486 (1976), (SR-MSE-76-14); Securities Exchange Act Release No. 12834 (Sept. 27, 1976), 41 FR 44242 (1976), (SR-PSE-76-21); Securities Exchange Act Release No. 12232 (Mar. 18, 1976), 41 FR 12370, 12371 (1976), (SR-CBOE-75-4); Securities Exchange Act Release No. 12043 (Jan. 23, 1977), 41 FR 4376, 4377 (1976), (SR-PSW-75-6). As of July 15, 1977, some of the options exchanges had not listed for trading the maximum number of options classes authorized for those exchanges.

and effects of such trading, (ii) whether self-regulatory and Commission oversight programs with respect to those matters have adequately kept pace with the dramatic expansion of standardized options trading, and (iii) whether such programs are adequate for the prevention of fraudulent and manipulative acts and practices and for the maintenance of fair and orderly markets and the protection of investors.

Since making the July 18, 1977 request, the Commission has received further information from its staff as a result of the ongoing investigations in connection with its announced general review of options trading. That information has tended to confirm the Commission's earlier impression concerning the capacity of the options markets to insure that expanded options trading would be adequately surveilled and regulated by the exchanges. The Commission has learned, among other things, that (1) the use of joint accounts by options market makers and others may escape adequate monitoring by present exchange surveillance systems, (2) member firms may be abusing the privilege of delivering exercise instructions to The Options Clearing Corporation for expiring options series after the final opportunity for public customers to do the same, and (3) the occurrence of questionable options selling practices may be more serious than the Commission had earlier anticipated. This information, along with the information previously compiled, leads the Commission to believe that perhaps: (1) manipulative and deceptive practices in the trading and selling of standardized options may be occurring to a greater degree than the Commission had perceived before July 18, 1977; and (2) lapses in surveillance and other regulatory programs by options exchanges to detect and deter such practices are more serious than the Commission had earlier perceived.

COMMENCEMENT OF INVESTIGATION

In view of the foregoing, the Commission has decided to commence a formal investigation and study of the problems described above with a view to determining whether standardized options trading is occurring in a manner and in an environment which is consistent with fair and orderly markets, the public interest, the protection of investors, and other objectives of the Act, as indicated above.[28] Specifically, the Commission believes it must attempt to resolve, among other issues, questions regarding the adequacy of current self-regulatory programs, including:

(1) the ability of self-regulatory organizations to detect price manipulations of options and their underlying securities;

(2) the ability of self-regulatory organizations to reconstruct, quickly and accurately, for each side of each transaction occurring either in an option or in its underlying security, information identifying all parties to the trade, the terms of the trade, the time of execution, and the clearing agencies involved, together with any later adjustments to positions in option accounts maintained at The Options Clearing Corporation, indexed by the particular trades to which such adjustments apply;

(3) the ability of self-regulatory organizations to resolve discrepancies between reported and cleared volume for each option series;

(4) the ability of self-regulatory organizations to prevent errors and abuses in the extension of credit to option market makers pursuant to Regulation T of the Federal Reserve Board;[29]

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28 See discussion supra at 12-24.

29 12 C.F.R. §§ 220.1-220.8.

(5) the ability of self-regulatory organizations to prevent and detect, at the commencement of trading on two or more options exchanges of the same class of options, trading volume which is created by floor members for the purpose of inducing the purchase or sale of such securities by others;

(6) the ability of self-regulatory organizations to enforce compliance by brokers and dealers with appropriate selling practices regarding standardized options;

(7) the ability of self-regulatory organizations to detect and prevent the misuse of market information in the trading of options, particularly in connection with the imminent or unreported execution of orders in underlying securities; and

(8) the ability of self-regulatory organizations generally to regulate abuses in the options markets in such a manner that the benefits of standardized options trading will outweigh the social and economic costs incurred by those organizations, investors, the options exchanges, and federal regulatory authorities in connection with dealings in such options and in the regulation of possible abusive practices.

To that end, the Commission has today ordered, pursuant to Section 21(a), and other sections, of the Act, that an investigation and study be conducted by its staff with a view to ascertaining what, if any, additional action is necessary and proper to aid in the enforcement of the provisions of the Act and the rules thereunder to protect investors and to insure fair dealing in the trading of standardized options and their underlying securities.[30] This investigation and study

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30 Commission order, In the Matter of TEMPORARY RESTRICTION ON THE EXPANSION OF EXISTING OR THE INITIATION OF NEW PILOT PROGRAMS TO TRADE STANDARDIZED OPTIONS.

will formalize the Commission's general review of all aspects of current standardized options trading and may include public hearings.

PROPOSED TEMPORARY RULE 9b-1(T)

In view of the commencement of a formal investigation and study of the questions presented above, and the Commission's present inability to make findings under the Act necessary to approve self-regulatory organization rule proposals contemplating expansion of existing pilot options trading programs or the initiation of new programs, the Commission has determined to propose a temporary rule under the Act deferring initiation of any new options trading programs or expansion of any existing ones until a thorough review of the status of the current options markets can be made. The temporary rule, as proposed, would also defer the trading of any class of options not listed for trading on that exchange as of the effective date of the rule.[31]

The Commission is preparing to take that action so that it may accomplish whatever steps are necessary or appropriate to insure the existence of adequate regulatory safeguards before any new or expanded options trading is permitted. Any further expansion at this time, either by an exchange's listing of additional classes of options, or by approval of a proposed rule change to initiate or expand options trading, in the Commission's view, would appear to be inconsistent with the necessity for determining by an orderly process whether such expansion could pose serious risk of harm to investors and to the securities marketplaces.

In this context, the Commission wishes to emphasize that proposed Temporary Rule 9b-1(T) is intended to preserve the status quo pending the Commission's consideration of the important issues articulated above. It is the Commission's intention to complete its investigation

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31 See generally note 27 supra.

and study as expeditiously as possible. To that end, and to facilitate prompt completion of the Commission's investigation and study, the Commission will require, and anticipates receiving, the cooperation of the affected self-regulatory organizations.

COMMENCEMENT OF DISAPPROVAL PROCEEDINGS

Finally, as a consequence of the foregoing considerations, the Commission has, this day, determined to initiate disapproval proceedings with respect to proposed rule changes by self-regulatory organizations filed pursuant to Section 19(b) of the Act which, if implemented, would expand options trading.[32] This action has been taken because the Commission believes that it does not have at this time an adequate basis under the Act to approve any rule change to expand options trading.

The Securities and Exchange Commission, acting pursuant to the Act, and particularly Sections 2, 3, 6, 9, 10, 11A, 15, 15A, 19(b), 19(c), 19(g), 19(h), 21 and 23 thereof (15 U.S.C. §§ 78b, 78c, 78f, 78i, 78j, 78k-l, 78o, 78o-3, 78s(b), 78s(c), 78s(g), 78s(h), 78u, and 78w), hereby proposes Section 240.9b-1(T) of Title 17 of the Code of Federal Regulations, to be effective, if adopted, as of October 17, 1977.

Proposed Temporary Rule 9b-1(T) simultaneously restricts the expansion of all existing options pilot programs, and temporarily defers the institution of new programs. It presently appears to the Commission that to the extent any burdens on competition are engendered by proposed Temporary Rule 9b-1(T), they are necessary and appropriate to insure investor protection and to protect the public interest, in furtherance of the purposes of the Act.

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32 See Securities Exchange Release No. 14057 (October 17, 1977).

The text of proposed Temporary Rule 9b-1(T) is as follows:

§240.9b-1(T) Temporary Restriction on Further Expansion of Pilot Options Programs.

(a) As used in this rule, the term "class of options" means all options of the same type (i.e., put or call) covering the same underlying security, and the term "series of options" means all options of the same class having the same expiration date and exercise price.

(b) After the third business day following the adoption of this rule, it shall be unlawful for any national securities exchange or registered securities association to permit trading in or quotation of any class of options which was not listed for trading or quotation through the facilities of such exchange, association, or affiliate thereof on October 17, 1977.

(c) It shall be unlawful for any national securities exchange, registered securities association, or registered clearing agency, by the adoption of any rule or by any other means, to permit expansion of existing programs for the trading of standardized options, to alter such programs in any material respect not expressly approved by order of the Commission, or to permit the initiation of any new programs designed to expand the trading of options; provided that (i) an increase in the number of outstanding options contracts of any series, or (ii) the introduction of any new series of options in a class of options already listed for trading on October 17, 1977, under the terms and conditions governing the introduction of such series in effect on such exchange prior to October 17, 1977, shall not be deemed to be an expansion of an existing program.

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REQUEST FOR PUBLIC COMMENT

With regard to the formal investigation and study initiated today, the Commission, as an initial matter, hereby solicits public comment on the issues described above including,

particularly: identification of and views as to particular practices and conditions in the exchange options markets and in the markets for securities underlying such options which may be injurious to investors; practices and conditions similar or related to those discussed above which may bear on the adequacy of present regulatory safeguards; the adequacy of exchange regulation of the existing pilot options programs to insure investor protection and the maintenance of fair and orderly markets; and the need for additional rulemaking with respect to the operation of the pilot options programs.

With regard to proposed Rule 9b-1(T), the Commission is particularly interested in receiving public comment as to: the effective date and possible duration of the temporary rule; the competitive impact of the temporary rule, if adopted; and the need to provide for exemptive relief from the rule, if adopted, specifying standards upon which, by reference to the Act's purposes, relief should be granted.

Separate comment is being solicited in connection with the disapproval proceedings described above.

All interested persons are invited to submit written data, views, and arguments on the foregoing issues on or before November 30, 1977. Written statements should be submitted in triplicate and addressed to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D. C. 20549. Reference should be made to File No. S7-722. All such communications will be available for public inspection.

George A. Fitzsimmons
Secretary