

CHAPTER VIII

ISSUES OF STRUCTURE IN THE STANDARDIZED OPTION MARKETS

I. INTRODUCTION

When announcing the initiation of the Special Study of the Options Markets, 1/ the Commission expressed its view that "experience with existing pilot options trading programs has not yielded answers to certain general questions bearing upon the future of standardized options trading." 2/ More specifically, the Commission stated its concerns regarding "how to develop standards by which to gauge, on a case-by-case basis, the appropriateness of particular self-regulatory organization proposals to expand options trading" and "how [standardized options] trading can or should be comprehended within the national market system for securities contemplated by the [Securities Exchange] Act." 3/

At the time of the Commission's announcement, the National Association of Securities Dealers ("NASD") 4/ and the New York Stock Exchange

1/ The Special Study of the Options Markets will be referred to as the "Options Study" in this chapter.

2/ Securities Exchange Act Release No. 14056 (October 17, 1977), 13 SEC Docket 366, 369 (November 2, 1977).

3/ Id.

4/ SR-NASD-77-2 ("NASD Plan"). The Commission gave notice of the NASD Plan in Securities Exchange Act Release No. 13230 (February 1, 1977), 11 SEC Docket 1630 (February 15, 1977).

("NYSE") 5/ had filed proposals to begin standardized options trading programs and the Chicago Board Options Exchange ("CBOE") 6/ had requested permission to commence trading in equity and other non-option securities. In addition, CBOE, the American Stock Exchange ("AMEX"), the Midwest Stock Exchange ("MSE"), and the Pacific Stock Exchange ("PSE") had proposed to list standardized options on underlying securities traded exclusively in the over-the-counter markets, 7/ and the Philadelphia Stock Exchange ("PHLX") and PSE had requested permission to eliminate the physical barriers existing between their stock and options trading floors. 8/ Further, MSE and PSE had proposed to permit individuals to hold simultaneous marketmaker appointments in listed options and their underlying securities under certain

5/ SR-NYSE-77-17 ("NYSE Plan"). The Commission gave notice of the NYSE Plan in Securities Exchange Act Release No., 13674 (June 24, 1977), 12 SEC Docket 1014 (July 12, 1977).

6/ SR-CBOE-77-14 ("CBOE Plan"). The Commission gave notice of the CBOE Plan in Securities Exchange Act Release No. 13672 (June 24, 1977), 12 SEC Docket 1012 (July 12, 1977).

7/ SR-PSE-76-17; SR-CBOE-76-16; SR-AMEX-76-28; SR-MSE-77-4. The Commission gave notice of these proposed rule changes in Securities Exchange Act Release No. 12539 (June 11, 1976), 9 SEC Docket 876 (June 30, 1976); No. 12703 (August 12, 1976), 11 SEC Docket 221 (August 12, 1976); No. 13095 (December 22, 1976), 11 SEC Docket 1269 (January 11, 1977); and No. 13406 (March 25, 1977), 11 SEC Docket 2150 (April 12, 1977).

8/ SR-PHLX-77-6; SR-PSE-77-13. The Commission gave notice of these proposed rule changes in Securities Exchange Act Release No. 13689 (June 23, 1977), 12 SEC Docket 1037 (July 12, 1977), and No. 13567 (May 23, 1977), 12 SEC Docket 471 (June 7, 1977).

circumstances. 9/ Finally, NYSE had proposed to rescind current restrictions on option trading by its stock specialists and registered stock marketmakers. 10/ Each of these proposals presented significant issues concerning the structure of the standardized options markets and the markets for their underlying securities. 11/

This chapter will discuss some of the issues that these proposals present with a view toward developing an analytical framework, formulated with reference to the purposes of the Securities Exchange Act ("Exchange Act"), within which to measure the appropriateness of these and similar proposals. It will present various factors that should be considered when evaluating such proposals, but will not present specific recommendations with respect to whether the Commission should approve or disapprove any particular proposal. 12/ The chapter will first discuss the statutory

9/ SR-MSE-77-28; SR-PSE-77-17. The Commission gave notice of these proposed rule changes in Securities Exchange Act Release No. 13707 (June 30, 1977), 12 SEC Docket 1101 (July 19, 1977), and No. 13725 (July 7, 1977), 12 SEC Docket 1119 (July 19, 1977).

10/ SR-NYSE-76-54. The Commission gave notice of this proposed rule change in Securities Exchange Act Release No. 12924 (October 27, 1976), 10 SEC Docket 786 (November 9, 1976).

11/ These proposals, with the exception of SR-NYSE-76-54, were voluntarily withdrawn subsequent to the initiation of the Options Study pursuant to an agreement among the Commission and the self-regulatory organizations participating in the moratorium. However, each of the proposals may be resubmitted after January 1, 1979 provided that the Commission and other affected self-regulatory organizations are given sixty days advance notice. See Securities Exchange Act Release No. 14878 (June 22, 1978), 15 SEC Docket 98 (July 5, 1978).

12/ Since these proposals are not pending before the Commission and may ultimately be submitted in revised form, recommendations concerning the specific proposals would be inappropriate at this time.

standards that should be applied when evaluating issues such as those that the proposals raise. It will then discuss (i) whether, and under what circumstances, standardized options of the same class, expiration date, and exercise price should be traded in more than one marketplace, (ii) the extent to which the trading of standardized options and their underlying securities should be integrated, (iii) whether, and under what circumstances, standardized options should be traded in the over-the-counter markets, (iv) whether, and under what circumstances, the trading of standardized options should be permitted on the NYSE, and (v) the steps the Commission should consider at this time to assure that the standardized options markets evolve in a manner which is consistent with the public interest in perfecting the mechanisms of a national market system.

II. THE STATUTORY STANDARDS

A. A National Market System

1. A National Market System and SEC Authority

The Securities Acts Amendments of 1975 (the "1975 Amendments" or the "Amendments") 13/ established as a purpose of the Exchange Act 14/ the

13/ Pub. L. No. 94-29 (June 4, 1975).

14/ 15 U.S.C. 78a et seq.

need "to remove impediments to and perfect the mechanism of a national market system for securities." 15/ The Exchange Act, as amended, provides:

The Commission is directed * * *, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under [the Exchange Act] to facilitate the establishment of a national market system for securities (which may include subsystems for particular types of securities with unique trading characteristics) in accordance with the findings and to carry out the objectives set forth in paragraph (1) of [Section 11A(a)]. The Commission, by rule, shall designate the securities or classes of securities qualified for trading in the national market system from among securities other than exempted securities. (Securities or classes of securities so designated hereinafter * * * referred to as 'qualified securities.') 16/

The 1975 Amendments did not define a national market system. Rather, the Congress granted "broad, discretionary powers [to the Commission] to oversee the development of a national market system and to implement its specific components in accordance with the [Congressional] findings and to carry out the objectives set forth [in the Exchange Act]." 17/ The Amendments were designed to provide "maximum flexibility to the Commission and the securities industry in giving specific content to

15/ Section 11A(a)(2) of the Exchange Act [15 U.S.C. 78k-1(a)(2)].

16/ Id.

17/ Senate Committee on Banking, Housing and Urban Affairs, Report to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 7 (1975) ("Senate Report").

the general concept of the national market system," 18/ and a national market system was to "evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed." 19/ The Congress expected, however, that "in those situations where competition may not be sufficient, * * * the Commission will use the powers granted to it * * * to act promptly and effectively to insure that the essential mechanisms of an integrated secondary trading system are put into place as rapidly as possible." 20/ As the Senate Committee stated:

[A] fundamental premise of the bill is that the initiative for the development of the facilities of a national market system must come from private interests and will depend upon the vigor of competition within the securities industry as broadly defined. Although the SEC's basic role would be to remove burdens on competition which would unjustifiably hinder the market's natural economic evolution and to assure that there is a fair field of competition consistent with investor protection in situations in which natural competitive forces cannot; for whatever reason be relied upon, the SEC must assume a special oversight and regulatory role. 21/

A national market system was intended to encompass "all segments of the corporate securities markets including all types of common and

18/ Committee of Conference, Report to Accompany S. 249, H.R. Rep. No. 94-249, 94th Cong., 1st Sess. 92 (1975) ("Conference Report"). See also Senate Report, supra, n.17, at 7-9.

19/ Conference Report, supra, n.18, at 92.

20/ Id.

21/ Senate Report, supra, n.17, at 12. See also House Committee on Interstate and Foreign Commerce, Report to Accompany H.R. 4111, H.R. Rep. No. 94-123, 94th Cong., 1st Sess. 44 (1975) ("House Report").

preferred stocks, bonds, debentures, warrants and options." 22/ This was deemed desirable because many of the goals of a national market system were considered to be "nearly universal in scope and might not be fully realized within separate market systems." 23/ However, the Amendments did not seek to "ignore or eliminate distinctions between exchange markets and over-the-counter markets or other inherent differences or variations in the components of a national market system" or to "force all markets for all securities into a single mold." 24/ Instead, the Congress recognized that the "unique characteristics of other securities * * * may require treatment different from that for listed common stocks" 25/ and, as a result, gave the Commission authority and flexibility to establish "subsystems within the national market system which are tailored to the characteristics of the particular types of securities which are to be traded in each subsystem." 26/

22/ Senate Report, supra, n.17, at 7. See also Conference Report, supra, n.18, at 92.

23/ Id.

24/ Id.

25/ Conference Report, supra, n.18, at 92-93.

26/ Id., at 93. See also Senate Report, supra, n.17, at 7.

2. Objectives of a National Market System

Section 11A(a)(1) of the Exchange Act states the Congressional findings that:

(A) The securities markets are an important national asset which must be preserved and strengthened.

(B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.

(C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—

(i) economically efficient execution of securities transactions;

(ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

(iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;

(iv) the practicability of brokers executing investors' orders in the best market; and

(v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

(D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers and

investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders. 27/

These are the essential "goals and objectives of a national market system for qualified securities." 28/

More specifically, a primary objective of the national market system is "the centralization of all buying and selling interest so that each investor will have the opportunity for the best possible execution of his order, regardless of where in the system it originates." 29/ The 1975 Amendments established "a clear Congressional policy supporting the preservation and extension of the protections associated with auction-type trading for appropriate securities under appropriate circumstances" 30/ and had "as a fundamental goal the elimination of fragmented markets for securities suitable for auction trading." 31/ In this regard, the Senate Committee stated:

The Committee found that public investors could enjoy two important benefits when trading in an ideal auction-type market for securities as opposed to a purely dealer market: (1) Their limited price orders would have to be satisfied before any trans-

27/ 15 U.S.C. 78k-1(a)(1).

28/ Senate Report, supra, n.17, at 8.

29/ Senate Report, supra, n.17, at 7. See also House Report, supra, n.21, at 50-51.

30/ Id., at 18.

31/ Senate Report, supra, n.17, at 17. See also House Report, supra, n.21, at 50.

action could be effected at the same price, by a specialist or other market maker for his dealer account, or by the customer's broker for the latter's proprietary account, or by any participant in that market at a price less favorable to the other party; and (2) Their market orders could be executed against another public limit or market order at a better price than that currently being quoted by any dealer for his own account.

* * *

[Exchange auction trading rules] protect public investors against prearranged trades that do not secure the best execution available and against the payment of a spread to a dealer. However, because the market for most listed securities is fragmented, i.e., conducted on several exchanges as well as in the third market, the value of this protection is considerably less than it might appear. For example, a limited price order is presently "protected" as to price priority on the exchange on which it is held but it is not protected in any way [with] respect to trading on another exchange or in the third market. As a consequence, a limit order for a listed security held in only one of several markets for that security need not be executed before a transaction is effected at the same price or at a price less favorable to the other party in another market. In the Committee's view this is the basic problem caused by the fragmentation of the securities markets: the lack of a mechanism by which all buying and selling interest in a given security can be centralized and thus assure public investors best execution. Until such centralization is accomplished, the protections and benefits of the auction market will remain limited. * * * Therefore, the Committee believes that to eliminate market fragmentation and thus to achieve a true national market system, a set of trading rules and procedures must be adopted which will tie the individual market centers together. 32/

32/ Id., at 16-17.

Another of the "fundamental purposes underlying the national market system * * * is to enhance the competitive structure of the securities markets in order to foster the risk-taking function of market makers and thereby to provide free market incentives to active participation in the flow of orders." 33/ A "healthy, highly competitive system of market makers" was considered "essential to an efficient national market system." 34/ The Congress expressed its view that "many types of market makers are necessary" to assure that the securities markets are able to meet the needs of individual and institutional investors and that "encouragement should be given to all dealers to make simultaneous markets within the new national system." 35/ Moreover, the Congress expected that the "competitive structure and incentives" to engage in marketmaking activities that would accompany the establishment of a national market system "should supplement, and ultimately may be able to replace, most affirmative requirements to deal imposed by regulation." 36/

33/ Id., at 14. See also House Report, supra, n.21, at 50.

34/ Id.

35/ Id.

36/ Id.

3. The Elimination of Unnecessary Regulatory Restrictions

To achieve the objectives of a national market system, the Congress called upon the private sector, under the supervision of the Commission, to develop and implement communication and data processing equipment to create a "single integrated [securities trading] system." 37/ The Commission's primary responsibility is "to remove burdens on competition which would unjustifiably hinder the market's natural economic evolution and to assure that there is a fair field of competition, consistent with investor protection, in situations in which natural competitive forces can not, for whatever reason, be relied upon * * * ." 38/ Accordingly, the Amendments charged the Commission "with an explicit and pervasive obligation to eliminate all present and future competitive restraints that [can] not be justified by the purposes of the Exchange Act," 39/ and directed the Commission "to remove existing burdens on competition and to refrain from imposing, or permitting to be imposed, any new regulatory burden on competition 'not necessary or appropriate in furtherance of the purposes' of the Exchange Act." 40/

37/ Id., at 9. See also Conference Report, supra, n.18, at 92.

38/ Id., at 12. See also Conference Report, supra, n.18, at 94-95 and House Report, supra, n.21, at 49-51.

39/ Id., at 13. See also Conference Report, supra, n.18, at 94-95.

40/ Conference Report, supra, n.18, at 94.

Accordingly, Sections 6(b)(8), 41/ 19(b) 42/ and 19(c) 43/ of the Exchange Act were amended to obligate the Commission to review self-regulatory organization rules and to abrogate or disapprove rules which have or would have the effect of placing a burden on competition that is neither necessary nor appropriate in furtherance of a legitimate regulatory objective. 44/ Similarly, Section 23(a) 45/ requires the Commission to evaluate its own regulatory proposals "in light of the fundamental national economic policy of furthering competition" 46/ and prohibits the Commission from adopting any rule or regulation "which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]." 47/ Under each of these sections, the Commission's responsibility is "to balance the perceived anti-competitive effects of [a] regulatory policy or decision at issue against the purposes of the Exchange Act that

41/ 15 U.S.C. 78f(b)(8).

42/ 15 U.S.C 78s(b).

43/ 15 U.S.C 78s(c). See also Section 31(b) of the 1975 Amendments, Pub. L. 94-29, Section 31(b) (June 4, 1975).

44/ Conference Report, supra, n.18, at 94; Senate Report, supra, n.17, at 13.

45/ 15 U.S.C. 78n(a)(2).

46/ Senate Report, supra, n.17, at 13.

47/ 15 U.S.C. 78n(a)(2).

would be advanced thereby and the costs of doing so." 48/ While the Commission is not required to justify its actions as "the least anti-competitive manner of achieving a regulatory objective," the Commission must "weigh competitive impact in reaching regulatory conclusions." 49/

As the Senate Report stated:

Competition would not * * * become paramount to the great purposes of the Exchange Act, but the need for and effectiveness of regulatory actions in achieving those purposes would have to be weighed against any detrimental impact on competition. 50/

4. Communication Among and Dissemination of Information About Securities Markets

Section 11A(b) and (c) of the Exchange Act gives the Commission direct jurisdiction over certain persons or organizations engaged in the business of collecting, processing, or publishing information relating to quotations for, indications of interest to purchase and sell, and transactions in securities. 51/ In particular, subsection 11A(c) was designed to "give the Commission extensive power to develop and regulate the national market system and the activities of persons involved in that system,"

48/ Senate Report, supra, n.17, at 13-14. See also Conference Report, supra, n.18, at 94.

49/ Id., at 13.

50/ Id., at 14. See also Conference Report, supra, n.18, at 94-95.

51/ 15 U.S.C. 78k-1(b), (c).

and the Commission's rule-making authority under the subsection extends to:

* * * facilitating the development of a composite tape and composite quotation system, determining the occasion for suspension of the operation of a tape or quotation system with respect to particular securities, establishing performance standards for securities information processors, prescribing the terms and conditions for retransmission of information collected by any exclusive processor, preventing the use or publication of fraudulent, deceptive, or manipulative market information, and integrating information services and market facilities. 52/

The Commission's direct regulatory authority under subsection 11A(c)(1) was intended to assure that the Commission would "play an effective leadership role in the establishment and regulation of a national market system." 53/ Accordingly, subsection 11A(c)(1) provides:

(c)(1) No self-regulatory organization, member thereof, securities information processor, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to collect, process, distribute, publish, or prepare for distribution or publication any information with respect to quotations for or transactions in any security other than an exempted security, to assist, participate in, or coordinate the distribution or publication of such information, or to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any such security in contravention of such rules and

52/ Senate Report, supra, n.17, at 103-104. See also Conference Report, supra, n.18, at 93.

53/ Id.

regulations as the Commission shall prescribe as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act] to--

(A) prevent the use, distribution, or publication of fraudulent, deceptive, or manipulative information with respect to quotations for and transactions in such securities;

(B) assure the prompt, accurate, reliable, and fair collection, processing, distribution, and publication of information with respect to quotations for and transactions in such securities and the fairness and usefulness of the form and content of such information;

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*

(E) assure that all exchange members, brokers, and dealers transmit and direct orders for the purchase or sale of qualified securities in a manner consistent with the establishment and operation of a national market system; and

(F) assure equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers effecting transactions in such securities. 54/

With respect to subsection (E), the Senate Report stated:

[T]he Commission would be required to assure that any order transmission or "switching" system utilized by a brokerage firm or an exchange operates in a manner consistent with the development and operation of a national market system. Large brokerage firms rely heavily on high speed systems for the direction of orders to a designated facility for execution. The Committee has been informed that many of these systems are currently geared to route orders for any particular security to only one market center, e.g.,

54/ 15 U.S.C. 78k-1(c).

the NYSE. The functioning of such systems in this manner is inconsistent with the development and operation of a national market system. It may also be inconsistent with a broker's obligation to obtain "best execution" for his customers. The subsection would accordingly give the SEC the responsibility to require brokers to utilize order switching services which are "neutral" as to market centers, giving preference to one execution facility over another only to insure best execution. 55/

5. Multiple Trading

Multiple trading is the trading of a security in more than one marketplace. Multiple trading may occur as a result of listing a security on more than one exchange, through the grant of unlisted trading privileges, or as a result of trading listed securities in the over-the-counter markets. Since 1934, the Commission has generally encouraged the development of competitive markets for securities listed on the NYSE. Traditionally, this has been done by facilitating the trading of these securities on regional exchanges pursuant to "unlisted trading privileges." Under Section 12(f)(1) of the Exchange Act, if a security is listed on one exchange, any other exchange may initiate trading in that security merely by obtaining the permission of the Commission. The Exchange Act also requires that the Commission grant an application for unlisted trading privileges with respect to a listed security if the Commission finds, after appropriate notice and opportunity

55/ Senate Report, supra, n.17, at 104-105. See also House Report, supra, n.21, at 41, 92.

for hearing, that the application is "consistent with the maintenance of fair and orderly markets and the protection of investors." 56/

As the Senate Report observed, the Commission has usually granted applications for unlisted trading privileges involving securities already listed on at least one exchange "as a matter of course," 57/ and the 1975 Amendments supported this approach. 58/ The Congress viewed unlisted trading privileges, and consequently multiple exchange trading of listed securities, "as appropriate to a national market system in which all market makers and brokers are permitted to deal freely with one another without unnecessary regulatory constraints." 59/

As the Senate Securities Industry Study stated:

Since the imposition of federal regulation in 1934, the SEC has consistently taken a position in favor of the competitive trading of listed securities in multiple markets * * * . It has also resisted efforts by the NYSE to prevent its members from dealing in such dually-traded securities on these other exchanges. The Subcommittee believes that restriction of trading in securities to a single market is a drastic measure, to be legislated only when the public interest clearly requires it. 60/

56/ Section 12(f)(1) of the Exchange Act [14 U.S.C. 781(f)(1)].

57/ Senate Report, supra, n.17, at 19.

58/ Id., at 106.

59/ Id., at 20.

60/ Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, Securities Industry Study, 93rd Cong., 1st Sess. 121 (1973) (footnotes omitted).

B. The Basic Statutory Goals

The 1975 Amendments sought to assure that the securities markets and the regulation of the securities industry "remain strong and capable of fostering [the] fundamental goals [that the Exchange Act established] under changing economic and technological conditions." 61/ However, the Amendments left unchanged the basic goals of the Exchange Act: to protect investors and the public interest, to provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs, and to provide, to the maximum degree practicable, markets that are free, open and orderly. 62/

While none of these terms is defined in the Exchange Act, the Report of the Special Study of Securities Markets provided insight into the "general significance and thrust" of some of them. 63/ As the Special Study explained:

61/ Conference Report, supra, n.18, at 92.

62/ Id., at 91-92. See, e.g., Sections 2, 6(a), 6(b)(5), 9, 10, 11A(a)(1)(C), 11A(a)(2), 11A(b), 11A(c), 15A(a), and 15A(b)(6) of the Exchange Act [15 U.S.C. 78b, f(a), f(b)(5), i, j, k-1(a)(1)(C), k-1(a)(2), k-1(c), o-3(a), o-3 (b)(6)].

63/ Report of the Special Study of Securities Markets of the Securities and Exchange Commission, Part 2, H.R. Doc. No. 95, 88th Cong., 1st Sess. 14 (1963) ("Special Study").

"Fair" and "honest" presumably encompass the notion of freedom from manipulative and deceptive practices of all kinds and may be regarded as positive expressions of the [Exchange Act's] ban on such practices, acts and devices. "Fair" also presumably implies, especially in the several references to "fair dealing" and also the reference to "unfair discrimination between customers or issuers, or brokers or dealers," that there be no undue advantage or preference among participants in the marketplace; i.e., that there be no unnecessary discrimination in opportunity or treatment or in access to facilities or information. As among participants within any properly recognized category--those making similar uses of, contributions to, and demands upon the market facilities--discrimination would be altogether unacceptable. As between different categories--where different uses, contributions, or demands might appropriately be recognized--differences in opportunity and treatment would be held to the absolute minimum consistent with the recognized differences. In short, a market which recognized any improper categories or permitted any unwarranted discriminations would not be considered "fair" in the fullest sense.

"Free" presumably implies that the forces of supply and demand should operate without interjection of artificial factors. Insofar as the extraneous factors might be manipulative, the concept overlaps that of fairness. But "free," in its ultimate sense, may go further to exclude extraneous forces of a beneficent (i.e., stabilizing or market ordering) nature. In the latter sense a completely "free" market would be permitted to affect prices regardless of the sharpness or duration of the resulting movements. "Open" presumably implies that anyone can enter the market to buy and sell. * * *

"Orderly" presumably implies efficiency and economy of operations, but also embraces concepts of regularity of operation--"a market which does not 'fold up' when the pressure on dealers becomes too heavy" and the concept of avoidance of wide price swings within relatively short spans of time.

In the sense of efficiency, "orderly" might include the degree of assurance, through available market mechanisms, that the highest bidders and lowest offerors do not miss each other to the disadvantage of both [and] * * * may also imply constancy over periods of days or weeks; i.e., a degree of stability. 64/

In this regard, it should be noted that the Exchange Act requires that each registered national securities exchange and association be organized and have the capacity "to carry out the purposes of [the Exchange Act] and to comply, and * * * to enforce compliance by its members and persons associated with its members, with the provisions of [the Exchange Act], the rules and regulations thereunder," and the rules of the exchange or association. 65/ The Exchange Act also requires that the rules of registered securities exchanges and associations be designed "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, * * * 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." 66/

64/ Id., at 14-15 (footnotes omitted).

65/ Sections 6(b)(1) and 15A(b)(2) of the Exchange Act [15 U.S.C. 78f(b)(1); 15 U.S.C. 78o-3(b)(2)].

66/ Sections 6(b)(5) and 15A(b)(6) of the Exchange Act [15 U.S.C. 78f(b)(5); 15 U.S.C. 78o-3(b)(6)].

III. THE MULTIPLE TRADING OF STANDARDIZED OPTIONS

On February 1, 1973, the Commission granted the application of CBOE for registration as a national securities exchange. 67/ In approving the CBOE application, the Commission stated:

Since the CBOE is a new exchange, and the first national securities exchange proposing to provide for the trading of puts, calls, or similar options, we have determined to permit it to test the market for such options within a controlled environment. CBOE has stated that it intends to commence operations as a "pilot project" and limit trading on its floor initially to call options in respect of approximately 30 underlying stocks, and increase the number of underlying stocks gradually and extend operations to other types of options as experience is gained and the market and its regulatory arrangements are tested. 68/

Thus, standardized option trading began in a "controlled environment" in which a limited number of call options were traded on one exchange.

Later in 1973, AMEX and PHLX expressed interest in initiating options trading programs. Although the Commission had received a report from the CBOE covering its first three months of operations, the Commission was of the view that the report was "inconclusive on a number of major questions" 69/ and

67/ Securities Exchange Act Release No. 9985 (February 1, 1973), 1 SEC Docket 11 (February 13, 1973).

68/ Id.

69/ Securities Exchange Act Release No. 10490 (November 14, 1973), 3 SEC Docket 39, 40 (November 27, 1973).

concluded that further study was necessary to resolve many of the issues that the CBOE "pilot project" and the plans of AMEX and PHLX presented. 70/ In particular, the Commission noted that AMEX and PHLX intended "to trade options having the same underlying issuers as some options which are traded on the CBOE" and announced that it had "not made any definitive determinations with respect to a number of basic questions concerning options trading on exchanges, including whether options should be traded, on a pilot basis or otherwise, on more than one exchange * * * ." 71/ To aid the Commission in its consideration of the AMEX and PHLX proposals, the Commission requested public comments with regard to "whether (and, if so, under what conditions) it ultimately would be in the public interest to have multiple exchange markets engaged in trading options as a permanent part of the nation's securities markets." 72/

While the AMEX and PHLX proposals caused the Commission to seek public comments concerning the appropriateness of permitting the trading of standardized options with the same underlying security, expiration date, and exercise price on more than one exchange, 73/ the Commission did

70/ Id.

71/ Id.

72/ Id.

73/ Trading the same options in more than one marketplace will generally be referred to as "multiple trading." See discussion at 17-18, supra. This practice has also been referred to as "dual trading." See, e.g., Securities Exchange Act Release No. 13325 (March 3, 1977), 11 SEC Docket 1886. (March 15, 1973), and No. 14854 (June 15, 1978), 15 SEC Docket 27 (June 27, 1978).

not directly address this issue after public comments were received. ^{74/} In February, 1976, however, CBOE, with informal Commission approval, permitted the trading of a class of options that was already being traded on PHLX. In March of the same year, the Commission, recognizing that "some of the (call) options that the PSE has proposed to list will be of the same class and expiration dates and prices as options which are presently listed on other exchanges," approved a PSE plan to permit standardized options trading and explicitly found that the PSE proposal was "consistent with the requirements of the Act and the rules and regulations thereunder applicable to national securities exchanges, and in particular the requirements of Section 6 of the Act." ^{75/}

Subsequently, PSE listed and began trading numerous classes of options that other exchanges had already listed. Other options exchanges also began to engage in multiple trading. On March 3, 1977, however, PHLX petitioned

^{74/} See, e.g., Securities Exchange Act Release No. 10981 (August 22, 1974), 5 SEC Docket 41 (September 3, 1974). Indeed, the AMEX and PHLX proposals were approved with hardly a mention of multiple trading. In the order approving the AMEX Plan, the Commission observed that the AMEX did "not intend initially to undertake the dual trading of options." Securities Exchange Act Release No. 11144 (December 19, 1974), 5 SEC Docket 734, 738 (December 24, 1974). Similarly, the Commission noted that PHLX did not "intend initially to undertake dual trading of options." Securities Exchange Act Release No. 11423 (May 15, 1975), 6 SEC Docket 894, 895 (May 28, 1975).

^{75/} Securities Exchange Act Release No. 12283 (March 30, 1976), 9 SEC Docket 317, 318, 319 (April 13, 1976).

the Commission for "(1) a suspension of all dual trading in options commenced subsequent to February 1, 1977; (2) a suspension of any dual trading in options not already started; [or] (3) a requirement of Commission approval based on showing of cause as to future dual trading." 76/ Responding to the PHLX request, the Commission held a public hearing on "the existing Commission policy permitting dual trading of options" and solicited public comments concerning "whether * * * dual trading of options is in the public interest at this time." 77/

After receiving public comments, the Commission issued a release stating its view that floor members of the options exchanges who may have been "increasing substantially their proprietary trading in certain dually traded options * * * [in order] to induce the purchase or sale of such dually traded options on their options exchanges instead of other options exchanges on which the same class is traded" may have engaged in conduct which violates Section 9 78/ and 10 79/ of the Exchange Act. 80/ In addition, the Commission "cautioned [brokers] against relying

76/ Letter to Securities and Exchange Commission from Elkins Wetherill, President, PHLX, dated March 3, 1977.

77/ Securities Exchange Act Release No. 13325, supra, n.73.

78/ 15 U.S.C. 78i.

79/ 15 U.S.C. 78j.

80/ Securities Exchange Act Release No. 13433 (April 5, 1977), 11 SEC Docket 2194 (April 19, 1977).