



# American Stock Exchange Inc.



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**Robert J Birnbaum**  
President

June 1, 1979

The Honorable Harold M. Williams  
Chairman  
Securities and Exchange Commission  
500 North Capitol Street, N.W.  
Washington, D.C. 20549

Dear Chairman Williams:

The American Stock Exchange wishes to register a strong protest concerning the action by the Commission in approving the expansion of the Chicago Board Options Exchange (CBOE) through its acquiring of the options program of the Midwest Stock Exchange (MSE) at a time when the Commission's moratorium prevents all other options exchanges from expanding. The Commission's decision\* to approve this consolidation cannot be justified on the basis of any of the facts presented and is contrary to law. Unless it is modified or clarified in essential respects, the Amex and other options exchanges will be irreparably harmed in their ability to compete with the CBOE -- a result which is clearly not in the public interest.

Our concern with the Commission's action in this matter is twofold. First, it violates the specific terms of the moratorium as laid down by the Commission, and to that extent is both arbitrary and discriminatory. Second, it ignores a basic precept of the Securities Acts Amendments of 1975 that Commission action should be aimed at fostering, not undermining, competition among market centers.

The Commission cites as a principal reason for approving the proposal at this time its desire to avoid risk of further drain on MSE's financial and regulatory

\* Securities and Exchange Act Release No. 15762  
(April 24, 1979) (the Order).

The Honorable Harold M. Williams  
Page Two  
June 1, 1979

resources -- an issue which is highly debatable in view of the limited data submitted by MSE and CBOE on this point. Assuming this to be the case, however, it does not follow that the proposed combination should be approved. The Commission clearly has available to it alternatives which will alleviate any burden on MSE and at the same time avoid the unfair and discriminatory results of transferring all the MSE options to the CBOE. The Commission can and should allocate these options on an equitable basis among all of the options exchanges desiring to participate. Only through this means can the Commission exercise its regulatory authority in an even-handed manner and avoid further enhancement of the already dominant position of the CBOE.

Moreover, such an allocation would result in cost savings to member firms through more efficient use of the facilities and personnel presently employed in the execution of options transactions on the remaining options exchanges. Since the MSE has determined to liquidate its options program, the Amex believes that it should be done in a manner that will help reduce costs and eliminate duplicate facilities which no longer add to the economic well-being of the brokerage community. Allocating the MSE options among all the remaining options exchanges and permitting MSE to withdraw from the options business at the earliest possible time will serve to achieve this objective just as effectively as the CBOE proposal and at the same time will avoid the anticompetitive and discriminatory aspects of that proposal.

#### Commission's Action Violates Moratorium

At the behest of the Commission, the Amex and other options exchanges agreed in July 1977 to refrain from any further expansion of their options programs until the Commission completed an overall study of the options market.\* Pursuant to the understanding with the

\* See Securities Exchange Act Release No. 13760 (July 18, 1977). Other markets desiring to initiate new options programs also agreed to defer seeking approval of those programs pending termination of the moratorium.

The Honorable Harold M. Williams  
Page Three  
June 1, 1979

Commission, if any self-regulatory organization (SRO) should fail to continue to honor the moratorium all other SROs would be relieved of their undertaking.\* The Commission, however, made it abundantly clear that failure to honor this moratorium would result in rule-making proceedings aimed at barring any further expansion until the special study of the options market had been completed. Thus, it is clear that this "voluntary agreement" was on the one hand coerced and at the same time conditioned on the mutual acceptance of the terms of the moratorium by all SROs and the maintenance of the status quo insofar as the number of options classes traded on each exchange.

Under the terms of the moratorium, each of the SROs agreed to three specific restrictions -- (1) they agreed to withdraw all expansionary rule proposals pending before the Commission, (2) they undertook to refrain from filing any further expansionary rule proposals pending termination of the moratorium, and (3) they agreed not to add further options classes which had been previously authorized by the Commission but had not yet been filled.\*\* The SROs were requested in January of this year to continue to adhere to these terms and conditions pending completion of the Commission's review of the Special Study of the Options Market published on February 15, 1979, and in February

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\* See Appendix to Securities Exchange Act Release No. 14878 (June 22, 1978) which specifically provides that if any SRO no longer is prepared to abide by the moratorium, it must give the Commission sixty days' advance notice of its intention to file expansionary rule proposals and after the lapse of such sixty-day period all SROs would be free to file such proposals.

\*\* Securities Exchange Act Release No. 14878 (June 22, 1978)

The Honorable Harold M. Williams  
Page Four  
June 1, 1979

this request was again extended to include such period as may be required to implement the recommendations of the Special Study Report.\* Despite the mutual undertaking by all of the SROs to continue to adhere to these terms and conditions, the Commission accepted the filing of the proposed CBOE-MSE combination in December 1978 and approved the proposal on April 24, 1979. This was clearly in contravention of the ban against filing further expansionary

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\* See Securities Exchange Act Releases No. 15485 (January 10, 1979) and No. 15575 (February 22, 1979). In this latter Release, the Commission, in requesting the SROs to engage in a cooperative effort to implement the Options Study's recommendation, expressed the following position concerning termination of the moratorium:

"If the plan is successful, the Commission expects to remove the moratorium as to all self-regulatory organizations at the same time. Thus, the existing options exchanges could begin to fill previously authorized but unfilled options classes simultaneously and the Commission would be in a position to consider expansionary proposals filed thereafter by any self-regulatory organization." (Emphasis added). (Page 4, Footnote 5).

proposals during the pendency of the moratorium.\*

The fact that the proposed combination is to be effected in two stages does not place it beyond the reach of the moratorium. Accepting for the sake of argument the Commission's conclusion that the interim relocation of MSE options trading to the CBOE floor does not constitute expansion of the CBOE,\*\* the fact remains that the proposal as presented by the

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\* The Commission gave its approval to this consolidation despite the strong protest of the Amex that such action would violate the moratorium. See letter dated February 20, 1979 from Robert J. Birnbaum, President of the American Stock Exchange, to the Commission (File No. SR-CBOE 78-34).

\*\* We do not concede that this first stage is non-expansionary. As we point out in our letter of February 20, 1979 commenting on the proposed consolidation, during the relocation phase all of the former MSE options will be perceived by the industry and by the public to be CBOE options. Moreover, CBOE stands to gain financially from these options during this initial stage in that all revenues therefrom, in excess of certain fixed expenses of MSE, are to be paid over and retained by CBOE. It, therefore, has every incentive to promote and expand market interest in these options. CBOE's competitive advantage, gained from adding the present MSE options while all of its competitors are forced to maintain the status quo, will for all practical purposes commence as soon as the relocation is effected.

parties and as approved by the Commission envisions the eventual substitution of the CBOE as the sole exchange for the listing and trading of all options formerly traded on MSE. Even though this second stage -- the listing of the options on the CBOE and the termination of MSE's role as passive regulator and administrator -- is to be postponed until the Options Study recommendations have been implemented, the Commission's order nevertheless purports to grant approval now of this expansion of the CBOE, subject only to the condition that the regulatory improvements be in place before the actual listing occurs.\* Thus, during the period when the expansionary plans of all other options exchanges continue to be under wraps, the Commission has accepted and approved an expansionary proposal from the CBOE, albeit that the final stage of implementation of such proposal is postponed until the termination of the moratorium. No such exception from the moratorium has been granted to any other SRO and, in fact, the Commission has indicated that it will not entertain any expansion proposals until the Options Study recommendations have been implemented.\*\*

#### Unreasonable Burden on Competition

The Commission is obligated under the Securities Exchange Act of 1934 (the Act) to weigh competitive factors in its consideration of SRO proposals and to refrain from imposing or from permitting to be imposed "any burden on competition not necessary or appropriate in furtherance of the purposes" of the Act. Moreover, Congress, in adding this new standard to the Act in 1975,\*\* clearly expressed its determination that a fair field of competition among exchange markets was a

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\* See Order, p. 5, footnote 7 and p. 7.

\*\* See quote in footnote on p. 4, supra in which the Commission states that once the Options Study recommendations have been implemented it will then be in a position "to consider expansionary proposals filed thereafter." (Emphasis added).

\*\*\* Securities Acts Amendments of 1975 ('75 Act Amendments).

principal objective in the protection of investors and the maintenance of fair and orderly markets.\* Thus, it is apparent that the Commission, when faced with proposals having the potential for burdening competition among market centers, has a duty to explore alternative measures having less anticompetitive impact.\*\*

The present situation presents a prime example of an anticompetitive proposal which received approval without adequate justification and without consideration of less anticompetitive alternatives. CBOE is by far the dominant factor in the options market, having garnered approximately 60% of the total market share during 1978. With a headstart of nearly two years over any other options exchange, CBOE was able to preempt a very substantial number of the most attractive underlying stocks suitable for options trading. In view of the "freeze" on further expansion of multiple trading which has accompanied the moratorium and which is likely to continue for the foreseeable future, CBOE's position of dominance is not likely to be threatened.

MSE admittedly got a later start than the other options exchanges and, as a result, is the smallest factor in the market; nevertheless, its growth in

\* Securities Exchange Act, Sec. 11A(a)(1)(c)(ii).

\*\* See for example, the Report of the Senate Committee on Banking, Housing and Urban Affairs (No. 94-75, April 14, 1975) commenting on provisions in S. 249 which ultimately became part of the '75 Act Amendments:

"S. 249 is designed to force the Commission to focus with particularity on the competitive implications of each regulatory requirement. For example, in promulgating its own rules under Section 23 (a) and in reviewing proposed self-regulatory rules under Section 19 (c), the Commission would be required to make specific findings as to the justification for any limitation on, or restraint of, competition that would be involved. On review, such findings, to the extent they are based on evidentiary facts, would be subject to a searching and careful inquiry by the Court of Appeals to determine whether they are supported by substantial evidence." (Emphasis added.) Id., at 14.

The Honorable Harold M. Williams  
Page Eight  
June 1, 1979

volume has been steadily increasing and in recent months has approached 5% of total options trading.\*

Permitting an exchange with nearly 60% market share to acquire another having 5% market share (and climbing) clearly has the potential for significant anticompetitive effects and, in the absence of strong overriding public interest considerations which cannot be dealt with in any other manner, raises serious questions under the standard laid down by Congress. The need to carefully weigh anticompetitive impact is particularly acute in a market setting which is characterized by a small number of participants and in which restrictions are imposed on the ability of those participants to freely expand in accordance with their ability to attract business.

The anticompetitive impact of this proposed consolidation is exacerbated by the fact that there are only a handful of remaining underlying stocks that are likely to prove attractive for options trading. When the moratorium is eventually terminated, other options exchanges will have to compete with each other and with the CBOE for these few remaining classes of options, whereas the CBOE will already be assured of receiving 16 additional calls and 5 additional puts -- all of which have established markets by virtue of having been traded first on MSE and then on the floor of the CBOE during the "relocation" period. This will clearly give CBOE a substantial headstart in expanding its market regardless of whether the other exchanges are able at the termination of the moratorium to find some additional underlying stocks that appear to have potential for options trading. The MSE options may not be as attractive as some of the more actively traded classes presently listed on other exchanges (including the CBOE). But in general, they are far superior to the remaining eligible underlying stocks.

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\* For all of 1977, MSE's market share of total options volume was 1.5% and for 1978 it was 3.5%. The April 23, 1979 issue of Securities Week indicated that MSE's share of total volume had advanced from 4% to 5% from February to March of this year.



The Honorable Harold M. Williams  
Page Nine  
June 1, 1979

CBOE, with its dominant market position, its established order flow, its preeminence with respect to the most highly visible and most actively traded call options, and the resulting advantage it will have when additional put classes are authorized, is least deserving of special consideration when it comes to expansion. To bestow further competitive advantages on it at a time when all other exchanges continue to be subject to an absolute ban on even filing expansionary proposals does indeed require a heavy burden of justification.

#### Lack of Justification

The CBOE and MSE have failed to submit evidence in this proceeding which would even remotely justify the favored treatment being accorded the CBOE. Moreover, there has been no attempt to explore the alternatives which might be relied upon to meet the objectives cited by the Commission in its order without creating the anticompetitive effects which this consolidation will clearly engender. The Amex submits that if these alternatives were to be explored, the Commission would be forced to conclude that there is a more appropriate means of achieving its objectives and one that will not discriminate against, nor unduly disadvantage, any of the options exchanges.

The principal reasons assigned by the Commission for approving the CBOE-MSE consolidation are (1) to assure continuity of trading in the options currently listed on MSE; (2) to eliminate the uncertainty as to the future of the MSE options program; (3) to bring the MSE options under more sophisticated surveillance programs; (4) to eliminate any risk of further drain on MSE's financial and regulatory resources; and (5) to preserve the talents and resources of the MSE options professionals. Each of these objectives can be as effectively achieved by an equitable distribution of the MSE options among all the options exchanges as by awarding them exclusively to the CBOE.

Such an allocation would certainly assure continuity of trading in MSE options and eliminate uncertainty as to the future of the MSE options program. It would also provide the kind of improved surveillance which the Commission deems essential with respect to options trading. For example, the Amex believes that its own surveillance program, with the enhancements that are presently being implemented, provides a surveillance capability that is the equal of any in the industry.

The Honorable Harold M. Williams  
Page Ten  
June 1, 1979

An equitable allocation of these options would also stop the drain on MSE's financial and regulatory resources. Indeed, we see no reason why this could not be done immediately so that MSE would be out of the options business completely, which we understand to be its objective. We recognize that this would result in some expansion of the options programs of each of the exchanges to which MSE options are allocated, but it would not result in any overall expansion of options trading. It is very difficult for us to understand the rationale for contending that relocation of all of the MSE options to the CBOE floor during the course of the moratorium -- together with the promise that CBOE will have the exclusive right to list such options at the conclusion of the moratorium -- is consistent with the goal of protecting investors, maintaining fair and orderly markets and preserving competition among market centers, whereas the movement of some of these options to each of the remaining options exchanges is somehow inimicable to those objectives.

Finally, we would like to address the matter of preserving the talents and resources of the MSE options professionals. We question whether under the provisions of the Act this can be set up as an overriding objective, taking precedence over the express statutory determination that maintenance of fair competition among market centers is in the public interest. We find nothing in the Act to suggest that, if an SRO embarks upon a particular program which subsequently proves to be unsuccessful, some sort of insurance must be given to the market professionals who participated in that program to assure them a free opportunity to participate in another market.

Notwithstanding our concerns as to the validity of this objective, the Amex is prepared to consider some arrangement for such professionals to acquire options memberships on the Amex at a reduced price -- a membership that will enable them to trade in all Amex options rather than a mere handful, and one that will provide them with a permanent opportunity rather than the limited duration membership being offered by CBOE.

One further aspect of the CBOE-MSE proposal requires comment (although it was not specifically cited by the Commission as a reason for approving the consolidation) -- that is, the proposed financial

The Honorable Harold M. Williams  
Page Eleven  
June 1, 1979

arrangements between CBOE and MSE. If CBOE determines that MSE has valuable plant, equipment, leases, etc. being utilized in connection with its options program which CBOE would like to purchase at such time as MSE terminates its program, it should not necessarily be anyone else's concern. It does not follow, however, that CBOE should also be authorized to buy MSE's listings. The listing of a security is a regulatory matter which only the Commission has authority to approve or withhold. Therefore, the financial arrangements between CBOE and MSE cannot provide any justification for the Commission's decision in awarding these options to CBOE. We believe it entirely inappropriate and would set a very dangerous precedent to permit listings to become the subject of commercial barter between SROs,\* and the Commission should not lend its stamp of approval to any such arrangements.

We seriously doubt the Commission intended its action in endorsing the CBOE-MSE proposal to be viewed as constituting approval of the sale of listings and we appreciate that it may have been motivated, at least in part, by a deep concern for MSE's financial condition.\*\* Therefore, if the Commission has information indicating that MSE is in dire financial trouble as a result of its efforts to develop an options market and that somehow it should receive financial assistance in connection with its termination of that program, the Amex is prepared to sit down with representatives of MSE, the Commission and other options exchanges to explore areas in which such assistance might be made available. After all the facts have been developed, the Amex might be willing to make a reasonable financial contribution to help assure the viability of MSE. However, we do not believe that such a determination can be made on the basis of the information presently in the record in this proceeding.

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\* If listings were to be thrown open for bidding, then all options exchanges would have to be given an equal opportunity to bid.

\*\* In view of the paucity of supporting data in the record on this point, it is difficult to ascertain how serious this concern really is. It is to be noted, however, that the Order states the MSE options program broke even last year, and its trading volume has been up so far this year.

Summary of Amex Proposal

In an effort to assist the Commission in arriving at an appropriate solution to the problem of the MSE options program -- one that will comport with the public interest objectives of the Act and not discriminate against any of the other options exchanges -- the Amex proposes the following:

1. The Commission should devise a procedure for the equitable allocation of all MSE options among the remaining options exchanges.
2. Each options exchange indicating a desire to participate would be required to give an undertaking that it will provide continuity of trading for any such options allocated to it.
3. As soon as possible after the allocation has been completed, the listing of these options would be transferred to the respective exchanges to which they have been allotted and MSE would be relieved of all further responsibility therefor.
4. Each of the other exchanges, as a condition to participating in the allocation, should be encouraged to devise a plan that would permit former MSE options professionals to gain full membership in their options program under reasonable terms and conditions and at reasonable cost.
5. The Commission is of the view that the MSE is continuing to experience financial difficulties as a result of its attempt to establish an options market, the Commission should call a conference of all of the options exchanges which participated in the allocation of the former MSE options and request that they explore ways in which some form of financial assistance could be made available to MSE.

The Honorable Harold M. Williams  
Page Thirteen  
June 1, 1979

The Amex considers the issues raised by this letter to be of the highest priority, and is prepared to meet with the Commission immediately to discuss this matter.

Sincerely,

*Robert J. Burnbaum*

The Honorable Philip A. Loomis, Jr.  
The Honorable John R. Evans  
The Honorable Irving M. Pollack  
The Honorable Roberta S. Karmel