



The Chicago Board
Options
Exchange

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Commodities Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Attention: Secretariat

Gentlemen:

The Chicago Board Options Exchange ("CBOE") is pleased to comment on the proposal of the Commodity Futures Trading Commission ("Commission") for a commodity options pilot program (46 FR 33293, referred to herein as the "Release").

CBOE is a national securities exchange registered with the Securities and Exchange Commission ("SEC"). It is not a board of trade licensed by the Commission and it does not presently plan to apply for a license as a domestic commodity option exchange. Nevertheless, as the nation's oldest and largest options exchange, CBOE has a special interest in seeing that the proposed commodity options pilot does not disrupt the market for securities options, and that it does not injure or confuse investors in securities options. Also, because of its experience in operating and regulating an options market, CBOE is familiar with many of the issues referred to in the Commission's proposal. With this background, CBOE believes that it is in a unique position to comment on certain of the questions raised in the proposal and to make a number of other relevant observations. We intend to limit our comments to those aspects of the Release that pertain to securities-related options, although some of our comments may also be relevant to options on other types of property or interests.

At the outset, CBOE wishes to make it clear that it does not intend to address in these comments questions concerning the jurisdiction of the CFTC over securities-related options. Today, of course, there are no securities-related options traded in any market subject to the Commission's jurisdiction. There are, however, futures on certain exempt securities, and the Commission proposes to include one of these (GNMA futures) in the options pilot. The Release contemplates that if experience with options on futures is successful, the pilot will likely be expanded to include options on physical commodities, which leaves open the possibility that the Commission will seek to exercise

direct regulatory authority over options on exempt securities.* It is our position that the SEC, and not the Commission, has exclusive jurisdiction over options on exempt securities, and nothing herein should be construed as an expression of the view that the Commission has jurisdiction over them.

CBOE's views on the proposed commodity options pilot may be briefly summarized at the outset. First, CBOE doubts that the authorization of a commodity options pilot at this time can satisfy the statutory condition that, before a commodity options pilot may begin, the Commission must document its ability to regulate successfully commodity options transactions, especially in light of the acknowledged limitations on the Commission's resources and the many demands already placed on those resources.

Second, wholly apart from jurisdictional questions, we do not believe that the commodity options pilot should include options on futures on exempt securities. These options would not serve the economic functions served by futures contracts or by options on securities themselves, but instead are likely to disrupt both the futures and securities markets and to be injurious to users of those markets.

Third, in the event that the Commission determines to go forward with an options pilot that includes securities, and it is found that such options are within its jurisdiction, then we believe that restricting participation in the pilot to those exchanges that trade futures on the securities that underlie the options is an unnecessary and unjustified limitation on competition, and is, therefore, not the least anti-competitive means of achieving the statutory objective.

* For purposes of this letter, but without arguing the points, we have assumed that under no circumstances would the Commission have jurisdiction to regulate any instruments (futures, options or options on futures) relating to non-exempt securities. In its brief amicus curiae in Board of Trade of the City of Chicago v. Securities and Exchange Commission, currently before the United States Court of Appeals for the Seventh Circuit, the Commission has apparently conceded that the Commodity Exchange Act does not apply to, and that the SEC has jurisdiction over, nonexempt securities (pp. 11-13, 18).

Finally, we shall comment on a few of the more technical aspects of the proposal.

The remainder of this letter consists of an elaboration of the foregoing points.

The Commission has not documented its ability to regulate securities-related commodity options transactions as required by the Commodity Exchange Act.

As the Commission noted in its proposal, in 1978 Congress responded to the increased incidence of fraudulent and other illegal practices in connection with commodity options by banning these options altogether, except for a limited category of dealer options. In doing this, Congress recognized that the Commission's effort to regulate commodity options had caused a considerable drain on its resources and had diverted them from the Commission's primary task of regulating the futures markets.* The statutory ban on commodity options contained in Section 4c(c) of the Commodity Exchange Act contemplates the possible resumption of commodity options transactions in a limited pilot operation at such time as "the Commission transmits to... [Congress] documentation of its ability to regulate successfully such transactions...." In part, the ban on commodity options was intended to "give the Commission time to get its house in order on futures transactions and make the necessary managerial changes to insure successful Commission operations."**

* See The Reauthorization Hearings before the Senate Subcommittee on Agricultural Research and General Legislation of the Committee on Agriculture, Nutrition and Forestry, 95th Cong., 2nd Sess. 68 (1978) (statement by Senator Hudleston). The subject of the Commission's limited resources was also addressed in Executive Director Tendick's memorandum for the Commission dated June 2, 1981 on the subject "Resources to the Options Pilot Program." Mr. Tendick took note of the reduction of the Commission's personnel ceiling for fiscal year 1982 and the consequent curtailment of the Commission's activities.

** Report of the Committee on Agriculture, Nutrition and Forestry, U.S. Senate, to Accompany S. 2391, S.Rep. No. 95-850, 95th Cong., 2d Sess. 25 (1978) ("1978 Senate Report").

We do not believe that this test can be met by the Commission, at least not if the commodity options pilot is to include securities-related options. If the Commission cannot successfully regulate these options, we fear that the effect will be felt not only within the confines of the pilot, but that it will also adversely affect existing securities options markets, including our own. If the regulation of any securities-related instrument is weak, it is likely to affect adversely the integrity of the securities markets generally. The increased incidence of regulatory problems in one market, and the publicity that would be given to such problems, would create problems in all related markets, including our own.

The Commission's failure to document its own regulatory capacity is evident on the face of the Release. The Commission acknowledges that its own surveillance and enforcement resources are limited. [Release at 33295]. Presumably for this reason, the Commission proposes to rely heavily on the self-regulatory organizations to provide surveillance over the options pilot. Although self-regulation is undoubtedly an important component of a well regulated options pilot, we do not believe that it alone was what Congress had in mind in requiring "documentation of its [i.e., the Commission's] ability to regulate." Also, there is little discussion in the proposal of how the Commission would regulate the pilot or oversee the self-regulatory organizations, and whether it has the resources necessary for these purposes. Finally, any reliance intended to be placed on the National Futures Association as a self-regulatory organization must be questioned in light of the recent objections of the Justice Department to the registration of that organization by the Commission.

It is especially doubtful that the Commission can document its ability to regulate transactions in securities-related options effectively unless it is able to coordinate such regulation with regulation of related securities markets. All of the national securities exchanges that currently provide markets in securities options have from the outset developed systems for coordinating surveillance and enforcement with each other and with the markets in the underlying securities, all under the oversight of the SEC. Nothing less should be required of any securities-related options that might be traded under the Commission's jurisdiction.

The commodity options pilot should not include options on futures on securities.

Wholly apart from questions of the Commission's jurisdiction or whether the statutory condition referred to above has been met, we believe that there can be no justification for including options on futures on securities in a commodity options pilot. On the affirmative side, options on futures on securities have never been shown to serve any useful economic purposes, while on the negative side, they would present serious problems for existing securities markets and for investors. In both of these respects, we would distinguish options on futures on securities from futures and from options on securities, both of which have proved their usefulness in existing markets, including ours.

Part of the difficulty with options on futures on securities is that they add nothing to the economic functions served by futures and options, and, indeed, futures and options can serve these functions better than options on futures. Surely it cannot be claimed that options on futures on securities would serve any price discovery function whatsoever -- especially for underlying securities whose prices are available in active cash markets, and therefore do not need to be "discovered." Neither would options on futures on securities add anything that is useful for commercial hedgers, since hedging can better be accomplished with futures and options on securities.

Moreover, options on futures on securities are extremely complex instruments, the value of which depends upon the interrelationships among premiums, exercise prices, expiration dates, delivery dates, contract prices and cash market prices. It is difficult to imagine how the average investor could be made to understand these complexities and the risks involved in dealing in such instruments. Yet, because of their relationship with other securities markets, these instruments, in part because of their very complexity, could be misused by the unscrupulous in ways that would be especially difficult to detect.

Given the absence of any benefits from options on futures on securities, and the real risk of harm from these instruments, we do not believe that it would be in the public interest for the Commission to include them in the commodity options pilot.

It would be an unjustified restriction on competition to limit participation in a commodity options pilot to those exchanges that trade the underlying futures contracts.

Obviously, the proposed rule that only those exchanges that are designated to trade the underlying futures may participate in the commodity options pilot represents a significant impediment to competition. By excluding from the pilot not only existing commodities exchanges that do not trade the particular contracts that are designated for the pilot, but also new exchanges (which, if the pilot includes securities-related options, could include existing securities exchanges), the Commission has virtually assured that the large commodity futures exchanges that today dominate the futures markets will be able to extend that domination to the new commodity options markets. This is inconsistent with the express admonition of Congress that "the utility of commodity options should be determined by the forces of the market place, without any barriers being constructed by the Commission inconsistent with the provisions and purposes of the Commodity Exchange Act."*

The only justification for this clearly anti-competitive rule is the Commission's statement that, "[I]t believes it would be difficult for an exchange which was licensed to trade the option but not designated to trade the underlying futures contract to conduct adequate surveillance of that market." It is also stated that "close proximity" of the options and futures markets should improve the efficient transmission of market information.** Both of these statements are, in our view, without merit.

The best evidence of what is required for adequate surveillance of an options market can be found by examining the existing options markets and the exhaustive SEC study of their regulatory activities (Report of the Special Study of the Options Markets to the Securities and Exchange Commission, December 22, 1978; the "Options Study") -- subjects that are not even mentioned by the Commission. The two largest options exchanges (CBOE and AMEX) do not trade any of the securities that underlie their respective lists of options, and the other smaller options exchanges provide only a regional market in their underlying stocks. However, there is no evidence that this has in any way impaired the surveillance of any of these options markets. In the case

* 1978 Senate Report at 24.

** Release at 333000.

of CBOE, surveillance is maintained by means of the most sophisticated computerized audit trail surveillance system anywhere, a system that was cited by the SEC as a model for others.* To the extent that surveillance of CBOE's options market involves the market for the underlying securities, this is accomplished pursuant to established procedures for coordinating surveillance among all of the securities markets, including the New York Stock Exchange, which is the primary market for the underlying stocks.

Thus, it is not necessary for trading in derivative and underlying securities to be done on the same exchange in order to have effective surveillance. What is important to effective surveillance of an options market is that an audit trail system be in place, and that the surveillance systems of all of the exchanges that trade related instruments be integrated.**

On the other hand, to the extent that the options pilot was intended to include securities-related options, then to be consistent with the doctrine that effective surveillance requires the options and futures to be traded together, the Commission also should have considered other related derivative instruments and the underlying securities themselves in a totally integrated surveillance program. Not only was there no apparent consideration of these related instruments in connection with the options pilot, but historically, in permitting various commodity exchanges to trade futures on GNMA securities and Treasury securities, the Commission has never expressed concern that those exchanges were not also trading the underlying securities.

* Options Study, Committee Print 96-IFC3, 96th Cong. 1st Sess. 209 (1978).

** The Release raises the related question whether exchanges should be required to verify the time of each option transaction to the nearest minute, or alternatively whether a proposed time "bracket" identification is sufficient. Since the principal purpose of an audit trail is to permit the reconstruction of trades in proper sequence and in relation to other trades, it seems clear that this purpose cannot be met unless the precise time of each trade is known. The ability to reconstruct trades in time sequence would be lost if trades were not required to be identified on a minute-by-minute basis.

The second reason given for limiting the options pilot to those exchanges that trade underlying futures -- that this will increase the efficient transmission of market information -- totally disregards the manner in which market information is transmitted, at least insofar as securities-related options are concerned. In this age of modern electronic communications, it is an outmoded notion that markets must be physically adjacent to assure rapid access to price information. The Commission must know that today securities markets throughout the world have immediate access to real time market information through electronic means. This is how options are traded in Chicago (as well in San Francisco, London and Amsterdam) on underlying securities traded in New York.

The only kind of market information that may be uniquely available at the physical location of the market that trades an underlying security is the kind of market information that should not be used -- such as advance information about a trade that has not yet taken place. Instead of facilitating the improper use of this kind of market information, the Commission should be considering what regulatory safeguards may be necessary to prevent it.

Thus no substantial reason has been given by the Commission for limiting the options pilot to exchanges that are designated to trade the underlying futures. Because of the obvious anti-competitive impact of this limitation, it should be eliminated.

Other Comments.

The Release identifies a number of questions concerning specific regulatory requirements such as margin, position limits, sales practice regulation, suitability and last sale and quotation reporting, all of which have counterparts in the securities options market with which we are familiar. In many instances, the regulatory standards proposed by the Commission differ from those that currently apply in our market. While we have little concern with regulatory differences between commodities and securities markets generally, these differences would become very significant to us if the commodity options pilot were to include securities-related options, because of their obvious impact on competition among markets.

CBOE welcomes competition with other securities options markets, including markets under the aegis of the Commission if the Commission should be determined to have

jurisdiction over them, but we do not think that competition among markets should depend upon regulatory differences. We are not now in a position to suggest how each of these regulatory disparities should be resolved, nor do we want to suggest that the Commission's proposals should necessarily be revised to make them conform to regulations that have previously been adopted by the SEC. However, we do think that if securities-related options are to be included in the commodity options pilot, then it is appropriate, if not required by Section 2(a)(8)(B) of the Commodity Exchange Act, for the Commission to consult with the SEC concerning these differences, in an effort to eliminate as many as possible by agreement between the two agencies. This will enable competition between markets to be based upon meaningful factors, such as the usefulness of products traded, the efficiency of markets and the quality of services provided, rather than unjustified regulatory disparities.

The only specific area of regulation that we will mention, insofar as it pertains to securities-related options, is margin, since differences in margin requirements can be especially significant to competition among markets. Initial margin requirements for all securities-related options, including options on exempt securities, are today determined by the Federal Reserve Board. We believe that to assure adequate control over margin requirements applicable to all securities-related options, as well as to remove any incentive for a particular market to lower margins in an effort to gain a competitive advantage, the Federal Reserve Board's authority should extend to all such options, including any that might be included within the Commission's pilot.

Our final technical comment concerns the scope of the Commission's authority to grant exemptions from the rules governing the pilot. As proposed, the Commission would be empowered to grant exemptions from all commodity options rules "other than §§33.2(a), 33.27, 33.28, or 33.29...." Our concern is that this limitation on the Commission's exemptive authority may be unduly restrictive in light of possible jurisdictional conflicts that may arise in the future. Whatever position one takes on the jurisdictional questions that have been raised between the Commission and the SEC, it must be recognized that these questions are quite complex, involving not only competing claims of exclusive jurisdiction, but also the possibility of concurrent jurisdiction in some areas. Thus, it is entirely possible that the orderly resolution of these questions may depend not only upon the courts or Congress, but also upon the agencies themselves, who may find it useful to settle some

of their differences by granting exemptions in appropriate cases.

Although it is not now possible to foresee the precise circumstances in which exemptions might be granted, it does seem clear that the exemptive rules themselves should be as broad as possible in order to afford the Commission maximum flexibility to deal with such situations as might arise. At the least, this suggests to us that there should be no self-imposed limitations on the Commission's authority to grant exemptions, and that the "other than" phrase quoted above, or at least the reference to §§33.27 and 33.28, should be deleted.

Respectfully submitted,


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