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Chairman John S. R. Shad
Commissioner Philip A. Loomis, Jr.
Commissioner John R. Evans
Commissioner Barbara S. Thomas
Commissioner Bevis Longstreth
Securities and Exchange Commission
500 N. Capitol St., N.W.
Washington, D.C. 20549

Dear Chairman and Commissioners:

We understand that the Commission will shortly consider a Staff recommendation that multiple trading, even though deferred as to stock options, should be opened up now as to non-equity options. As we have said before (letter of 8/18/81 re Release Nos. 17631, 17632, 17795 and 17578), we agree that the two situations are different, and it follows that the policy considerations regarding multiple trading are also different. However, we strongly believe, apparently contrary to the Staff, that the policy considerations applicable to non-equity options should lead to indefinite deferral of multiple trading on these options as well as stock options.

Two of the three reasons set forth in Release Nos. 17577 and 17795 for distinguishing non-equity options from stock options* were (1) difficulties of the Commission's

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* The other reason was that the Commission's concern as to the viability of certain regional stock exchanges, if unable to trade some classes of stock options exclusively, did not extend to non-equity options, which are not now traded on any exchange. However, as noted in our 8/18/81 letter and below in this letter, we believe that multiple trading of non-equity options, whereby an imitator could ride on the coattails of an innovator, could seriously harm the ability of existing options exchanges to compete effectively.

assuming an allocation role in view of the limited number of optionable non-equity instruments and (2) the desirability of competition based on variations in contract design. We believe that these two points are really two sides of the same coin, and the name of that coin is innovation -- genuine, creative innovation. If the full significance of innovation in respect of new non-equity products is understood -- particularly (i) the potentially great competitive role of true innovation, and the threat to that potential posed by multiple trading, and (ii) the way that true innovation can and should determine market allocation for new products -- we believe it becomes evident that the two points mentioned by the Commission do not add up to reasons for opening up multiple trading but, rather, buttress the case against multiple trading.

We would first suggest the importance of distinguishing between (a) competition-innovation in developing new products and (b) competition-innovation in "contract design"; and, within the latter category, between (1) minor variations that basically would amount to multiple trading with loss of standardization and (2) variations significant enough to produce a new and different product and thereby avoid the issue of multiple trading.

(a) Competition-innovation in development of new products. We do not agree with the comment in Release Nos. 17577 and 17795 that there is a limited number of non-equity products suitable for options trading. The four existing options exchanges have been vigorously engaged in developing new products since the termination of the options moratorium. Each has developed and filed at least one different product, and each probably has (or at least CBOE has) one or more other new products in an advanced stage of research and development. Further, the number and variety of financial futures developed by the commodity exchanges in recent years show that exchanges devoting talent and resources to the development of new products can come up with many different ones.

There is no reason to think that a bar to multiple trading in non-equity options would prevent any exchange from developing a new product if it were seriously interested

in doing so. To the contrary, multiple trading would undoubtedly tend to chill new product development, whereas barring such trading -- inherently based on imitation -- would foster genuine new product development.

As the Commission knows, the development of a really new options product is a costly, time-consuming and demanding process. In an unregulated market, a competitor which undertook the burdens of developing an equally complex new product would expect to commence business as soon as it was satisfied that the product was ready for the marketplace. And it could ordinarily assume that its headstart would provide sufficient rewards to make its efforts worthwhile.

A national securities exchange, on the other hand, must file its new proposal publicly (for anyone to copy) and then wait through the review period, during which would-be competitors, i.e., imitators, can file clones. Thus, regulation itself reduces the headstart advantage that could be expected in an unregulated market. Moreover, since experience has clearly demonstrated that multiple listing of options does not produce lasting competition among markets (because of the "primary market syndrome"), innovation is further chilled by the realization that a mere imitator which is able to start trading at the same time may have as good a chance as a true innovator to capture the entire market. If multiple trading of new products is permitted, exchanges will have little incentive to pay the high price of development and innovation.

(b) Competition-innovation in "contract design." We believe it is both necessary and possible to distinguish sharply between (1) variations in contract design that are relatively minor, so that the end result really amounts to multiple trading with loss of standardization and (2) variations that are basic enough so that the end result is not multiple trading but truly different products. We believe the distinction between these categories will ordinarily be self-evident, but if not self-evident, the answer will become evident enough through a combination of (i) the second exchange's explanation in its filing of why its proposed variations are major (so as to amount to a new and different product) rather than minor, and the first exchange's response, and (ii) industry comments (which can be expressly sought) as to whether the second

proposal will fill a new and different need in the marketplace.*

If a proposal is found to come within category (2) (i.e., basic enough to amount to a new product), the above discussion of new product innovation (pp. 2-3) is applicable: There would simply not be any multiple trading within the meaning of any ban on multiple trading and competition by worthwhile innovation would be encouraged. If a proposal falls within category (1) (i.e., minor variation), there is no worthwhile innovation but, rather, there are all the problems of multiple trading plus additional problems due to loss of standardization.

In connection with stock options the Commission early refused to allow relatively minor variations in contract terms; i.e., it insisted on standardization, in order to avoid problems of illiquidity, undue complexity for brokerage firms and confusion of public investors. The

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* In Release 17795 the Commission, while "not inclined to substitute its judgment for that of a self-regulatory organization with respect to...optimal contract design," (p. 5) expressly invited comments on, among other questions, the relative merits of establishing contracts on specific issues as compared with a "market basket" approach, including the relative utility of the two approaches for hedging purposes and their relative pricing efficiency (p. 12); the ramifications of two or more exchanges' determining to trade options on the same underlying issue (p. 13); the usefulness for hedging purposes of options limited to 12 months as compared with futures that may extend for 23 months (p. 14); the relative merits of three-point and one-point price intervals, including "the appropriate balance between permitting market participants to fine-tune trading strategies...and possible liquidity problems or other regulatory concerns" (p. 14); the utility of Treasury bill options contracts designed in various ways (p. 16); and whether optional cash settlement would diminish the utility of the Treasury options market (p. 18). If the Commission felt it could and should evaluate comments on all these aspects of contract design, it surely can evaluate arguments and comments as to whether design variations in a second proposal would result in a truly useful, different product, as distinguished from a mere loss of standardization.

same policy should apply to new non-equity products, where the possibility of all these untoward consequences is, if anything, greater.

This does not mean that initial contract designs should remain frozen. What it does mean is that improvements in contract design (short of truly creative ones, producing a truly different product) should be accomplished in the first instance in the innovator's market, rather than letting a would-be competitor point to a relatively minor change as justifying multiple trading, with loss of standardization and with the inevitable (and chancy) race between innovator and imitator to capture the whole prize.

Nor is there reason for concern that a useful product might wither away because the originating exchange might not make needed improvements so as to develop its full potential. In the first place, if competition to originate new products is encouraged (and not chilled by allowing imitative trading), each exchange will be motivated to excel not only in innovation but also in performance -- another fundamentally desirable form of competition. If an exchange fails to keep up in performance, after a fair chance to realize the full potential of a new product without the burden of multiple trading, a different product will fill the vacuum.

Finally, in considering the negative ramifications of multiple trading of non-equity options, we believe the Commission should give special attention to the fact that non-equity options are new, untried and complex products. Because they are new and complex, the markets for these options may be especially vulnerable to start-up problems for many months following commencement of trading. The true innovator and developer of a new non-equity option clearly will be in the best position to detect and cure such problems. An imitator, not having the in-depth understanding gained in the process of inventing a new product, is much less likely to see or respond adequately to unexpected problems; indeed, through lack of understanding and fear of delaying its "catch-up" efforts, an imitator may actually impede the working out of solutions. Further, the very existence of multiple trading (especially with minor variations in contract design) may obscure start-up defects in design of an untried new product, or in sales practice regulation, surveillance of trading and the like, and is likely to complicate the remedying of such defects when identified.

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In sum, we believe that the approach suggested above -- letting a true innovator go forward without imitative multiple trading -- would result, in practice, in resolving the two concerns (expressed as two distinctions from multiple trading of stock options) of the Commission, as summarized on pages 1-2 above:

(1) Allocation. An exchange that had researched and developed a new product, filed necessary rule changes in substantially complete form, and shown that it was willing and able to proceed, would be allowed to open and conduct its new market for an indefinite period without any other exchange being authorized to trade a substantially similar product. A truly significant variation in contract design, such as would be demonstrably a new product and recognized as such by industry commentators, would be similarly treated and could obviously enlarge the universe of available new products -- and the incentive to compete innovatively. The Commission would not need to play an allocation role, because innovation coupled with entrepreneurship would effectively perform that role.

(2) Competition. At the same time and on the same analysis, meaningful, as distinguished from trivial, competition in contract design would be greatly encouraged. True innovators would know that, if they designed well, they would have a reasonable opportunity to reap the rewards of their innovation and entrepreneurship, without fear that a mere imitator could readily steal the show. All exchanges would be motivated to become innovators, because would-be imitators (or trivial-variation innovators) would know that (in Commissioner Evans' recent words) "the future is for those who are prepared."

There need be no concern that this would lead to a static or anticompetitive world. Competition to innovate in offering new products and to maintain their viability and popularity, which would necessarily include alertness to possible improvements as well as efforts to perform well as a marketplace, would assure a far more competitive -- and more enduringly competitive -- world than multiple trading without innovation could possibly do.

At the same time, the approach suggested above would avoid what we (and the member firm community) have previously pointed out as being very serious problems and drawbacks of multiple trading of options.

Very truly yours,

Walter E. Auch

cc: Douglas Scarff (3 copies)