

NEWS

**SECURITIES AND
EXCHANGE COMMISSION**

Washington, D. C. 20549

(202) 755-4846



HOLD FOR 12:00 P.M. RELEASE, NOVEMBER 14, 1973

OPTIONS: THE "NEW GAME IN TOWN"?

An Address By

A. A. Sommer, Jr., Commissioner

Securities and Exchange Commission

November 14, 1973
Securities Regulation and
Enforcement Cooperative Conference
Parker House
Boston, Massachusetts

OPTIONS: THE "NEW GAME IN TOWN"?

A. A. Sommer, Jr.*
Commissioner
Securities and Exchange Commission
Washington, D. C.

It is a truism today to say that the securities markets are in a state of profound change. Not only are changes occurring rapidly and not only have many changes already occurred, but profounder changes, culminating in a "central market", the shape and dimensions of which no one is quite sure of at the moment, are in store. The impact of the computer on the methods of trading securities has been huge - witness NASDAQ - and promises to be even more dramatic as all those involved in the process seek means of using this new technology in a manner which will best serve investor interest.

Among other changes there have been changes in the approaches exchanges have taken to the securities traded through their facilities. Only fairly recently did the New York Stock Exchange admit warrants to trading and it has lately proposed to lower the standards according to which it admits warrants to trading. The American Stock Exchange has appointed a committee to study a proposal to continue trading on its floor of securities after they are admitted to trading on the New York Stock Exchange.

*The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or of my fellow Commissioners.

Certainly one of the most significant changes in the nation's market places has been the commencement of trading in call options on the Chicago Board Option Exchange. Since April of this year this new exchange has been in operation and the first interim report covering three months of operation has been issued.

Put and call options are not, of course, a new phenomenon. Nor is their regulation a new occurrence. During the hearings that preceded the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 there was evidence that the use of options had been one of the means by which markets were manipulated to the disadvantage of the public. Because of the actual and potential abuses, the original drafts of the Securities Exchange Act would have outlawed the purchase or sale of options through an exchange or in connection with exchange-traded securities. Apparently, however, Congress decided that it was virtually impossible for it to distinguish between a "good" and a "bad" option, and, rather than prohibiting all such options, it gave the Commission broad power to regulate their trading under Sections 9 (b) and (c) of the Securities Exchange Act. The Commission has not used this rule making authority until quite recently, but relied mainly on self-regulation. The various exchanges, in 1935, adopted rules which prohibit a floor broker

of an exchange from initiating a transaction on the floor in a security if he holds or has sold an option with respect to that security and specialists are prohibited from option activity with respect to the securities in which they are acting as specialists.

Options have been a mode of market activity for many years. All of us are familiar with the ads that have appeared over the years by the dealers in put and call options noticing the prices at which options could be purchased to call or put securities of well-known issuers. Frequently, individual investors were told that options offered unique speculative opportunities and they were frequently encouraged to test their ability to make speculative profits through options. Not only were options availed of by investors in the hope of speculative profits, but they frequently served the purposes of less speculative investors who might, for instance, seek to protect long-term profits from excessive erosion through the use of options or might simply utilize options as a means of enhancing investment gain by means of the premium received for the options. The statistics, in so far as they were available, indicated that writing options was generally a good business while buying options was generally unprofitable. Relatively little information has been available with regard to the impact of option activity on the trading markets and, as a matter of fact, because of the limited amount of such activity, most market scholars were relatively unconcerned with that end of the business.

All of the activity in options was over-the-counter. Furthermore, options were in effect "custom written", that is, they had expiration dates and exercise prices that depended upon the date that they were purchased and the market for the underlying stocks at the time they were purchased. Also there was no organized secondary market for options: when a person purchased an option there was no easy means of disposing of it otherwise than by exercising it to purchase or sell the underlying security or by allowing it to expire if the exercise was uneconomic. Thus options were neither fungible nor liquid.

Recognizing the limitations of previous option activity, the Chicago Board of Trade in the late 60's began studying the possibility of organizing an exchange on which options could be traded much after the manner in which other securities are traded, using the various commodity futures trading and clearing principles with which the Board of Trade was familiar - and it might be noted at the outset that options on stocks clearly are "securities" under all of the Acts administered by the Commission. Obviously, in addition to the economic and organizational problems posed by such a concept, there were significant regulatory problems. Options being securities, problems arose under the registration provisions of the Securities Act of 1933. In addition, all national securities exchanges must be registered with the Commission pursuant to the '34 Act and they must submit to the Commission constitutions,

by-laws and rules which are satisfactory to the Commission for the protection of investors. The Commission retains, after a securities exchange has registered, broad oversight authority with regard to the exchange's rules and operations.

In early 1969, the Board of Trade approached the Commission to discuss the possible organization of an options exchange and from then on there were extensive negotiations between the staff and representatives of the Board of Trade which culminated in February of this year in the registration of the Chicago Board Options Exchange, usually referred to as the CBOE. The Commission registered this exchange with the clear understanding that it was a pilot project and that approval of the registration did not in any fashion constitute a final conclusion of the Commission that trading in options on exchanges was consistent with the protection of investors, or that experience in the trading of options might not form the basis for a termination of the exchange's registration, or that trading of options on more than one exchange would be desirable. It was expected that the functioning of the CBOE would be observed very closely and it was hoped that the data arising out of its operations would form a basis for the development of a coherent, comprehensive policy with respect to trading in options.

For those of you who may not know the manner of trading or the manner of activity of the CBOE, perhaps it might be interesting to review it for a moment. First of all, only call options are written, that is, options which will afford their purchasers the right

to purchase securities at a stipulated price which is called the "strike price"; put options which allow their holders to compel the writer of the option to purchase securities at a stipulated price are not at the present time traded on the CBOE. All options traded on the CBOE expire on one of four dates: the last day of April, the last day of July, the last day of October or the last day of January. The strike price is set by a body of the exchange and it will be rounded to the closest \$5 in relation to the market price of the underlying stock at the time it is set. Thereafter, as the market fluctuates, new options with the same expiration date may be written, with strike prices adjusted in intervals of \$5 for securities having a market price of less than \$50, \$10 for securities having a market price of less than \$50 to \$100, and \$20 for securities having market prices in excess of \$100. At the present time options are written for a maximum of 9 months. As an example, let us assume that at the end of July Consolidated Widgets was selling for \$28 on the New York Stock Exchange and the CBOE opens up a new 9 month series of options which would expire at the end of April, 1974. The strike price of these options would be set at \$30. Then the market would take over and through the traditional auction process someone interested in selling an option would strike a bargain on the premium (i.e., the amount paid for the option) with someone interested in buying an option. Thus, a seller of the

option expiring at the end of April at a strike price of \$2 over the current market might offer to sell for \$700 an option on 100 shares (which is the unit of trading) and if he could find a buyer a bargain would be reached. Obviously the price in the market place of an option depends upon two factors: the strike price and the length of the option. The higher the strike price is over current market the lower will be the value of the option; similarly, the longer the option the higher is the premium the purchaser would be willing to pay.

Basically call options are written by two kinds of people: people who own the security with respect to which the option is written, and people who do not own the security. The latter kinds of options are called "uncovered" or "naked" options. Obviously there has to be some assurance that if it becomes desirable for an option holder to exercise his option the one who wrote the option will be sufficiently responsible financially to make good on the contract and deliver the security upon exercise. To assure this every option traded on the CBOE must be endorsed, that is, guaranteed, by a member of the exchange and the exchange's clearing corporation itself stands behind the options. Thus, an investor has a high measure of assurance that if he makes a profit through the option market he will secure it promptly - - an assurance that was sadly lacking in the operation of Goldstein, Samuelson which dealt in options on unregulated commodity contracts. When the option matures one of three things generally could happen. If the market price in relation

to the option price is bad, that is, the holder could not exercise the option and sell the security at a profit, the holder will allow the option to expire. If, however, it is economically desirable to exercise the option, then the holder can do one of two things: he can exercise the option, take delivery of the security and sell it to realize his profit or perhaps only reduce his loss if the market price is more than the strike price but less than that plus the premium he paid. Or, and this apparently is the most frequent consequence, he can sell the option to one of the writers of the options for an amount equal to his potential profit if he exercised it and sold the underlying securities. Thus, by way of example, let us assume that the strike price on a security is \$25, the market at the expiration date is \$30 and the option holder paid \$200 for an option on 100 shares, or two dollars a share. Ignoring execution costs and tax consequences, he has the potential of \$3 a share net profit if he exercises his option and then immediately sells his shares. But with CBOE, he may sell his option for \$500, thus realizing his \$300 net profit without the need for any intervening transaction in the underlying stock.

Actually, very few option holders ask for delivery of the security. CBOE's experience with the first set of options which expired at the end of July, showed that about 80% of the holders of profitable options at the time of expiration chose to sell them rather than to take delivery of the stock.

The most significant advance in the option markets is the development of an organized secondary market in options as a consequence of their fungibility. Previous to the advent of the CBOE, a purchaser of an option could for practical purposes do nothing with it until it expired except exercise it or negotiate its resale to the writer. Now, however, the writer and the holder are "unbundled" and the latter can find a buyer through the auction processes of the CBOE.

A word about the mechanics of option trading on the CBOE. As you know, the specialist on a securities exchange typically plays a dual role - - he acts as a broker accepting and executing orders for his "book" and he acts as dealer in buying and selling his speciality stock for his own account in order to give continuity and liquidity to the market. On the CBOE, however, these functions are separated with Board Brokers assuming the agency function and Market Makers performing the dealer function. Unlike other exchanges, there are competing Market Makers in each class of options.

For Securities Act purposes, the clearing corporation of the exchange is regarded as the issuer of all options and the options have been registered under the Securities Act using a Form S-1. I might add that the prospectus with respect to this kind of security is a very peculiar looking animal, particularly inasmuch as it does not describe the particular option which a person may have purchased. Rather it describes in some detail the process and the operation of the exchange, and lists the underlying securities which may be covered by options issued and traded on the exchange. Each purchaser of an option is supposed to receive a copy of a prospectus at the customary time - either with or preceding the receipt of his confirmation.

It is fair to say that the volume of trading on the CBOE has significantly exceeded expectations, naturally much to the delight of the sponsors of the exchange. The CBOE, which is in a pilot phase and deals only in 32 underlying stocks and is restricted to call options, has an average trading volume of 10,000 contracts per day. Since each contract represents a call on 100 shares of the underlying stock, this is the equivalent of a 1,000,000 share average daily volume. Moreover, the CBOE has outstanding approximately 500 authorized memberships (including 165 which were given to members of the Chicago Board of Trade) and is seeking to authorize additional memberships.

The CBOE's operations to date have produced some interesting data, not the least of which are indications that writers of options continue to gain at the expense of the buyers of options. However, because of a number of circumstances, not the least of which is the relatively limited period the exchange has been in operation, and another of which is the fact that the period covered by the first report of the exchange was a period of unusually limited and depressed activity on the New York Stock Exchange (where all the securities underlying options traded on the CBOE are traded) the information which has been forthcoming so far is insufficient to make any judgments with regard to this method of securities activity.

Several other exchanges have indicated an interest in commencing options trading on their exchanges. The Amex and PBW have gone a fair distance in developing plans for trading options on their floors, and other exchanges have begun to consider possible establishment of option markets. It might be noted that option writing on over-the-counter securities has increased with the introduction of NASDAQ and over-the-counter securities with their smaller float may have a greater potential for manipulation. In the past year there has been evidence that options may have been used to manipulate the market in at least two cases that we have under investigation.

The obvious public interest in option trading, resulting undoubtedly in large measure from the ease with which it may now be done, the liquidity which is now afforded such trading, and other circumstances attending the introduction of exchange trading in options, as well as the interest of other exchanges in commencing this kind of activity, all lead the Commission to the conclusion that the time has come for a comprehensive look at options and the manner in which they are traded. In reaching this decision, the Commission has not in the slightest been motivated by any preliminary or fixed beliefs that trading in options is always bad, that it should be discouraged, that it is inconsistent with investor protection, that it should be limited to one exchange, that it should not be expanded to any exchange that wishes to do so under appropriate rules. Rather, the Commission believes that now, with almost seven months of experience on the CBOE upon which to draw, and because of the necessity of dealing prudently with the desire of other exchanges to expand into this activity, it is time to assess this mode of activity against the traditional standard of investor protection.

While the Commission has attempted to deal with specific problems brought about by the operations of the CBOE, it has not addressed itself to the threshold question of what economic function is served by an option exchange. In its findings and opinion granting the application of the CBOE as a national securities exchange, noting that the CBOE had described its program as a

"pilot project", the Commission itself characterized the CBOE as "an experimental project" and indicated that further evaluations would be necessary regarding the nature of the CBOE's actual operations. The CBOE has submitted a report to the Commission on its first three months of operations but the report does not provide any answer to the threshold question. Moreover, the report is inconclusive with respect to a number of other major questions, such as the impact of CBOE's option trading on the markets for the underlying securities, the composition and investment objectives of the investors buying and selling in the CBOE market and the adequacy of the self-regulatory program of the options exchange and related matters of its economic viability. It is likely that a longer period of time is needed to supply adequate answers. In the meantime, the American and PBW Stock Exchanges are clamoring for a go-ahead signal from the Commission to start their pilot option programs.

As a consequence of the foregoing, the Commission is announcing today a thoroughgoing study of options and option trading which will be characterized by an invitation to all interested parties to submit written statements and appear at public hearings to be conducted by staff members - and I might add, hearings which will in many instances, I am sure, be attended by Commission members because of their intense interest in this area.

The basic areas of inquiry will be wide-ranging in nature and scope. I will detail some of the issues to give you an idea of the types of concern which the Commission has with respect to option trading on exchanges. In the Commission's evaluation of the CBOE's pilot project, we are concerned with: What economic functions are served by the writing or purchasing of options in today's markets (e.g., hedging, leveraging, speculation)? If there are several economic functions, to what extent is each actually served and likely to be served in the option market? By whom? Do these functions, either individually or in net effect, serve the public interest? What is the nature of the investor population that now participates, or that likely will participate, in the trading of options in an exchange option market? To what extent are the present participants and likely future participants, sophisticated; unsophisticated; professional; institutional; small; or investors that would not otherwise participate in the securities market? What is the actual and potential impact of an option market on the investment and trading habits of investors? Has or will the short-term trader impair liquidity in the underlying stock by switching his interest to options? Has or will investor interest be channeled away from low-priced securities or new issues?

Of special concern to the Commission has been the subject of the writing of uncovered options. What economic functions are served by uncovered option writing? Uncovered option writing until the advent of the CBOE had been de minimus. On the CBOE, however, 23% of option writing is uncovered according to the most recent figures available. This was as of October 15. In July and August, 35% of the outstanding options were uncovered. What are the actual and potential impacts of such uncovered options on the market for the underlying securities? Should the Commission's concern be diminished by the fact that in CBOE options, actual delivery of the stock occurred for only about 20% of the profitable options which expired in July, as I mentioned earlier? These percentages raise again the threshold question of what economic purpose is served by an option exchange. Initial evidence indicates that a significant number of option writers and most of the option buyers have no intention of acquiring the underlying securities. Thus, the activities of many writers and buyers in the CBOE market, unlike the activities of their counterparts in the over-the-counter option market, are never reflected in the market for the underlying security.

Other questions the Commission is considering are: To what extent should limits be prescribed regarding the number of option contracts which can be outstanding relative to any given security issue? Should there be limits on the number of options which can be written or held by the same person? How should such limits be developed? In this regard should options or uncovered options be prohibited with respect to certain security issues?

With respect to multiple pilot projects, we must consider whether exchange option trading should be limited to the CBOE pilot project, which is now underway and being monitored by the Commission, until sufficient information can be developed and evaluated? To what extent would additional pilots facilitate or obstruct the resolution of the questions which I mentioned previously?

Secondly, if multiple exchange pilot programs should be permitted, on what conditions? In this connection, it should be noted that both the Amex and the PBW draft proposals are based very largely on CBOE's plan. The major difference between CBOE's program and those of Amex and PBW is that Amex and PBW would expect to utilize their present specialist systems instead of segregating the agent and dealer functions between board brokers and competing market makers. Amex and PBW intend to trade options having the same underlying issues as some options which are traded on the CBOE as well as options on other securities; however, all securities subject to such options would be listed and traded on the New York Stock Exchange. Amex's options would expire in the same months as CBOE's but PBW plans to have its options expire in different months. As you can see, these multiple plans give rise to consideration of the need for and desirability of inter-market competition, a composite tape and quotation system and uniform trading rules,

clearing procedures and surveillance mechanisms. Not to be overlooked are the prospective burdens on and costs to exchanges and their members arising from such multiple trading of options and the accompanying regulatory programs.

The Commission is hopeful that as a consequence of this intensive survey we will be able to formulate conclusions to guide us in determining how the creation and trading of options can be regulated in the interests of investor protection. We are quite interested in certain broad collateral questions, such as the impact of option trading on the capital formation and the capital channelling process of our economy, even though if the Commission's role is narrowly construed this may not be a matter for concern. However, it is my belief that if the Commission's charter is properly interpreted, it cannot isolate the protection of investors from concerns with capital markets and their functioning. We will be particularly concerned with the dangers posed by considerations of suitability. While an option has the advantage of affording an investor an opportunity to leverage limited amounts of money very significantly, it also has the characteristic that within a relatively short period of time he may lose his entire investment. While there is an element of gambling perhaps in any securities investment, options would seem to have a larger element of that than other types of investments. Thus we must be intensely concerned with the conduct

of broker-dealers in advising customers concerning the suitability of options -- both their writing and purchase. A high grade utility common stock might well be a suitable investment for a widow with limited resources, but in all probability a three, six or nine month option to purchase that same security might be most inappropriate and unsuitable inasmuch as it would involve a loss of her total investment if the market movement of the stock did not make it favorable to exercise the option. And besides, an option carries no yield.

The Commission hopes that out of its request for written submissions and its oral hearings it will develop a fund of information and understanding with regard to the place of options in the market place and the economy which will permit it to decide very basic questions: The extent to which its rules should facilitate dealing in options; the manner in which participants in the market for options should deal with the public and with each other; the desirability of confining the option market to a single exchange, or to the over-the-counter market, or permitting the spread of such trading into multiple market places. These are only a few of the problems which must be addressed. I am sure that many of those in this audience have information and viewpoints which we would be happy to receive.