

REPORT OF THE SPECIAL GOVERNANCE COMMITTEE
TO THE BOARD OF DIRECTORS
September, 1978

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The Special Committee on Governance was created by the Board of Directors to consider possible means of strengthening the Exchange's governing and management structure. The Board's objective was to assure that CBOE's executive direction and policy-setting process are the most effective attainable at this critical juncture in the Exchange's affairs.

While there is every reason to be proud of the Exchange's past performance, it is also clear that the future is going to impose much greater demands upon our institution. Our growth alone has greatly enlarged CBOE's institutional responsibilities and the accompanying need to broaden understanding of the purposes and uses of our market. The Exchange is also faced with the prospect of intensified competition, fundamental changes in the structure and mode of operation of securities markets generally, and heightened regulation of the options market. Plainly, CBOE needs leadership that is capable of formulating, advocating and implementing courses of action that will serve to strengthen the Exchange's competitive position and the workings of our market. Moreover, the Exchange must be capable of governing its affairs so as to maintain the confidence not only of all categories of our members but also of the entire financial community, the investing public and those in government concerned with the protection of investors and the integrity of markets.

Since no government or management is ever any better than the quality of its leaders, structural changes alone cannot assure accomplishment of these objectives. However, the Special Governance Committee believes that an optimum governing structure can make an important contribution to the Exchange's performance per se and can also contribute to the Exchange's ability to attract and retain superior top management.

In addressing the need for governmental changes, the Governance Committee started from the point of departure of examining real or perceived shortcomings in CBOE's present structure. These center upon the lack of definition and resultant confusion as to the respective roles of the Chairman and the President both from an executive standpoint and with respect to the Exchange's public representation. The present method of selecting the Chairman (by membership vote) and his term of office (one year) were also considered from the standpoint of balancing the need for representative government with the need for greater governmental continuity. The policy-making interface between elected members of the Board and the Exchange's full-time executive

officers was considered in the same context as well as from the standpoint of satisfying all concerned of the Exchange's continuing commitment to serving the investing public.

On the basis of its evaluation, the Governance Committee has agreed upon a number of changes which it believes will serve both to strengthen the Exchange internally and to augment public confidence in our market. These changes relate to the responsibilities and method of selection of the Exchange's principal officers as well as to the composition of the Board of Directors. The Committee's recommendations can best be summarized by describing its provisions for: (1) the office of Chairman; (2) the new member position of Chairman of the Executive Committee; (3) the office of President; and (4) the composition of the Board.

(1) The Chairman

The Governance Committee recommends that the Chairman should become the Exchange's full-time chief executive officer and principal public spokesman. Rather than having this position filled by a member elected annually by membership vote, the Committee believes the Chairman should be selected by the Board for a considerably longer term of office whose exact duration, as well as his compensation, should be established by the Board.

Under the Committee's proposed new structure, the Chairman would in large measure combine the present responsibilities of the Chairman with the chief executive responsibilities now vested in the President. (As an exception, the Chairman's present prerogatives as to appointments to Exchange committees would be shifted to the Chairman of the Executive Committee, as discussed below.) Such a strengthening of the Chairman's role would clearly establish that leadership of the CBOE has been vested, with some permanence, in a chief executive officer whom the rest of the world as well as the membership can hold accountable for the Exchange's performance.

(2) Chairman of the Executive Committee

While strong in its belief that the Exchange needs a full-time chief executive as chairman, the Governance Committee is equally convinced that a principal member officer will continue to be needed. Neither policy formulation nor its execution can be accomplished effectively over time unless the membership retains a sense of involvement and representation in the process. The leadership of a fellow member is vital to maintaining a community of interest between the Exchange's government and its governed, and his role must carry with it enough authority to command the attention of both.

The Governance Committee devoted considerable time to determining the title, responsibilities, mode of selection and eligibility criteria of the individual who would fill this key position. Its recommendations on each of these accounts are set forth below.

Title: The Committee believes the title Chairman of the Executive Committee is better suited to the position than the alternative of Vice Chairman. In so concluding, the Committee has concurrently recommended the elimination of the current position of Vice Chairman so that the Chairman of the Executive Committee would be clearly identified as the Exchange's principal elected member officer.

Responsibilities: Presiding at Executive Committee meetings would be only one of many responsibilities of the member filling this position. As stated above, he would also assume the existing prerogatives of the Chairman for making appointments, with the approval of the Board, to all Exchange committees, and he would be specifically charged with coordinating the activities of the various committees. In addition, the Chairman of the Executive Committee would act as Chairman in the event of the absence or a vacancy in the chairmanship.

Mode of Selection: Rather than being directly elected by the full membership, the Governance Committee believes the Chairman of the Executive Committee should be selected by the Board from among the Exchange's elected member directors. The Committee recommends this approach for several reasons:

- (1) Selection by the Board will tend to foster a complementary working relationship between the Chairman and the Chairman of the Executive Committee. Such compatibility is critical for the proposed new governing structure to function effectively over time.
- (2) Selection by the Board will help to avoid divisive contests for the principal member's office in which inflamed rhetoric and adverse publicity could prove damaging to the Exchange. There could, of course, continue to be contests for any or all of the member director seats on the Board, but these tend to attract less publicity and are not as suggestive of governmental instability.
- (3) Selection by the Board will tend to assure that the member assuming this position will have had previous experience on the Board, which the Committee believes will enhance his effectiveness.

Eligibility: The Committee believes it vital that the principal member officer maintain the confidence of the Exchange's seat holders that he is representative of their interests; it therefore recommends that he be selected from among those elected directors who own or control their own memberships.

(3) The President

The Governance Committee recommends that the President should act as the Exchange's chief operating officer. While his responsibilities would be primarily administrative, the Committee believes that the President should continue to serve as a member

of the Board and the Executive Committee and thus have a voice in the formulation of policies which he would be responsible for implementing.

(4) Composition of the Board

The CBOE's 21-man Board is presently comprised of an elected member Chairman and Vice Chairman, the President, 15 elected member directors and three appointed public directors. The Governance Committee's recommendations with respect to the Exchange's principal officers will have the effect of reducing the size of the Board to 20 in that the position of Vice Chairman will be eliminated and the new position of Chairman of the Executive Committee will be filled from among the 15 elected member directors.

In addressing the question of how to reconstitute the Board with an odd number of directors, the Governance Committee has come to the belief that a thoroughgoing review is needed of the overall size and composition of the Board. This review would encompass such questions as whether the Board is the proper size for optimum effectiveness, whether the different categories of member representation are defined as well as they might be and whether the proportions of member and public representation on the Board are optimal. Both in terms of time and scope, such a review is not consistent with the Board's mandate to the Committee to submit recommendations regarding the chairmanship and related changes to the September meeting of the Board so that any Constitutional amendments involved can be acted upon in time to be effective with respect to this fall's nominating and election process. Therefore, the Committee has made only one limited recommendation regarding Board composition at this time while requesting a further mandate from the Board to undertake the more thorough review that the Committee believes is needed. Any recommended changes resulting from this review would be submitted to the Board at a later date, and their implementation would plainly have to be deferred until a subsequent year.

The Committee's one further recommendation for adoption at this time is to accomplish the restoration of a 21-man Board by making provision for one additional public director. This change, bringing the total number of public directors to four, would be accomplished by having two such directors appointed each year for two year terms as compared with the present procedure whereby one public director is appointed each year for a three-year term. Consistent with the overall enlargement of the Chairman's role, responsibility for nominating public directors would be placed with the Chairman, subject to approval of the Board.

The Governance Committee believes that enlarged public representation can make a meaningful contribution to the Board's effectiveness along with evidencing the Exchange's commitment to serving the investing public. While the Exchange's three public directors have always served us well, the present

limitation on their number has not permitted representation from all of the spheres that can beneficially be included in the Exchange's policy-setting process. These include men of public affairs, the academic community, various categories of institutional investors, and the companies whose stocks are the subject of listed options trading.