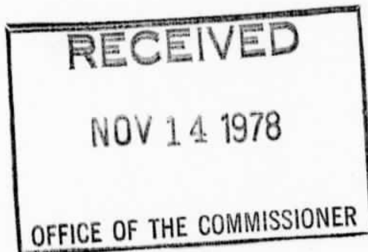
Options – Market Structure


SCHIFF HARDIN & WAITE

7200 Sears Tower, 233 South Wacker Drive, Chicago, Illinois 60606
Telephone (312) 876-1000 Twx 910-221-2463

WASHINGTON OFFICE:
1101 Connecticut Avenue, N.W., Washington, D.C. 20036
Telephone (202) 857-0600


November 10, 1978

Mr. George A. Fitzsimmons, Secretary
Securities and Exchange Commission
500 North Capitol Street, N.W.
Washington, D.C. 20549

Re: File No. S7-744

Dear Mr. Fitzsimmons:

As the Commission knows, this firm is principal outside counsel to the Chicago Board Options Exchange, Incorporated (CBOE) and we assisted CBOE in the preparation of its letter dated September 22, 1978, in File No. S7-744 (CBOE comment letter). This letter is written in the name of our firm because in part it reflects matters that are peculiarly within our professional experience. However, you may regard it as an additional statement in support of CBOE's position on the question of the New York Stock Exchange's (NYSE) creation of an options market.

This letter deals only with the competitive aspect of that question, as distinguished from other regulatory concerns discussed in the CBOE comment letter. In particular it is addressed to the NYSE's contentions in its letter dated September 22, 1978 (NYSE comment letter) to the effect that preventing the NYSE from creating a sixth competing options market would be contrary to the procompetitive policy of the 1934 Act, and that such dominance as the NYSE might achieve would be the result of its providing a superior market.

Even if it be assumed that the NYSE's dominance in stock trading could have been achieved entirely through competitive merit (ignoring its history of anticompetitive and monopoly-protecting practices), its achieving dominance in options trading clearly would not be dependent on competitive merit. Nor would it be dependent on the NYSE or any of its members engaging in deliberately anticompetitive practices, although there would certainly be opportunities

for such, which would be difficult to detect and to regulate. Rather, in view of the NYSE's unmatched power and resources, the limited universe of stocks suitable for options trading, and the inherent, vitally important, interrelationships of options and underlying stocks, the NYSE's present monopoly position in the trading of underlying stocks would almost inevitably extend to options trading, quite apart from competitive merit or anti-competitive practices as such. The NYSE's entry would probably also strengthen its monopoly position in the trading of listed stocks and could be the death knell of the policy favoring competition among markets.

In considering what is likely to happen in the future, we believe it is important to recall what has happened in the stock markets during the past forty years and in the options markets during the past six years, leading to the monopoly that exists today in the former and the competition that exists today in the latter.

### A. NYSE's monopoly position in stock trading and governmental efforts to dilute it.

Basic facts concerning the NYSE's monopoly position are contained in the CBOE comment letter, the American Stock Exchange's letter of September 29, 1978 (AMEX comment letter) and other materials in File S7-744. Following are some highlights of the history of the NYSE's activities in achieving and protecting its monopoly position and of governmental efforts to foster competition:

1. The 1934 Act had the effect of drastically curtailing the role of the regional exchanges as primary markets for stocks of smaller or regional companies (see Report of the Special Study of Securities Markets, part 2, pp. 917-18). When these exchanges turned to multiple trading of NYSE-listed stocks, the NYSE attempted to stifle the competitive threat by using its regulatory power over its members in such a way as to thwart market-making on regional exchanges. In 1941, in the Multiple Trading Case, the Commission emphatically asserted the public interest in competitive markets and rejected the NYSE's proposed rule.

2. In 1963, the Special Study explored the roles of the third market and the regional exchanges in the trading of NYSE-listed stocks (Report, part 2, pp. 910-16,

937-42). It discussed the NYSE's contention that both forms of competition did more harm than good by causing fragmentation, but concluded that, on balance, the benefits of competition outweighed the benefits of concentration (id., part 2, pp. 954-57).

3. The Special Study also explored the subjects of automation and institutional trading. As to automation, the Special Study found clear indications that the NYSE not only had not moved forward significantly but had actually stifled forward movement (id., part 2, pp. 190-201, 353-54). As to institutionalization, the Special Study showed that the NYSE's failure even to introduce any kind of volume discount into its fixed commission structure was driving stock trading into indefensibly artificial patterns (id., part 2, pp. 311-21).

4. After 1963, the NYSE continued to protect its monopoly. It was not a leader in innovation -- certainly not commensurately with its resources or position in the industry -- but was quick to imitate and exploit the innovations of others. It was usually a reluctant follower at best in efforts to create industry-wide facilities that might enhance intermarket competition, cooperating only when it became clear that the facilities would be created without its participation and/or that it could dominate them.

5. The 1975 Amendments strongly reaffirmed the governmental policy favoring intermarket competition and gave the Commission more explicit powers to carry out this policy. Yet the NYSE's monopoly position is as strong as ever, with the third market having a greatly diminished role compared with a decade ago and the few remaining regional exchanges fighting valiantly for survival (and their survival apparently depending, in some instances, on maintaining economically viable options markets). Nor has competition been introduced into market-making in stocks: the NYSE's specialists, with one limited exception, still have no competition on the NYSE floor.

B. The competitive situation in options trading and governmental efforts to enhance it.

Basic facts as to relative market shares for all options classes and for multiply-traded classes are set forth in the CBOE comment letter. But again, it is worth

recalling some highlights of history -- so utterly different from the history of stock trading -- leading to the current situation:

1. In 1973, CBOE created the first options exchange. It was a pilot in every sense, because it involved many major innovations and/or departures from familiar and tried trading mechanisms. The innovations proved so sound, and the pilot so astonishingly successful, that would-be competitors very promptly appeared. (The NYSE was not among them; it evidently preferred to wait until all research and development costs and risks had been borne by others, so that permanence and scale of the options market, commensurate with the NYSE's stature, would be assured before it started its own venture.)

2. CBOE's innovations included separating the broker and dealer functions of traditional specialists and turning the latter function into a highly competitive one within a single exchange floor. CBOE felt at the time that this structure -- a universal auction with competing market-makers on a single floor -- might serve as a prototype for the "central market system" toward which the Commission had already begun to bend its efforts (per its 1972 Policy Statement) even before Congress made it a specific policy objective in the 1975 Amendments. However, the Commission declined to accept this view and, instead, forcefully reaffirmed the policy of competition <u>among markets</u>: In view of the interest of others in creating competing options exchanges, the Commission permitted expansion of CBOE's pilot only on condition that CBOE would satisfactorily address itself to achievement of a common clearing system. As a result, the CBOE Clearing Corporation -- one of CBOE's basic innovations, whose novel functioning was crucial for creating fungible options and making a secondary market viable -- became The Options Clearing Corporation, owned equally by all options exchanges and controlled by none of them.

3. Although multiple trading in options has been limited in scope, intermarket competition remains strong. No options exchange dominates the market, in resources or market share, as the NYSE dominates the stock market. No options exchange dominates any essential industry-wide facility as does the NYSE, and none has more than a minor share of trading volume in the underlying stock market. (Indeed, CBOE and the AMEX do not have any market in the stocks underlying their options.) Innovation in methods

as well as products is a constant source of rivalry, and the competing exchanges are continuously challenged to develop new and more efficient operating and regulatory systems. Experience with multiple trading has demonstrated, however, that even in options trading the "primary market" concept (discussed in the CBOE comment letter at pp. 12, 31) is the major determinant of order flow, while at the same time the normal test of primacy is a majority of order flow. The result is that order flow tends to beget order flow in snowballing fashion, and a majority share can readily ratchet into an overwhelming share.

C. Why NYSE's creation of an options market would further entrench its monopoly in stock trading and almost inevitably extend it to options trading.

It is disingenuous for the NYSE to refer to itself as being just a "sixth competitor" and therefore adding to competition. The NYSE would be utterly different from any or all of the existing five competitors -- so utterly different that it is more realistic to think of some or all of the existing five competitors being taken out of, rather than a sixth being added to, the field of competition.

The NYSE's entry into the options market would not merely "burden" competition within the meaning of the 1934 Act; there are very strong reasons to believe that it would turn what is now a competitive market (and, when and as it becomes feasible to introduce appropriate national market system facilities, could become much more competitive) into one that would be as monopolistically dominated as the stock market. And this would be likely to happen whether the NYSE were to proceed by building or acquiring, whether or not it initially introduced side-by-side trading or combined market-making, and quite apart from any past or future use of specifically anticompetitive tactics.* It would be likely to come about for the fundamental, in-

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* We believe it can be shown that the NYSE's entry into options trading would violate the antitrust laws. But the Commission is not required to find a technical violation of the antitrust laws in order to disapprove the NYSE's entry. The test under the 1934 Act is much easier and simpler: "burden on competition." Any event or development that threatens drastic impairment of competition is obviously a "burden."

herent reasons stated in the CBOE and AMEX comment letters and summarized below, some of which (pars. 1-5) simply reflect the NYSE's overwhelming power and resources, tangible and intangible, and others of which (pars. 6-10) derive from the close interrelationships between stocks and stock markets on the one hand and options and options markets on the other hand.

In considering these reasons, it is worth noting at the outset that there is no simple cause-and-effect relationship among them, in the sense that the NYSE's predominant power results from factors A, B, C and D, etc., or that such power produces consequences M, N, O and P, etc. Rather, there is -- historically, currently and prospectively -- a complex interweaving of causes and effects. One could start with almost any of the points listed below and show that it synergistically contributes to, and is contributed to by, every other.

1. The NYSE presently enjoys "primary market" status par excellence. It has the overwhelmingly largest order flow in its listed stocks, including virtually all stocks underlying listed options; and since order flow begets order flow, competing stock markets are hard put to hold their own order flow, let alone cut into the NYSE's. As a result of the NYSE's primary market status in respect of the leading corporate stocks, it has achieved unmatched prestige and publicity. The "Big Board" stands out by itself in the eyes of the corporate community, the financial community and the investing community. NYSE quotations and transaction reports are far more generally available than those of any other market. The NYSE's primary market status also serves brokers and other fiduciaries defensively, because they feel safer from criticism or complaint if they routinely go to the well-publicized primary market, thus further reinforcing that status.*

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* Indeed, recent experiences with the Intermarket Trading System (ITS) -- in which regional exchanges find that orders flow to the NYSE even when a regional exchange is making the better market (see, <u>e.g.</u>, <u>Securities Week</u>, Oct. 23, 1978, p. 13, and Oct. 9, 1978, p. 2, and <u>Wall Street Letter</u>, Oct. 16, 1978, p. 6, and Oct. 2, 1978, p. 6) -- demonstrate the continuing gravitational pull of the name "NYSE" on stock order flow.

2. The NYSE has financial resources and revenues greatly exceeding those of any other exchange.* It can build automated systems, expand capacity, subsidize particular functions, outbid others in hiring and retaining experienced personnel, and in many other ways outstrip and overwhelm competitors having much more limited resources.

3. The NYSE membership dominates the brokerage community and basically constitutes the power structure of the financial community. Its leadership is physically concentrated in New York and its offices, facilities and systems are far better equipped to handle NYSE business than any other. The welfare and prosperity of the NYSE are much more important to the member community than any other exchange's. The self-regulatory system of the NYSE applies to its member firms virtually to the exclusion of that of any other exchange.

4. The NYSE's specialists have informational advantages and market-administering capability (especially at openings) that are unmatched elsewhere and that can be used for the benefit of the NYSE and to the detriment of competing markets. They also have unmatched financial resources, which can be used to subsidize competitive functions or can be concentrated at critical places and times so as to outmatch the resources that competitors can bring to bear. The importance to member firms of maintaining good relations with NYSE specialists, because of their enormous capability of facilitating the firms' handling of complex transactions, must also be counted as a unique resource of the NYSE.

5. The NYSE dominates major automated systems for channeling orders, disseminating quotations and market information and expediting the clearing of transactions and movement of securities. In some instances this may

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* In its comment letter, the NYSE attempted to minimize the impact of its financial resources by claiming (p. 15) that 90% of its 1977 total revenues were "absorbed" by "expenditures relating to the principal function of maintaining the primary marketplace for listed stocks." But even 10% of the NYSE's 1977 total revenues is significant compared to the total revenues of the options exchanges, all of which (except CBOE) must also spend part of their revenues to operate their equity markets.

be the result of innovation; in most, it simply reflects overwhelming size, resources and power and also contributes to continuing dominance.

6. The universe of stocks eligible for options trading is very much smaller than the universe of corporate stocks. The NYSE overwhelmingly dominates -- with an average market share of over 80% -- the trading of virtually every corporate stock that is presently an underlying stock or that is ever likely to be regarded as eligible and suitable.

7. Options are "derivative" or dependent securities in relation to stocks. Underlying stock price movements have much greater impact on options price movements than vice-versa; and "market information" as to the underlying stock market, and advantages derivable therefrom, are of far greater significance for profitable participation in the options market than vice-versa.

8. Option prices (premiums) are typically only a small fraction of underlying stock prices. For this and other reasons, the amount of dollars involved in options trading is a small fraction of the amount involved in underlying stock trading; and the gravitational pull of stock dollars on order flow will always be greater (other things being equal) than the gravitational pull of options dollars.

9. Market information advantages, in addition to bearing on regulatory concerns (see the CBOE comment letter, at pp. 22-24), may have important competitive significance. As the overwhelmingly predominant market for underlying stocks, the NYSE is by far the most important source of non-public market information. NYSE options floor members are much more likely to have access to such information than floor members of any other options exchange, and investors and their brokers will be more likely to share in that advantage, or at least will have the perception that they are more likely to share in it, if they send orders to the NYSE options market rather than to any other options market.

10. Investors, professional and non-professional, increasingly make use of combined orders. The pattern of order flow is more fixed in respect of underlying stocks than in respect of options -- if only because the options market came into being very recently -- and it is fixed overwhelmingly in the direction of the NYSE. It is virtu-

ally a foregone conclusion that combined orders would tend to gravitate to the NYSE rather than to any present options exchange -- especially the two major ones, CBOE and the AMEX, that do not trade their underlying securities at all.

D. Potential for anticompetitive tactics.

All of the above are inherent, inescapable features of the situation that would exist if one of six options exchanges were to have the overwhelming resources, tangible and intangible, of the NYSE and were the overwhelmingly dominant market in virtually every underlying stock for options classes traded anywhere. Even without assuming any affirmative resort to anticompetitive tactics, it is difficult to see what would keep the NYSE's monopoly position in stocks from extending sooner or later to options. But, as brought out in the CBOE and AMEX comment letters, there would, additionally, be many possibilities for anticompetitive activities on the part of the NYSE and its specialists that would tend to assure and reinforce the same result.

E. Significance of "separate" stock and options markets.

There may be a misconception in some quarters -- possibly even within the Commission -- that the NYSE's creation of an options market would not be a threat to competition in options trading if that market were "separate" from the NYSE's stock market and side-by-side trading or combined market-making were not involved. There are at least two basic answers.

First, as forcefully developed at pp. 25-35 of the AMEX comment letter (CBOE having stated the same conclusion in fn. ** at p. 37 of its comment letter), there are strong reasons to believe that the NYSE would not proceed to create an options market except with the expectation of ultimately integrating it with its stock market. Not only do the NYSE's own filings give strong indication of this, but it is doubtful that there would be financial community support for a new options market that would not provide a significant new dimension such as side-by-side trading or combined market-making.

But even assuming a permanent separation of trading floors, in the sense of a significant physical distance

between them, it would be unrealistic to assume corporate separateness, or non-sharing of resources, or non-mutuality of interests, or even an absence of intermarket communications. The NYSE obviously intends any options market created by it to be an integral part of its corporate complex. All of the great resources that now reflect and contribute to its dominance in stock trading would become resources of its options market. The factors enumerated at pp. 6-9 above that now motivate member firms to channel their order flow in underlying stocks overwhelmingly to the NYSE would tend to carry over to an affiliated options market as well. Even the advantages derived from the powerful position and resources of NYSE stock specialists would tend to carry over to an affiliated options market, because of the strong mutuality of interests and affiliations that could exist between firms or individuals operating in the two markets,* the many possibilities that would be present for reciprocal favors, and the pervasive importance to member firms of maintaining the goodwill of the stock specialists.

Nor would it make any significant difference whether the NYSE used a competing market-maker system or a specialist system in its options market. Extending the present specialist system to the options market might hasten the day, but all the factors that in all likelihood would result in extending the NYSE's stock dominance into the options market would be basically operative regardless of the trading system that NYSE might adopt for its options market. That is to say, since these factors (as seen at pp. 6-9 above) relate partly to NYSE's overwhelming power and resources and partly to the close interrelationships between options and underlying stocks and between their respective markets, and since these factors (as pointed out in the preceding paragraph) would be effective even assuming permanent separation of the NYSE's trading floors, the use of a specialist system on the NYSE options floor would merely be cumulative in relation to the other forces that, in any event, would be likely to impair drastically, or even destroy, effective competition in options trading.

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* Of course, the same individual could not be active on two floors at once, but the same firm or affiliated firms could place different individuals on both floors at once.

F. Conclusion.

Although we believe the NYSE's creation of an options market would raise serious questions under the antitrust laws, it is not necessary to show an antitrust violation in order to establish that there would be an unnecessary and inappropriate "burden on competition" within the meaning of the 1934 Act.

Intermarket competition is an important feature of the options market today, and it is the policy of the 1934 Act to protect and nurture such competition. The NYSE's entry into that market -- in whatever form, whether by acquisition or otherwise, and whether or not there would be physical separation between stock trading and options trading -- would almost inevitably mean that the NYSE's present dominance of the stock market would sooner or later encompass the options market as well.

The result would not be to "add a sixth competitor," because in all likelihood the role of the present competitors would be reduced to approximately that of the NYSE's competitors in stock trading. Indeed, there would very likely be a two-way burden on competition, because the NYSE's dominance of the options market would tend to undermine the ability of the regional exchanges to compete with the NYSE in stocks and increase the NYSE's dominance of the stock market.

Sincerely,

Milton H. Cohen

cc: Chairman Harold M. Williams
Commissioner John R. Evans
Commissioner Philip A. Loomis, Jr.
Commissioner Irving M. Pollack
Commissioner Roberta S. Karmel
Mr. Andrew M. Klein
Mr. Sheldon Rappaport
Mr. Richard L. Teberg
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