OFFICE OF THE PRESIDENT
PHILADELPHIA STOCK EXCHANGE

February 21, 1979

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

Re File No. S7-744

Dear Mr. Fitzsimmons:

On September 25, 1978, the Philadelphia Stock Exchange, Inc. ("PHLX") submitted a response to the Commission's request for comment on market structure issues concerning standardized options trading, contained in Release No. 34-14854. At or about that time comments were submitted by a number of other organizations including Chicago Board Options Exchange ("CBOE") and American Stock Exchange ("AMEX"). On January 26, 1979, the Department of Justice submitted comments on the issues presented by Release No. 34-14854 ("D.J. COMMENTS"). PHLX undertakes here to reply to some major aspects of the D.J. COMMENTS.

1. The D.J. COMMENTS address themselves almost exclusively to the positions of NYSE, AMEX and CBOE. The plight of the regional exchanges is dealt with first by the confident assertion that "in our view all existing options exchanges can continue to compete vigorously" (page 11). This is "supported" by footnote 11 in which it is noted that regional exchanges still survive, and small regret is registered if that survival is jeopardized by the removal of "artificial barriers to competition."

There follows a suggested solution by way of a national market system including options. We agree that once such a system is in place and fully effective, regional exchanges will be able to compete on reasonably equal terms with NYSE and others. But Congress and the Commission are already committed to a national market system which will <u>ultimately</u> solve the problems, or most of the problems, dealt with in the Release. The issue here is how the regionals are to survive during the interim period so that they will be able to add their competitive values to the national market system when it arrives. The Department of Justice offers nothing on this point.

2. The D.J. COMMENTS similarly wish away the crux of other problems presented by the Release. The stark fact that multiple trading in options is a practical barrier to best execution for the benefit of the investor, is dealt with by calling for a decrease in or an elimination of search costs -- without the slightest hint as to how to accomplish this (page 13). And the conflict of interest problem in dual market-making is handled by means of general assertions that opportunities for manipulation are minimized by the presence of competing

market-makers and can in any event be controlled through (unspecified) regulation and surveillance (page 21).

3. In our prior submission we made reference to the fundamental monopoly position of NYSE and the fact that NYSE now seeks to use its monopoly power in equity securities to achieve an additional monopoly in the trading of options (page 10 et seq.).

The D.J. COMMENTS do not deal with the point made by PHLX. They do not indicate the slightest awareness of the NYSE monopoly position. Instead they treat the inevitable transfer of all options trading to NYSE as a mere reflection of consumer preference (page 14). We suggest that the normal consumer "preference" for trading equity securities on NYSE at present, and for the trading of options there when the field is taken over by NYSE, is the rough equivalent of a consumer "preference" for the use of AT&T facilities in making telephone calls.

4. The D.J. COMMENTS reflect very little awareness of the actual position of the ultimate consumer -- the public investor. Remarkably, the problem of discrepancy in pricing is treated as a matter of risk of liability of the broker, without any apparent concern for the Commission's obligation to seek fair treatment for the investors (page 13). Indeed the D.J. COMMENTS suggest (page 27) that the Commission's concerns can be satisfied by the reflection that the brokers would presumably be channeling their orders to NYSE "for legitimate business reasons," i.e. because it may be easier and cheaper to send all orders to NYSE (see page 13).

5. The fundamental fallacy pervading the D.J. COMMENTS is the attempt to deal with a highly regulated, uniquely structured, industry on the basis of a simplistic approach appropriate to a business controlled by pure market forces.

In a standard kind of antitrust analysis, governmental intervention is limited to the removal of artificial barriers in the form of restraints of trade, giving rise to a free market in which it is conclusively presumed that the optimum results are achieved by the unhindered interplay of competitive forces. This model simply will not fit the securities business, the very structure of which is the product of a complex of statutes enacted by Congress and regulations adopted by the Commission to implement Congressional intent.

The point is perhaps most strikingly and relevantly exemplified by the very question of whether exchange options trading should be permitted at all, and if so, which underlying securities supply an appropriate base for options trading. If the matter should be left to the interplay of competitive forces in a free market, then each exchange, and indeed each market-maker on an exchange, should be free to trade options in any security. Thus, the marketplace itself would determine which options were economically appropriate as a product competitive to equity securities.

It is true that Congress has mandated consideration of competitive factors in securities exchange regulation. But it is worth noting that the mandate is to preserve fair competition among exchange markets. Exchange Acts, Section 11A (a)(1)(c)(II). The word "fair" does not appear in the fundamental antitrust provisions of the Sherman Act, 15 U.S.C. Section 1 et seq., because the basic antitrust approach assumes that the product of free competition is always fair or, more realistically, desirable whether it is fair or not. Thus, if we were dealing only with the Sherman Act (and if we could ignore the monopoly position of NYSE), we could understand the tendency of the Department of Justice to dismiss lightly the problem of survival of regional exchanges, and to interpret the economic power of NYSE as merely the automatic result of consumer preferences or the legitimate business decisions of brokers. But his approach is not congruent with the Exchange Act, or the factual matrix in which exchanges function.

We respectfully suggest that the Commission's policies should be geared to what will most likely happen as a result of their adoption. A priori assumptions about the nature and effect of competitive forces in general are no substitute for careful analysis of the effect of the NYSE proposals on the existing options market structure. We believe that such analysis shows that the NYSE application would lead to an NYSE monopoly, and that no amount of theorizing can square this result with a pro competitive objective.

Respectfully submitted,

PHILADELPHIA STOCK EXCHANGE, INC.

By ___________________________________
Elkins Wetherill, President