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REGULATION AND EXPANSION OF OPTIONS MARKETS

ADDRESS BY

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I appreciate the opportunity to participate in this conference on what I believe is one of the most important developing areas of our securities markets. The brochure announcing the conference billed my part on the program as providing the Commission's view on such unresolved issues as restricted options, higher position limits, dual trading, and new products. I am sure most, if not all, of you know that neither I nor any other Commissioner can legitimately speak for the agency on issues that have not been fully considered by all of us and, naturally, the topics of this conference represent such issues. Nevertheless, I can give you my own tentative views and provide some insight as to what might be expected from the Commission.

In my opinion, we are now at a critical stage in the development of standardized options markets. Trading volume has grown progressively since April of 1973, following Commission approval for the Chicago Board Options Exchange to begin a standardized options pilot program. Unfortunately, along with the growth came abuses which the Commission concluded were sufficiently serious to require careful scrutiny of the adequacy of Commission and self-regulatory organization rules, and the ability of the existing regulatory systems to detect and prevent fraudulent, deceptive and manipulative activities in options and underlying markets. After some real soul searching, the Commission concluded in July of 1977 that it was necessary to have a moratorium in

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The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

options growth. In the following two and one-half years the industry and the Commission sought to provide a regulatory framework for options within which further expansion and experimentation could occur consistent with investor protection and fair and honest markets.

New options rules, together with procedural improvements that have been made in self-regulatory organization ("SRO") options surveillance and compliance programs, are vital components of such a framework. The most important component, however, is a commitment to investor protection and fair and honest markets by the people responsible for making the system work.

The rules and regulatory programs adopted in response to the recommendations of the Options Study affect all segments of the options industry--member firms, the SROs, and the Commission. Because the member firm has first-line supervisory responsibility for its options activities, the new rules governing member firm internal supervisory controls are perhaps the most important aspect of this enhanced self-regulatory system. I believe that most sales practice abuses can be prevented through effective supervisory controls which have the demonstrated support of top management.

The SROs are charged statutorily with the responsibility of enforcing compliance by members and their associated persons with the rules and regulations applicable to options trading. SROs should be able to discharge this responsibility quite effectively if the new procedural

enhancements that have been made in their examination and compliance programs, particularly with regard to account selection, account review, and the review of member firm supervisory controls, are vigorously applied. In addition, the effective utilization of improved trading surveillance systems should enable SROs to detect most currently known trading abuses involving options, thereby facilitating the fairness and integrity of options markets.

The final element of an effective regulatory system is appropriate discipline of persons who violate applicable rules and regulations. Thus, member firms and self-regulatory organizations must not be hesitant to initiate disciplinary action where violations are indicated.

In order to fulfill the Commission's role in overseeing the operation of the new options regulatory scheme, we have directed substantial staff resources to the creation of an office in the Division of Market Regulation, whose function is to conduct regular on-site examinations of SRO surveillance and compliance programs. This inspections office currently is focusing on the new options rules and procedures. In addition, of course, the Commission always stands ready to take direct enforcement action when necessary to ensure the protection of investors and the operation of fair and honest securities markets.

While the elements of the regulatory system that have been adopted in response to the Commission's Options Study should instill greater investor confidence in the

integrity of options markets, other regulatory measures recommended by the Options Study deserve further consideration. For example, the establishment of a central information registry was recommended for customer complaints received by the SROs, their member firms and the Commission. Such a registry would provide expeditious, economical access to complaint data for bona-fide regulatory purposes and could enhance significantly the ability of the SROs to detect selling practice abuses.

Two factors have delayed implementation of this recommendation. First, the SROs were concerned that they might be subject to potential federal and common law liability in connection with the establishment of the registry, and have requested that the Commission promulgate a rule authorizing its establishment. Our Division of Market Regulation is currently preparing a recommendation to the Commission for that purpose.

In addition, neither the National Association of Securities Dealers nor the New York Stock Exchange, the two SROs which have expressed an interest in acting as custodian of the registry, has been willing to let the other undertake this responsibility, despite constant prodding from our staff to resolve the impasse. This isn't too surprising considering our experience in many other areas where agreements among or between competing self-regulators has been unattainable without a mandate from the Commission. But, it is particularly unfortunate in view of the general consensus that the registry would be an effective tool.

The NYSE has recently communicated to our Division of Market Regulation an alternative proposal, providing that it would maintain a complaint registry for all NYSE members, while the NASD would maintain a similar registry for non-NYSE members. In this manner, it would appear that the objective of having all complaint information regarding each member firm or registered representative accessible in a single registry could be achieved. I understand, however, that the NASD has not agreed with this approach. In my view, if the NASD and the NYSE are unable to resolve the custodial issue expeditiously, the Commission should not be reluctant to do so in connection with its rulemaking proceeding.

Another area of unresolved regulatory concern relates to the inclusion of information regarding brokerage commissions on customer account statements. The Options Study found that the lack of a comprehensive statement of account to the customer, and the inability of many options customers to understand their account statements enabled registered representatives to mislead them about the profitability of their options transactions. The Study concluded that in order for an options customer to be able to oversee his own account effectively, the account statement should disclose, among other things, all costs incurred during the period covered by the statement including commissions attributable to each transaction and total commissions for the period. I find it particularly troublesome that, despite the fact that several firms in the industry group sampled by the Options

Study had commission information detailed on internal copies of account statement forms, very few of those firms included this useful information on the account statement sent to the customer. Indeed, it would seem that all firms would have to maintain this information for purposes of registered representative compensation.

At the time the Commission terminated the options moratorium, the Division of Market Regulation indicated that it would recommend that the Commission propose and solicit comment on a rule requiring the inclusion of commission information on customer account statements. I believe the potential benefits to public options customers from the inclusion of such information warrant a rule proposal, and that such a proposal deserves very careful consideration by the Commission and the industry.

The Commission's efforts in developing a comprehensive regulatory scheme for options were for the purpose of providing an environment in which further expansion of options markets could occur and in which we could find it in the public interest to authorize experimentation with new products and regulatory initiatives. I believe we have now established a regulatory framework within which such activities may be considered.

Substantial expansion has already occurred in the options market since the termination of the moratorium. Following agreement among the options exchanges on an acceptable allocation procedure, the options exchanges

collectively have selected sixty additional underlying securities for options trading and have begun to trade most of these new options. In addition, the process of adding puts classes on underlying securities on which calls currently are traded is nearly completed. To my knowledge, this is proceeding without any apparent operational or regulatory problems, and I commend the industry for the responsible manner in which these new classes have been introduced.

The Commission will soon address several regulatory initiatives by the options exchanges, including the elimination of the restricted options rules and the modification of position limits and strike price intervals. I believe that responsible experimentation with such longstanding options rules can now be permitted, and, indeed, encouraged, in an effort to remove or reduce unnecessary regulatory restrictions and to allow the free interplay of competitive market forces, consistent with investor protection and fair and honest markets.

In this regard, the options exchanges and the NASD have all filed proposals to eliminate the restricted options rules, which initially were adopted because of concern that as options become deep-out-of-the-money, they may be sold improperly to public customers who do not understand the high probability that the options will expire worthless.

As the options markets have expanded, however, new uses for restricted options have been developed that had not previously been considered, some of which involve



relatively conservative trading strategies. In addition, as the Options Study noted, the restricted options rules result in pricing inefficiencies and a loss of market liquidity. For example, when an option becomes restricted, the holder of such an option who wishes to close out his position is confronted with a limited market since a large number of potential buyers are barred from the marketplace.

The likelihood that such options may be improperly sold to public customers should now be minimal, in view of the new options suitability rules and improvements in brokerage firm internal supervisory controls. In addition, some options exchanges have agreed, if the Commission approves the elimination of the rules, to give special scrutiny in the course of their member firm examination programs, to the review of selling practices with respect to deep-out-of-the-money options to ensure that they are not being improperly sold. The Commission expects to receive similar undertakings from the other options exchanges and the NASD shortly. Under these circumstances, restricted options rules may be an unnecessary, artificial trading restriction, which should be eliminated.

The Commission has also received proposals from the options exchanges to increase position limits on the same side of the market to 2,000 contracts from the current level of 1,000 contracts. The present position limit was adopted primarily to minimize manipulative potential and prevent the accumulation of large options positions which,

if exercised against uncovered writers, would require them to buy the underlying stock and, thus, affect its price. Such position limits, however, also prevent large investors, primarily institutions, from covering positions of more than 100,000 shares of stock and, therefore, do not provide sufficient risk limiting capabilities for large portfolios. Another concern regarding the current level of position limits is the possible adverse impact on market liquidity.

While a number of alternatives to liberalize position limits were mentioned in the Options Study, I believe the SROs have elected a responsible approach as an initial experimental step. In addition to the general proposal to raise position limits to 2,000 contracts across the board, the CBOE has indicated in its filing a desire to conduct experiments, such as the removal of position limits entirely on particular options for a set period of time, in order to determine whether further expansions of position limits may be appropriate. While I am not familiar with the specific details of the CBOE's proposal and, thus, am unable to suggest a final conclusion as to its propriety at this time, such experiments may be the only way to obtain information regarding the appropriateness of further liberalization of position limits. If these kinds of experiments are permitted, they must be very carefully monitored and responsibly limited so as to ensure that the concerns that initially prompted the adoption of position limits are minimized.

Other current issues in the options area include multiple trading and the CBOE's proposal to trade options on Government National Mortgage Association ("GNMA") pass-through securities. As many of you know, the Commission has deferred further action on the expansion of multiple trading in order to afford the SROs an opportunity to consider whether, and to what extent, the development of market integration facilities could minimize concerns regarding market fragmentation and maximize competitive opportunities in options markets. While I understand that the work of the task force established to address this issue is proceeding, apparently the Commission's September 26 deadline for submission of a final report will not be met. Participants have indicated, however, their intent to submit reports to the Commission at that time detailing progress to date and any preliminary conclusions reached. Assuming these reports indicate acceptable progress, the Commission should be amenable to extending the deadline for receipt of a final report.

Although I concurred in the Commission's determination to defer temporarily further action on the multiple trading issue, I continue to believe that multiple trading is an essential element of an efficient and competitive options market system. This is not to say that there are not legitimate concerns that must be addressed, and tough decisions that must be made when the Commission again considers the expansion of multiple trading. The Commission must balance

the benefits of increased competition against possible adverse consequences, such as the deterioration of competition in options markets which might result from that action over the long term.

In spite of our limited experience with multiple trading thus far, a number of positive effects on options markets are apparent. It was noted, for example, in the Options Study that multiple trading may improve the quality of the markets for multiply traded options, at least in the short term. In addition, the existence of alternate marketplaces has, to some extent, operated to discipline the quotations of market makers on the primary market and has contributed to the depth and liquidity of the market for particular options classes. Multiple trading also has resulted in increased competition among options exchanges in the types of services offered to the brokerage and investor communities, including reduced brokerage charges, enhanced floor operations and the development of automated systems that have reduced the cost of execution. Moreover, without multiple trading, the Commission finds itself in the undesirable position of assuming an oversight role in the allocation of securities to particular markets.

On the other hand, to the extent that multiple trading results in a significant dispersion of order flow among competing options exchanges, it raises concerns regarding market fragmentation and may create difficulties for brokers attempting to send their customer orders to the

best available market. Prices in a fragmented market may not reflect a complete assessment of all buying and selling interests. Moreover, because the mix of buy and sell orders in a particular market may differ significantly from the mix in other markets, multiple trading may result in pricing disparities among markets trading the same options class, particularly at the opening.

More significant, however, in the current environment is the concern that multiple trading may impede fair competition among market centers and among market makers. This concern results primarily from the practice of brokerage firms using their order routing systems to automatically transmit small customer orders to a designated market center. A principal factor in the broker's determination of where to send such orders is the volume of orders executed on each exchange. As a consequence, designation decisions of a few large firms have caused virtually all retail order flow to be routed to a single exchange. Thus, with existing facilities and practices multiple trading may result in meaningful competition among market centers only until one exchange is designated as the primary market for a particular options class.

These are very difficult issues requiring careful consideration. It is my view, however, that the securities industry and the Commission must be willing to confront and resolve them much more expeditiously than we have those involved in the implementation of a national market system for equity securities.

I would like to turn now to the CBOE's GNMA options proposal, which I believe provides the Commission and the securities industry with a unique opportunity. The proposed GNMA options contract would represent a significant departure from the equity options contracts with which the Commission and the securities industry are familiar, requiring the Commission and the self-regulators to venture into a new and technically quite different area. Approximately 70 comment letters received thus far by the Commission from the mortgage banking industry have been overwhelmingly supportive of the proposal. Commentators have stated that the proposed GNMA options contract may be, in the words of one commentator, a "tool of potentially great significance to mortgage finance and new residential construction." It is argued that, particularly in light of recent regulatory difficulties in the over-the-counter GNMA standby market, exchange-trading of standardized GNMA options is essential to the continued ability of participants in the mortgage industry to make advance loan commitments. The President of GNMA also has strongly endorsed the establishment of a regulated GNMA options market, stating that such a market has "the potential for serving a sound economic purpose in the marketing of mortgage loans, for doing so in an efficient environment, while at the same time avoiding the trading abuses that have occurred in the unregulated market for standby contracts."

Just last Friday the Commission received a very carefully considered and well thought out comment letter from the Deputy Secretary of the Treasury, Robert Carswell. Noting that the initiation of exchange-traded options on GNMA's is an important development in the evolution of financial cash derivatives, Mr. Carswell concluded that there are important benefits to be gained from such a contract, providing there is proper regulation and control of the market. He expressed the Treasury Department's preference for regulated exchange trading for cash derivatives over unregulated over-the-counter trading because of the efficiencies and safeguards introduced by exchange trading, such as increased market efficiency through lower transactions and surveillance costs and increased liquidity, as well as safeguards such as guaranteed contracts, margin requirements, capital requirements and customer suitability requirements.

The Treasury letter also cites certain regulatory concerns which I share and which I hope can be resolved. Among the concerns noted in the letter are the facilitation of opportunities for speculative abuses by market participants, the need for strict customer suitability standards, and the importance of an effort by the CBOE to ensure that customers are aware of the risks and obligations involved in writing GNMA options.

The Division of Market Regulation currently is devoting substantial staff resources to analyzing the CBOE's

proposal to ensure that, if the Commission ultimately determines to approve the trading of GNMA options on the CBOE, such trading will occur in an optimum regulatory environment.

My present view of the CBOE proposal is that an exchange-traded GNMA option has the potential to be an economically useful and commercially viable investment vehicle for certain investors. My tentative inclination is to permit the CBOE to test the market for GNMA options so that we may see whether experience bears this out.

One of the comment letters on the GNMA proposal stated that the Commodity Futures Trading Commission ("CFTC") has jurisdiction, perhaps exclusive, but at least concurrent, over the CBOE's proposed GNMA options contract. Without prejudging the issue, I would only observe that there is language in the Commodity Exchange Act which specifically limits the authority of the CFTC in this area. Section 2(a) of the Act states that: "Nothing in [the Commodity Exchange Act] shall be deemed to govern or in any way be applicable to transactions in . . . government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade." Since the CBOE's proposal would provide for the trading of an options contract on a national securities exchange registered with the Commission, I question whether there is a serious jurisdictional issue. In any event, such assertions should not dissuade us from considering the proposal and reaching an early decision.



The resolution of the issues I have discussed and others shaping the future of options markets will test the metal of our system of self-regulation. I am confident, however, that through the joint efforts of the options industry and the Commission we will meet these challenges, and thus enhance the quality and competitiveness of our options markets as well as develop to their fullest potential the legitimate uses of options as investment vehicles.