

Securities and Exchange Commission Historical Society
Interview with William Brodsky
Conducted on January 5, 2010 by Kenneth Durr

KD: This is an interview with William Brodsky, January 5, 2010 in Chicago, Illinois by Kenneth Durr. I saw somewhere a mention that you'd ben at the New York Stock Exchange when you were sixteen years old.

WB: My first job on Wall Street was on the floor of the New York Stock Exchange in 1961 when I was seventeen years old. It was an eye-opening experience. It was something I wanted to do. I worked for a firm that is long gone now called De Coppet & Doremus. There were two firms on the New York Stock Exchange floor in those days that had a special license to handle odd lots, and odd lot being under a hundred shares. If a Merrill Lynch customer wanted to buy 150 shares of stock, the Merrill Lynch broker could buy a hundred shares of stock, but the fifty shares had to be done through one of the two odd lot firms. One was called De Coppet & Doremus, the other was called Carlisle & Jacquelin.

Basically, if it were 150 shares, they'd give the order to one of the two firms, and they would buy the hundred shares at whatever the market price was. Then they would have a markup on the odd lot. An eighth of a point extra up to \$25 a share, and a quarter of a point over. One of the interesting things as you look back is how expensive things were to do back then, because it was all manual.

KD: Was this an internship?

WB: It was a summer job that I was able to obtain because my father was on Wall Street in the business, and he knew I wanted to work on Wall Street. This was my first taste of the business. The way he did it was he never wanted me to work for his firm, so he traded me with a fellow from another firm, and he took his son. I was a trade. We made \$1 an hour. The problem is that the Stock Exchange in those days was open from ten until three, so I made \$6 a day, but I was a teenager, and I ate more in food than I made.

KD: Then you went to Syracuse. It sounds like you were determined to work in the finance industry. But you got a law degree. What was your thinking behind that?

WB: Yes. At that time, my orientation was to have a law degree for the value of what a law degree provided, but not necessarily to practice law in a traditional way. In fact, when I graduated from law school, I went to a brokerage firm and was a lawyer at the brokerage firm. I was in what was then called the compliance department, which was a whole new concept back then. Compliance as we know it today is a big part of the industry, but it was not in those days. I had the benefit of being in a small firm and learning a lot about the business from many facets, because the smaller the firm, the more you could interact with different problems and issues.

KD: How did you get to the AMEX? Tell me a little bit about that.

WB: What happened was that in 1972 and 1973 Wall Street was getting ready for a major change. That was what was called May Day. May Day was the change from fixed to unfixed commissions. The first date was May 1, 1973, when commissions on the trading floor would be unfixed, and then May 1, 1974, when commissions for the public would be unfixed. Commissions for the first time in the history of the stock exchange in New York would be negotiable. The firm I was with, what you might call an institutional boutique, Model Roland & Co., recognized that the new world would be a very difficult place for them to adjust to because they didn't have the capital that some of their big competitors had. Their big competitors were Goldman Sachs, Salomon Brothers and Drexel Burnham.

Those firms were their competitors. The partners, many of whom were approaching retirement age, wanted to find a way to get their capital out, and they were planning to basically sell out. I looked at it, and I said, "This is a time of great turmoil in the business. Why don't I go do something else and wait this period out?" I started looking for jobs, particularly at either the New York Stock Exchange or the American Stock Exchange. I was very fortunate to get a very attractive job offer at the American Stock Exchange, which, at the time, was very highly thought of as a place for professionals to work.

Their staff had a very, very good reputation. A lot of the reason was that some of the best and the brightest people who had worked at the SEC in the '60s had gone to the American Stock Exchange, people such as Ralph Saul, Bob Birnbaum and Norman Poser, all of whom worked on the Special Study of the Securities Markets. The chairman and CEO at the time was a wonderful guy named Paul Kolton, who was someone who had come to the American Stock Exchange from the New York Stock Exchange. All those things interested me, and the job was a perfect match for my background because it was the government relations and policy planning area.

Although I went as a lawyer, I wasn't doing what I would call grunt legal work. I was doing policy issues. One of my first assignments was to work with people in Washington on what later became known as the Securities Acts Amendments of 1975, which really laid the groundwork for the national market system, some of which is only now being fully realized in terms of open access and real competition.

The whole goal was to break the monopoly of the New York Stock Exchange, which took more than thirty years. It actually took more than thirty years. I went there in the winter of 1974 – to the American Stock Exchange – in the policy planning area. But a funny thing happened. I had done work at Model Roland to get the firm qualified to become a member of this newfangled exchange in Chicago called the Chicago Board Options Exchange, and I had written an article about the CBOE that had been published in a prestigious securities law journal. Not two months after I joined the American Stock Exchange, they said, “You know, you know something about these new options. We want to get in the business. You can help us do that.” Even though I stayed in this policy planning area for a while, I was really part of the new product development team that got the AMEX to be the second exchange in the world to get into options. Actually, options, to a large extent, saved the AMEX decades later.

KD: What was that task about? What were your priorities, and what were the steps you ran through in terms of getting AMEX up into the world of options?

WB: There were two challenges. The two biggest challenges were that, one, the old-timers of the AMEX thought of themselves as a stock exchange and looked down on options as being

something unseemly. That was a big hurdle. What I did is, I ultimately became head of the option division at thirty-two years of age, and I assembled a team of people who worked for me, and we were what I would call an exchange within the exchange, because the stock people wanted nothing to do with us, including the traders, by the way, on the floor.

The second thing was that one of the biggest impediments was the SEC. The SEC was a very difficult impediment in terms of getting the CBOE launched. The CBOE was, in fact, the first exchange created and approved by the SEC since its creation in 1934! I think it took five years. When the AMEX came in, the SEC was equally challenging in terms of all the hurdles that we had to traverse. One of the most interesting things that the SEC did is that the CBOE, at the time, was in the business for a year and a half, and it wanted to expand the amount of options it offered, and they wanted to get into put trading.

The AMEX, on the other hand, wanted to get into the business. The SEC said, “Look, CBOE, if you want to expand, and AMEX, if you want to get into the business, what we want is basically one clearing house.” This was a very novel concept because, at that point in time, each exchange in the country had its own clearing house. The SEC did something that probably, in a traditional legal sense, was completely illegal, but they used their persuasive powers because they had the power to approve a new exchange, or the rules to create an option division within an exchange, and they basically forced the AMEX and the CBOE to make a deal.

In exchange for the ability to expand, the CBOE let AMEX become a 50 percent owner of this new clearing entity, which had been the CBOE Clearing Corp., and it became the Options Clearing Corp., which today is the largest derivative clearing house in the world. It has an exemplary record, and it was built, not only on the foundation of what CBOE started, but it was because of the AMEX trying to get into the business that it became more mutualized and served all exchanges.

KD: Was the Pacific Exchange coming in at that point too?

WB: In the sequence of things, the Philadelphia Exchange came next. They were third. Then the Pacific Exchange was fourth. Then later, the Midwest Stock Exchange was fifth.

Unfortunately for them, they came in late, and they got out early. The New York Stock Exchange, which had looked completely down on options, came in even later, and later sold out to the CBOE in 1997 because Grasso, in those days, didn't want anything to do with options. It turns out now that if you look at the business plan of the New York Stock Exchange and NASDAQ, options are vital and a very, very important part of not only the growth of these multiline exchanges, but a very big part of their profitability.

KD: You were talking about the SEC and some of the challenges they put up. You would have been trying to get the AMEX options business really moving when the SEC puts in the freeze on options. One would think that would be a difficult thing to have happen to your business. Tell me a little bit about how you deal with that period.

WB: That was 1978, and I think what drove it was that the SEC realized that the option business was growing faster than they could really cope with it, and so they decided to impose what was known as the options moratorium. It gave the SEC a breather where they could get their arms more around the business, and it was a big blow to those of us in the business because there was a large demand from customers. In fact, one of my fondest recollections of running the option business at AMEX in the '70s was that, as a stock exchange, we felt if we listed an option on a company, we would write them a letter and say, "Congratulations, we have great news, we're going to list options on your stock."

As head of the option division, I'd sign the letters, and I would get the most irate phone calls from the CEOs of these public companies, like, "How dare you?" and, "You don't have the right to do that," and "We don't want options on our stock." By the time I left the AMEX four or five years later, companies were begging us to list options on their stocks because what was developing was a two-tier market. Companies that had options on their stocks realized greater liquidity and more investor interest because options enhanced the ability of investors to use those stocks as investment vehicles. It was an interesting thing to see this sea change from belligerence to, "How do we get options on our stock listed?"

KD: What was behind the belligerence?

WB: Belligerence was lack of knowledge.

KD: Was there a sense that you're gambling on their company?

WB: I think there was the gambling aspect, but I think it was also the term at the time was the tail's wagging the dog, those kind of concepts, because there wasn't a lot of empirical data. People didn't have years of experience. In those days, the only options that traded on exchanges were on U.S. exchanges, and there just wasn't a lot of analytical information on these things.

KD: This sea change, you saw that by the time you decided to leave the AMEX. Things were chugging along pretty well there.

WB: I was very happy at the AMEX, and looked at having a pretty good long career there. But a headhunter from Chicago came my way and said to me that there was an exchange in Chicago that was interested in hiring me to be chief operating officer. In addition, they had just secured a license from Standard & Poor's to trade futures on the S&P 500 index. Here I was, thirty-eight years old, and I looked at my future at the AMEX, which although it was good, there were several people ahead of me, including Arthur Levitt who was chairman and CEO at the time, and I said, "These people are not going anywhere. This is an opportunity to leapfrog my career." The biggest challenge for me was to move my family to Chicago because we were dyed-in-the-wool New Yorkers. The idea of picking everything you ever knew and learned and moving to Chicago was a big deal.

What made it easier was that, for my seven or eight years at the AMEX in the options industry, I was on the board of the Options Clearing Corp., as the AMEX's representative. I would come to Chicago every other month for board meetings. I knew that Chicago was not only a nice city, but what was even more important was that the culture of Chicago and its intense interest in building derivatives on options and futures, on financial instruments, was quite remarkable. I

had gotten to know the people in Chicago and from a professional point of view I knew that the action, the innovation and the growth in futures and options was Chicago.

When I finally accepted the position to come to the CME, which was in August of 1982, people in New York looked at me like I was crazy. “What are you doing? You’re leaving the center of finance, the capital of the financial world, to move to the wild west.” I understood something they didn’t, which was that the real innovation was happening in Chicago. I went to the CME because of stock index futures and the opportunity to grow professionally of running the exchange, because the chief operating officer at the time really ran the exchange.

KD: Was the S&P 500 futures the first really big stock index?

WB: It was the first big stock index future. Actually, the first one to start trading was in Kansas City in February of ’82, but the CME was so intent on making it successful that it had a great critical mass of traders, and the S&P 500 was the bigger name. It just bullied its way in terms of sheer determination to build the liquidity and make it work.

KD: Did you have a sense that it was going to do that?

WB: When they approached me, they had just started trading, and it was still very embryonic. But I also was impressed by the people at the Exchange, and by the sheer size of the Exchange. When I was at the AMEX, there were about 650 members of the AMEX total. The New York Stock Exchange had, at the time, 1,366 members total. When I joined the CME, they had just created a new index and option market division, which if you combined with the already existing membership ranks that they had more than 2,000 members.

The sheer depth of trading talent was staggering. It was a much more open community than the New York financial community. We used to kid around that if you wanted to become a specialist in the New York Stock Exchange, you had to have a father who was a specialist, whereas in Chicago, people were given much more opportunity to break into the system without any pedigree, without any connections. In that sense, it was uplifting and a breath of fresh air to

see that there was an openness to allowing people who didn't have connections to come in. I think that that was also a hallmark of the Chicago community, much more than the New York community. The New York community was much more closed.

KD: Meritocracy.

WB: Yes.

KD: Leo Melamed would be a good example of that, I guess.

WB: He and Jack Sandner actually hired me, and I was very impressed with them. Truthfully, I am still friends with them today. They hired me to come in, and it was under them that I became president of the Exchange in 1985. I became president and CEO June 1st of 1985, and come this June, I will have been CEO of two of Chicago's largest exchanges for twenty-five years.

KD: Did you take your chief challenge at this point at being to really leverage these stock index futures?

WB: The biggest challenge was, literally, education of the financial community. Most people looked at what we had created at the Merc in stock futures as a bunch of wild-eyed pork belly traders trying to interfere with the smooth functioning of the financial markets. It was either distrust or disgust. "Who are these people in Chicago who dare to trade financial instruments?" The New York Stock Exchange, on one hand, as they did with options, looked down on the futures, but it didn't take long for the people there, the leadership there to understand that this was something significant. John Phelan, who was chairman of the New York Stock Exchange at the time, recognized the importance of this and created the New York Futures Exchange.

They started trading futures on the New York Stock Exchange Composite Index as a competitive initiative, but the reality is that the CME not only had a head start and it had the better index, but it also had the determination and the troops, because the New York Stock Exchange was always

wedded to the way they always did things. They believed they needed specialists. It was based on a much more rigid approach to a business structure.

There was a feeling for a while, that the sheer fact that it was New York would overtake it. In fact, they tried to trade Treasury bond futures. They even hired the president of the CBOE, Bill Smith, to become president of the New York futures exchange. That was a real New York-Chicago brawl of sorts, but it didn't in any way take away from the underlying economic value of using a stock index future as both a hedging vehicle and as a substitute for buying the stocks themselves.

In fact, one of the things I found the most fascinating in the early days is I'd been a stockholder of the S&P 500 index fund through Vanguard for many years and as a securities lawyer, I would read the prospectus just to understand how they are explaining the product. Buried in the prospectus early on was the fact that Vanguard was using the S&P 500 future as a way of making sure that they had cash available to the mutual fund holders because, since the fund had to always be invested in stock, they also had to make sure that there was cash available for redemptions. They would use a certain amount of the money in the fund in stock index futures and keep some cash in T bills available for redemption and, therefore, always be fully invested. To me, that was a validation that this is not just for speculation. There are highly legitimate ways of using this vehicle.

KD: There were a lot of people saying that up until the market break in '87 when things changed a little bit.

WB: There was one major event that preceded that, and that was the phenomenon that was known as triple witching. As soon as stock index futures started to really grow, it became obvious that there was an effect on expiration Fridays on the stock market when the futures and options would expire at the same time, and it was called triple witching. It was the expiration of the individual equity options originally created at the CBOE, but now traded all over. Options on IBM, GE, Microsoft, etcetera. The expiration of stock index options at the CBOE, which CBOE created, which now became the S&P 100 and later the S&P 500 option.

Third was the expiration of the futures on the S&P 500. When all those would expire quarterly on the same day at the end of the day, it would create disruption in the stock market because it all happened – “settled” – at the close. The specialist system, quite frankly, was not equipped to handle the enormous volumes, both buying and selling volumes that occurred at the close. At that time, the Merc leadership and the New York Stock Exchange leadership sat down together, and we made a deal that was something that I understood and convinced my Merc colleagues was a legitimate compromise. That was to move the expiration of the stock index futures from the close of the day on Friday – which is the worst time because no one wants to get stuck with the position over a weekend – to the opening of the morning on Friday. That preceded the crash of '87. That was a very important thing because it was a private sector solution to both a real and a perceived problem. Triple witching at that time was a big deal. It was a day where people would quake – “What’s going to happen at the close? Is the market going to go up 200, down 200?” We actually solved the problem, and it’s good that we did.

Now that was – I can’t tell you precisely, but '86, '87 – before the crash of October 19, 1987. Of course, the crash of 1987 was based on a lot of macroeconomic forces, and a lot’s been written on it. I could go into it in length, but I think in general, the market was overvalued, interest rates were too high, and I can tell you I knew on Sunday night, based on what was going on in Asia, and even before the opening, based on what was going on in Europe, that we were going to have a terrible, terrible day. I was in the office very early that morning, and it was a terrible, terrible day.

Part of the problem was that there were people who were using portfolio insurance. As with what we’ve been through recently in terms of a market disruption, people always assume that the liquidity you have when things are calm is going to be there when things are not calm. It was a disastrous day because everyone wanted to sell at the same time, and there weren’t enough buyers, literally. Of course, when we had, after the crash’s aftermath, a big study by Nick Brady, and a very fine staff run by Bob Glauber up at Harvard, the bottom line of the report was that, lo and behold, Wall Street or the government, through this study, said that these markets, both the

futures markets on stock indexes, the options markets and the stock markets, were really one market.

To those of us in Chicago, that was not a surprise. We knew these markets were interconnected. They weren't separate markets. To the New Yorkers who kind of rejected the fact that anything legitimate could ever go on outside of ten blocks away from Wall Street, in fact, the Chicago markets were literally linked to the New York markets, even if the New Yorkers didn't want to acknowledge it.

KD: You're trading on the S&P. You're watching the New York Stock Exchange.

WB: Not only that. The futures were a leading indicator of what the stock market was going to do, whether it was an hour in advance or a minute in advance, because there was no other similar barometer like it in the past. The Dow or the S&P cash index reflects the process of what has already occurred, where the futures were, basically, a little bit of a predictor of what's going to occur.

KD: Nevertheless, and moving out of your time at the Merc, the volume of futures contracts went down tremendously after that. People stopped being involved. You've got the SEC and David Ruder saying it's all the futures' fault. How did you dig your way out of that?

WB: I testified in Congress a lot during that period, and David Ruder and I locked horns a lot. One of the frustrations I've always had is that the SEC has been run by too many lawyers. In this case, I'm proud that I'm a lawyer because I feel I can criticize lawyers more easily, but I think it's very important to recognize that markets are economic mechanisms. And unfortunately, when David Ruder said it's all the fault of the futures markets, in my view, he didn't have the facts, and we didn't yet have the Brady report, and we didn't see how these markets were linked.

There also has been and continues to be a certain frustration that the SEC doesn't regulate the stock index futures markets. For example, margin levels were very different in the stock index

futures markets than they were in the comparable options markets. That concept continues today, though much less so, because the U.S. regulatory system grew up in two different ways. The futures markets were regulated by the CFTC and under the Agriculture Committee, and the equity markets under the SEC through what are now the Financial Services and Banking Committees. There's always been a tension. To a certain extent, the SEC was never as vigorous as it should've been in terms of getting jurisdiction in the first place. The famous Shad-Johnson Accord of 1982 kind of solidified that there was going to be this bifurcated structure going forward.

I would say that there were some major issues, clearly, when David Ruder was chairman and certainly when Richard Breeden was chairman of the SEC. But I will tell you, having been at the CME at the time, we fought like crazy to preserve the jurisdiction of the CFTC because we feared that the SEC would not look at these markets in an economic way, but rather in a regulatory way without the real heavy economic orientation that we had on the futures side. That issue still exists today. The SEC is still too dominated by lawyers. I have no hesitation to say it. The CFTC is, on the other hand, dominated by economists. There's probably something in the middle that would probably be a preferable balance, but you're not going to see that happen too easily.

KD: You ended up going from the CFTC-regulated Merc into the CBOE with the SEC to deal with. How did that happen? Where did that transition come from?

WB: I had been at the CME almost fifteen years, and I was getting offers to come back to New York as well as an offer to come to the CBOE, and I felt that it was time to make a change. I felt that at the stage of my life, I had spent, as I said, almost fifteen years at the CME, and I thought it was time to make a change. I was very glad that the CBOE offer came about. It was kind of a special situation since my most memorable experience of being in the securities business was being head of options at the AMEX. To come to the Exchange that was my arch enemy, at the AMEX was very special and CBOE continues to be the leader of the option industry. Therefore, the offer was a very special and unique opportunity for me.

KD: What were the strengths that the CBOE had back in the late 1990s?

WB: It certainly had the innovative record. CBOE has always been and continues to be the innovator in the option business. At a time where other exchanges, the American Stock Exchange was a very substantial exchange when it competed with the CBOE, and was always number two to the CBOE for many, many years, but the CBOE always innovated, in terms of products, and distinguished itself through investor education and industry leadership. It created the first index options, it pioneered the concept of flex options, which is where you can modify the terms of the option, it created a volatility index in the '90s, and then in the recent decade, we created volatility as a tradable product, both in futures and options. Clearly, CBOE always had the leadership, both in terms of products and in terms of industry leadership in Washington on regulatory issues. I was very aware of that.

Of course, CBOE also had a unique situation. When I came to CBOE, 27 of the 30 Dow stocks were solely listed on the CBOE. Very soon after I joined the CBOE that became an issue between the CBOE and the SEC and the Justice Department – should there be multiple listing of options? When I saw the handwriting on the wall, the thing that I did was to lead the initiative to multiply list options on other exchanges, figuring we ought to do it before the government forces us to do it. That was a very challenging time – I believe that was in 1999. We also knew ISE was coming on board, and they were going to be the first totally electronic exchange, and I felt that we'd be better placed to compete with a really electronic exchange if we were multiply listed, listing options with other exchanges because we would've been better placed competitively.

KD: Does this get to the consent decree?

WB: What happened was, the Justice Department came to us and said, "Why aren't you multiply listing these options?" My answer to them was, "Look, if there are three gas stations on an intersection corner, why should the government come in and tell me that I have to open a gas station on the fourth corner?" It didn't make sense, particularly since we had all the good

products. It wasn't all the same gasoline. We had IBM and GE and Coca-Cola and twenty-seven of the Dow stocks.

KD: Were the other options exchanges tending to sell other things in order to make their niche?

WB: There is a lot of history here. There were incidents back in the '70s where CBOE and AMEX both listed the same option, and there were difficult problems with pricing where customers' orders at say, Merrill Lynch would be sent to one exchange, and from Dean Witter sent to another exchange, and the prices on the same option at the same moment in time were completely out of whack. It wasn't fair to the customer. The SEC was struggling with how to make it more fair to customers, and there wasn't a linkage in the option markets at the time. At a certain point in time, the SEC said, "We're not going to have multiple listing anymore. We're going to have a lottery." The SEC mandated the lottery.

When I arrived at the CBOE, we were operating under this lottery, and then the Justice Department said, "The fact that you have a lottery – we don't care." Basically, the Justice Department ignored the SEC. The SEC was not a player here. Then the SEC reversed itself and basically threatened us. I was the one that initiated the multiple listing just to say to the Justice Department, "Look, we'll do it. Don't tell us what to do; we'll do it." Nevertheless, they wanted, as Joel Klein said to me at the time – because I went in to see him (he was the head of the antitrust division) – and he said, "We want a piece of flesh. Even if you said you're going to multiply list, we don't care. You're going to have to sign a consent decree."

It was very unfair how it was handled because the SEC, in my view, completely abrogated their responsibility here, and basically, let the Justice Department run with it. The SEC never said, "Hey, you know what? We told these exchanges that we're going to have a lottery. We told them implicitly that we have given them protection from the antitrust laws." Therefore, the Justice Department should never have threatened us the way they did. But life is the way it is. I made the deal, we had a consent decree, there were no fines, but we had to sign a consent decree, so we did.

KD: Did you travel around and talk to the heads of the other exchange and say, “This is what we need to do, do you agree?”

WB: No, I couldn’t do it. We weren’t allowed to do it. We just made a decision one day that we were going to list options on Dell Computer on the Philadelphia Exchange, and Microsoft on the Pacific, and it created a multiple listing war. We knew that we had more to lose than to gain, which is why we hadn’t done it in the first place. If you have twenty-seven of thirty Dow stocks and there are five other good options out there, we go after their five, they go after our twenty-seven. But we made a business decision to do it as a way of taking the initiative away from the Justice Department because if we hadn’t done it, it could’ve been a lot worse.

KD: That was a pretty big step then, changing the whole terms.

WB: Right. Again, part of it was tied to the fact that we knew ISE was coming on, that we were going to have compete anyway, and why not just get it over with.

KD: A little more about ISE. All the other options exchanges have got the open outcry, they’ve got the floor. ISE is going to be totally electronic. What did you expect to happen when that came online?

WB: We didn’t really know, but what we decided was that we can’t allow, as the leading exchange, someone to come up with a new mousetrap and not have a mousetrap of our own. I went to the membership, I think it was in 1999, and literally got authority permission by getting a vote to spend \$50 million – this is more than ten years ago – to build our own electronic trading system. But I had to do it on the condition that I couldn’t turn it on unless I went back to the membership for a vote because the floor, in those days, was so powerful. In fact, that’s what we did.

When ISE came on, it started slowly, so people said, “Ah, it doesn’t mean anything.” But with every passing month, they started gaining market share, and gaining and gaining. We then

modified our plan to have an electronic trading system that we called the hybrid, which was the combination of the new system and the old floor, which then made it necessary to rewrite the system, and we lost two years doing all that. In the meantime, ISE was taking market share from us day by day, week by week, month by month. By the time we were starting to turn on the system, we were now playing catch up because they had gained so much market share.

In fact, as we're speaking now at the beginning of 2010, we are stronger now than we've been vis-à-vis the ISE in more than five years. We have clawed our way back. Once customers got used to trading electronically in the same way that people now make their plane reservations electronically, they don't go back to the old system.

We had lost a lot of business. On the other hand, we're the first exchange to create a true hybrid trading system which actually works. So, although 95 percent of our trades are done electronically, we still do about 25 percent of our volume in open outcry, which is a real testament to what we created when we built our system called the hybrid.

KD: Would that have happened had the floor traders not have been so powerful?

WB: Well, there was a big fight. I actually have buttons that say, "Brodsky Must Go." They were out to get me because they knew if we succeeded in putting electronics in, that many of them would be out of business. My resolve to compete electronically went back to my days at the AMEX, and my great respect for what CBOE meant as an institution. I was not going to allow CBOE as an institution to slide into an abyss during my tenure because of some narrow-minded traders who were only worried about their short-term income. Moreover, the floor traders were not equity owners of the exchange, but they leased their seats from former floor traders who identified with the current floor traders. They did not embrace electronics due to their prior orientation. This is one of the main reasons why we needed to demutualize so that the ownership interests and the institutional interests could be aligned.

KD: At this point, what's the attraction for the open outcry system?

WB: The answer is because customers want the business done that way. There are still trades that get done through human interaction and through negotiations, whether they're complex trades, very large trades, or they're trades when markets are very volatile where they want human judgment. We don't mandate how a customer's orders are executed. It's totally up to the customers. If you went down to our floor today, you would see major firms, such as Goldman Sachs and other firms that use their own or independent brokers, who rely on individual human beings to facilitate their orders only because they're willing to pay extra to have them done that way. That was because the New York Stock Exchange hoped to do so, but they were behind the eight ball because they hadn't prepared for electronic trading.

When John Thain took over, one of the first things he did is to buy Archipelago because it gave NYSE the electronic platform, but he didn't have much time to integrate and create a real hybrid, which they suffer from today.

KD: Other things that you were faced with at this point. You did a long-term strategic plan in the late '90s, early 2000s when you came in. Was demutualization a component of that from the very beginning?

WB: No, demutualization came somewhat later because, first of all, there were no exchanges in the United States demutualized before 2000. The first exchange in the world was Australia, and the very strong culture in Chicago of the power of floor members made demutualization kind of an anathema to them. Their view was, "I don't want the institution to make money. I'll make the money." So we ran them really as non-profit cooperatives. By the way, the New York Stock Exchange was no different. In fact over the years, many of the people who owned the seats had retired and were now leasing out their seats, and the seats became very profitable to the owners in terms of monthly rents. On both CBOE and the New York Stock Exchange, the rents were shockingly high, and the returns were better than you could get anywhere else. People who owned the seats said, "Why would I want this any differently?"

What really happened is that the Merc found itself in a very politically difficult situation where the whole governance structure was crumbling, and that was a factor regarding why I left the

Merc and came to the CBOE. It took several years after I left for that reality to come home to roost. The Merc didn't wake up one day and say, "Oh, we think we'll demutualize because our stock will be worth a lot." Managing the membership and the conflicts of interest within the membership really forced the Merc to demutualize. The demutualization inevitably led to the IPO. But then, the IPO was staggeringly successful because, at the time of the IPO, people had no idea what exchanges were worth.

The Merc stock went from thirty-five, literally, up to seven hundred, straight up, because people on the investment side, at the big brokerage firms and institutional investors started understanding the operating leverage of exchanges. Instead of giving the money back to the seat owners, if you could handle it within this corporate entity and make this a valuable business, all of a sudden, the stock was worth a lot. From the time the Merc went public and the stock shot up, it became almost inevitable that other exchanges would want to demutualize.

Of course, the CBOE had its own unique problem of this exercise-right issue with the Board of Trade, which has, until this year, made it impossible for us to demutualize. We are now here talking about our demutualization because we finally, after over four years, have freed ourselves of the litigation that's going to allow us to do the same.

KD: The idea, though, is that when all these exchanges are realizing this intrinsic value that had never been realized before, if CBOE doesn't do it, you were going to lose out. Was that the idea?

WD: Well, you lose out what I could call strategic optionality. People would come to us and say, "Hey, let's merge. Hey, let's do a deal together. Why don't we take over you, you take over us," or any of many strategic things that companies can do, we couldn't do it. If you have seat holders, to try to get them to vote to do something of a strategic nature is almost impossible. You had to create a corporate form where you could do things more like a public company as opposed to what was really a country club structure.

KD: I've looked at this on the New York Stock Exchange and, of course, Dick Grasso's story is really tied up in working with the people on the floor and this big political power. How did you deal with that, and when did you hit the point where you could realize the things you wanted to realize for the CBOE above these self-interested people on the floor?

WB: There's no special point in time. What happened is, particularly with the advent of ISE, we were facing competition like we never had before, and ISE was run much more like a company, a normal company, and not like an exchange, because they never had seat owners who were individuals. They had firms such as Morgan Stanley, Bear Stearns, Interactive Brokers, Citadel – they were real businesses. When they would sit in a board room, they could make decisions as businesses, and we couldn't. I went to our board and I said, "We can't go on like this. We're going to have to run this place, even though we're not demutualized, as if we were." We have a great board, and people understood it at a macro level. We are now in our fourth year of running ourselves as a for-profit company, even though we literally are still technically a membership organization.

KD: Which is a really interesting concept. How do you do that? Do you set up profit centers?

WB: No. What we did is, instead of reducing our fees to minimize it, we wanted to show the world that we could be profitable in the same way that a demutualized exchange could be. We now have a very strong track record, which helps us in where we're going to go from here.

KD: Another landmark, opening the stock exchange. One would think you're going out of your core competency here – your thing is options, and all of the sudden, you've got a stock exchange. Tell me a little bit of the thinking behind that.

WB: Before we did that, we actually started a futures exchange. A futures exchange was significant in its own way also because we had this very special product which was called VIX. We wanted to trade it and we had two choices. We could have teamed up with another exchange, like the CME – which we could've done in a minute – or we could do it ourselves. We decided that we had enough competence because we built the electronic system for our

option market. When we built it, we built it so it could handle what we called multiple platforms. One was to trade futures, one was to trade stocks, and one was to trade options.

Once we had the system in place, adding an exchange was easy. Our futures exchange actually drives a tremendous amount of business to our option market, because the VIX future basically settles into the S&P 500 options. Even though the futures volume on our futures exchange isn't so great, it adds lots of volume to our option market.

The Stock Exchange was really another aspect – again, having the electronic platform that runs the other markets, we could add a stock exchange very easily, and of course, it's all under the SEC, so we didn't have any problem getting approval there. The whole idea is to find ways for both our traders and our customers to do combination orders in options and stocks. Why send it to the New York Stock Exchange? Why send it to the Chicago Stock Exchange? Try to keep it within the same tent.

KD: My whole focus here is about SROs and the nature of self-regulation, and you've talked a lot about membership and the pre-demutualized organization. How is the self-regulation of the CBOE going to change?

WB: I don't see any major change occasioned by our demutualization. I haven't seen that at other exchanges either. Many exchanges have shed their self-regulatory function, giving it to FINRA, in particular. One of the things that CBOE has been very highly praised for is that, because it was the first options exchange, it was always the leader in understanding option markets and self-regulation. In fact, we right now do all the insider trading investigations on behalf of all the other options exchanges through an affiliate organization we call ORSA, which is the Options Regulatory Surveillance Authority.

I don't see any substantive change in the near future. There's clearly a trend toward more consolidation of regulation, and we do cooperate with FINRA. In fact, all of our sales practice investigations, which we used to do ourselves, we now have shifted to FINRA. I don't see any

real changes coming up. We take it very seriously. We're always gotten very high marks in the SEC in that regard.

KD: Is there anything that we haven't covered that you'd like to bring out at this point?

WB: We've covered a lot. One of the nice things about talking to you on January 5, 2010 is that in the last three or four days, we've had articles in the newspaper about options that five years ago I wouldn't have believed would have been front page news in *The Wall Street Journal*. One of them was yesterday, literally, entitled, "Options Trading Grew Up in 2009." It's the second year in a row that more options have traded in the United States than futures. People look at futures as an industry, whereas options is a sub-industry of the securities industry. Yet, for the second year in the row, we have traded more options than futures. One of the reasons is that options have a very broad audience.

We at CBOE, and I think this must be said, have made an enormous contribution to the growth of the option business, not only in product innovation, and not only in regulatory activities in Washington, but in investor education. People say to me from all over the world – because I'm now serving for the first time as chairman for the World Federation of Exchanges, the first time anyone from a derivative market has ever held that position – "Why do options work so well in the United States, and not so well in London? Not so well in Frankfurt? No so well in Japan? Not so well in Singapore?"

The reason is that CBOE, from the very beginning, educated stock investors on how to use options to enhance their stock portfolio, whether it's to protect them from the downside or increase income, and not to teach people how to speculate, which we do if we are asked, but how to take people who want to own stocks for the long-term and enhance that experience. I think these are dividends that have paid off, and of course, all the other exchanges have benefited from it. CBOE has had the Options Institute for decades now where we've always wondered, why should we put all this money into it, we don't get a full return? But we still think it's worth it.

KD: Terrific. Thanks so much.

WB: Pleasure.