The Chicago Board
Options
Exchange

February 14, 1979

Mr. Michael Maloney
Assistant Director
Division of Market Regulation
Securities & Exchange Commission
500 North Capitol Street, N. W.
Washington, D. C. 20549

Dear Mr. Maloney:

Pursuant to your request I have set forth below a discussion of the problem we foresee could occur during the continuation of the closing experiment if stock underlying an option traded on the Exchange is halted on the principal exchange during the day prior to 2:45 p.m. (CST) and trading is permitted to resume subsequent to 2:45 p.m. (CST) on that principal exchange. This discussion supports the Exchange's belief that in such a circumstance the Exchange must be in a position to conduct a rotation in order to insure that the public as well as all other market participants are extended a fair and orderly means of effecting transactions in the affected options class before trading ceases for that day. The following briefly reviews the scope of the problems which the Exchange believes could confront it, the unsatisfactory means now available to address them and the Exchange's recommended solution.

I. <u>Description of the problem</u>

It has been the practice of the CBOE to declare a halt in the trading of options on an underlying security if trading in that security has been halted on its principal market. Upon the resumption of trading in the underlying security, the CBOE has reopened trading in the options of that security by conducting a re-opening rotation. There have been those few occasions when the halted underlying secruity has reopened at the very close of a trading session for the dissemination of a closing price for the security.[1]

Prior to October 23, 1978, the reopening of a security underlying an option traded on CBOE at the closing bell on the principal exchange for that security posed no special procedural problem for options trading on the CBOE. One trading rotation was conducted based on the final print, and this rotation functioned both as the reopening rotation and the regular daily

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1 Since January, 1978, only one security underlying a CBOE option class has opened on the close. On January 26, 1979, trading in shares of Bally Manufacturing Co. halted at 2:33 p.m. CST on the NYSE. Trading resumed at 3:0 p.m., with shares trading up $1-3/4 from the last price preceding the halt and up $3-1/8 for the trading session.

closing rotation which had no predetermined time period for its completion. However, since the October 23rd initiation of the experiment eliminating the daily closing rotation and fixing the cessation of trading at 3:10 p.m. (CST) on all exchanges trading listed options, the Exchange has interpreted the experiment as precluding any trading past 3:10 p.m. (CST). Therefore no rotations of any kind have been held which extended beyond 3:10 p.m. (CST), regardless of how compelling the circumstances.

II. Available Courses of Action

When a security underlying an option re-opens on the closing bell, the CBOE is confronted by three choices which arise as a result of the limitations of the experiment: it may choose not to reopen trading in options of that security for that session; it may allow trading to resume without a rotation for the final minutes of the trading day; or it may conduct a re-opening rotation which must cease at 3:10 p.m. regardless of whether it has been completed. Each of these choices is considered unsatisfactory for the reasons stated below.

A. Remaining Halted

The public and the CBOE membership have been made to understand that options trading continues until 3:10 p.m. (CST). If the underlying security reopens at 3:00, a customer who may have had an order in the marketplace for some time may reasonably expect his order to be acted upon.[2] Given the number of orders which may have been accumulated during the halt and the rule which regularly allows options trading until 3:10 p.m., failure to reopen trading runs counter to the expectation of the options customer that he will be accorded a final opportunity to establish, adjust, or liquidate a position, much as the equity customer has been accorded such an opportunity through the final print of the underlying security.

B. Opening Without Rotation

The circumstances normally attendant to trading halts militate against reopening options trading without the benefit of a rotation.

Under normal trading conditions, the continuous auction market works to reflect all factors in the marketplace. This is usually accomplished through small incremental adjustments, with a rough equilibrium between supply and demand constantly established and readjusted.

During a halt in trading these normal processes of readjustment are suspended, and pressure on the pricing mechanism is built up in two ways: (1) a great number of customer orders are routed to the trading floor, creating a supply or demand which is not gradually reflected, but which will eventually require rapid accommodation; and (2) dealers themselves

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[2] For example, on January 26, 1979, Bally Manufacturing halted on the NYSE at 2:33 p.m. CST, and reopened on the close. A customer who had entered a market order at 2:40 p.m. CST would have expected a report on that order.

have no way of estimating the supply or demand to be accommodated. This situation may lead to inverted markets, with bidders willing to pay above the lowest available offer, or wide markets, with dealers cautious in the face of unknown market factors. Intensified pressures generated by a backlog of orders, coupled with the increase in crowd size which normally accompanies significant price movements in a security, can create a chaotic resumption of trading. These same general factors which have required the halt in the underlying security on the principal market to enable the specialist to organize and reflect supply and demand before a price is established for the security are present upon the reopening of the options market.

Because of these factors, the CBOE has routinely conducted a reopening rotation for options on a halted underlying security upon resumption of trading in that security. However, if the security opens a short time before 3:00 p.m. or at 3:00 p.m., it is not possible to guarantee the re-opening rotation will be completed by 3:10 p.m. Since the completion of a rotation cannot be guaranteed, the conditions of the current experiment militate against the commencement of such a rotation.[3] The experiment as presently constituted then, because it allows for no circumstances in which transactions may occur after 3:10 p.m., mandates that the options market reopen and accommodate disruptive factors in multiple option series without benefit of any organizing procedure. This enforced surrender of a tried and tested technique for bringing order to a chaotic market appears incompatible with the statutory objective that a fair and orderly market be maintained.

C. Conducting a Reopening Rotation by 3:10 p.m.

If reopening trading without a rotation cannot be regarded to be in the best interest of a fair and orderly market, the requirement that such a rotation, once begun, be completed before 3:10 p.m. also handicaps the market's functioning.

Because of the volatility of the market conditions after a halt, and because orders continue to flow to the trading floor after 3:00 p.m., there is virtually no way to predict the volume of orders or the imbalances created by these orders which might require accommodation in a final reopening rotation. To begin such a rotation under an obligation to complete it by 3:10 p.m. commits the trading crowd to a haste which, depending upon the number of orders to be processed, may border on recklessness. Such a deadline vitiates the orderliness of the rotation and may be inconsistent with a broker's fiduciary responsibility for his orders.

On the other hand, to cut-off the rotation without allowing each series to trade is unfair on its face. A customer who places an opening or closing order for a far-term option series is arbitrarily denied his opportunity to participate in the market based on the expiration month of the option. Moreover, that same customer who has acquired a stock position and has entered a market order in a far-term option to hedge this position may justifiably object to the failure to complete his order or to give him the opportunity to revise it. Further, at precisely the time it is

3 The difficulties inherent in an incomplete rotation are discussed below.

most required, dealers will be inhibited in their ability to make markets since their opportunity to protect their positions through spreads in farther term series will be reduced or eliminated.

III. Request for Modification

Based on the trading conditions described above, the CBOE respectfully requests that the Commission adopt a no-action position which would provide the CBOE with the ability to commence and complete a trading rotation should a halted option security open after 2:45 p.m. (CST), whether or not such a rotation is completed before 3:10 p.m. This modification is consistent with CBOE Rule 6.6(b), which allows Floor Officials to declare a market "fast" and to direct that one or more trading rotations be employed in unusual market conditions in the interest of maintaining a fair and orderly market. While the CBOE believes such a provision may not be used at all during the extension of the experiment, the circumstances of a resumption of trading in the affected options class following a trading halt in an underlying security requires this flexibility. Please direct any questions regarding the above discussion to the undersigned.

Sincerely yours,

Scott L. Lager

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