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Morgan Stanley

August 6, 2003

By Overnight Delivery

Annette L. Nazareth, Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

4-469

Re: *ISE Petition fo Rule-Makin Regarding Index Options*

Dear **Annette:**

On November 1, 2002, the International Securities Exchange, Inc. submitted to the Commission a Request for Rulemaking *to* Amend Rule 19c-5 Regarding Certain Options Exchange Licensing Arrangements (the "19c-5 Petition"), requesting that the Commission adopt proposed changes to Rule 19c-5 (the "Rule Change") under the Securities Exchange Act of 1934, as mended The Rule Change would prohibit an options exchange from being a party to any exclusive or preferential licensing arrangements with respect to index option products and options overlying other instruments, including options on securities whose value is based on an index. For the reasons set forth herein, Morgan Stanley & Co. Incorporated generally supports the ISE's efforts and urges the Commission to take prompt action to eliminate such exclusive licensing arrangements

Morgan Stanley believes strongly in the value of eliminating barriers to the multiple listing and trading of standardized index option contracts on the various U.S. national securities exchanges that trade standardized options. Multiple listing and trading of options provides significant benefits to investors and to the marketplace, including reduced fees, narrower spreads and increased liquidity, attracting additional sources of capital and a greater number of liquidity providers to the listed options markets

Background

In 1989, the Commission adopted Rule 19c-5, eliminating formal barriers to multiple listing of stock options.[1] Rule 19c-5 was proposed pursuant to Sections 6(b)(8) and

[1] *Multiple Trading of Standardized Options*, Securities Exchange Act Release No. 26870, 54 FR 23963 (June 5, 1989) (the "Adopting Release").

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11A(a)(1)(C)(i) and (ii) of the Exchange Act, which prohibit exchanges from imposing unnecessary or inappropriate burdens on competition and direct the Commission to promote efficient execution of transactions, as well as fair competition among brokers and dealers, and among exchange markets. "These sections codify a Congressional intent that the U.S. securities markets, including options markets, be free from competitive restraints to the furthest extent possible consistent with the other goals of the Act."' The Commission determined that the markets for listed options had become sufficiently developed that limitations on multiple listing of stock options were no longer necessary and that "further expansion of multiple trading [of stock options] will continue to encourage service innovations by the options exchanges."[3]

In proposing Rule 19c-5, the Commission relied in part on the results of two staff studies, both of which found that where multiple listing of options was permitted, the result was a significant narrowing of spreads and increase in cost savings for investors.[4] The studies examined trading in listed options on over-the-counter stocks, which had been subject to multiple exchange listing during the period in which stock options on listed stocks were not. According to the Commission, these studies supported the theory that effective competition does not depend on the number of actual competitors, but rather on the ease of entry and exit in the market, and that even where virtually all trading volume is on a single exchange, options eligible *for* multiple trading will have significantly lower spreads." "Both Staff Studies found that the spreads between the bid and the *offer for* options subject to multiple trading were significantly narrower than the spreads for options listed exclusively on one exchange."[6]

Despite the Commission's adoption of Rule 19c-5, the exchanges continued with listing and related practices that restrained multiple listing of stock options. In September 2000, however, the American Stock Exchange, Chicago Board Options Exchange, Pacific Exchange and Philadelphia Stock Exchange submitted Offers of Settlement to the Commission in

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Adopting Release at 23970 (footnote omitted).

[3] *Id.* at 23971.

[4] ***Multiple** Trading of Options*, Securities Exchange **Act** Release No. 24613, *52* FR 23849, 23552 (June *26,* 1987) ("The [Directorate of Economic and Policy Analysis] Study estimated that multiple **trading** in options on OTC securities had saved investors who ***bought*** or **sold** these options $25 million from June 1985 to May 1986. The [Office of **the** Chief Economist] **Study** predicted that extension of multiple trading to all individual **equity** options would **result** in **an** annual savings of $150 million **to** all investors.")(footnotes omitted].

[5] **Adopting** Release **at** 23964. This result was consistent with earlier Commission findings. ***See.** e g , Release Discussing Exchanges' and NASD's Proposed Rule Changes and Soliciting Comment on Granting Unlisted Trading **Privileges to Exchanges for Purpose of Allowing Integrated Market Making***, Securities Exchange Act Release No. 22026, 50 **FK** *203*10, *2033* 1 (May 15, 1985) ("experience has indicated that potential competition **does,** in fact, encourage **primary** markets **to** achieve **greater** efficiency **and** other operational improvements") (footnote omitted).

[6] Adopting Release at **23964** (footnote omitted).

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connection with allegations that they refrained from multiply listing a large number of options and failed to enforce compliance with certain of their rules designed to promote competition, as well as rules that prohibited anti-competitive conduct such as harassment, intimidation, refusals to deal and retaliation against market participants that sought to act competitively. The exchanges agreed to comply with undertakings designed to eliminate these anti-competitive practices.[7]

Multiple Listing Benefits Investors

The options markets have changed considerably since the time Rule 19c-5 was adopted, and even since the exchanges' agreement with the Commission and the Department of Justice to refrain from anti-competitive practices. Multiple listing of stock options has been proven to be not only viable, but desirable, fostering competition and reducing costs to investors. Multiple listing has been shown time and again to work to the benefit of investors, providing the kind of active cornpetition that narrows spreads and reduces costs.

Any doubts as to benefits of such competition have been eliminated since the launch of the ISE in May 2000. The ISE has brought an unprecedented level of competition to the options market. In just three years, the ISE has grown to a pre-eminent position in the U S. listed options market [8] The intermarket competition enhanced by the ISE was at least partially the impetus for the other exchanges to begin multiply listing options.' More importantly, it has benefited investors. "The ensuing wave of competition was so strong that the exchanges stopped charging a fee of 36 cents per contract "[10] Since that time. costs have declined and spreads in listed stock

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[7] *In* the *Matter of Certain* Activities *of Options Exchanges, Order Instituting Public Administrative Proceedings Pursuant to Section19(H)(1) of the Securities Exchange Act Of 1934, Making Findings and Imposing Remedial Sanctions,* Securities Exchange Act Release No 43268, 73 SEC Docket 530 (September 11, 2000) (the "2000 Order") The exchanges also consented with the U S Department of Justice to the entry of a final judgement requiring [illegible] from all cat ng stock options between them in l related anti-competitive conduct *U.S. v. American Stock Exchange, LLC, Chicago Board Options Exchange, Incorporated; Pacific Exchange, Inc., and Philadelphia Stock Exchange, Inc* , Civ No 00-CV-02174 (EGS), *2600* U S Dist LEXIS 20964, at *5-6 (D D C December 6, 2000) ("no defendant shall maintain any rule, policy, practice. or interpretation that directly prohibits, or that has a purpose and an effect of indirectly prohibiting, it from listing any equity option class because that option class is listed on another exchange")

[8] *See, e.g , CBUE Gets SEC OK to Launch Hybrid Trade System*, Forbes corn (June 2, 2003) http //www forbes com/newswire/2003/06/02/rtr988653 html ("In February. ISE overtook the CBOE to become the industry's largest equity options exchange ")

[9] *Best Little Options Exchange in America?*, Business Week Online (September 2 2002) (ISE's registration filing "achieved what even the government hadn't been able to do the exchanges gave up exclusivity) http //www businessweek com magazine/content 02_35 b3797092 htm

[10] *Id., see also* 19c 5 Petition ("With the advent of multiple trading the exchanges quickly eliminated all customer trading fees in competitively-traded products. while raising professional trading charges The resulting savings allowed broker-dealers to discount commissions to investors leading to significant savings ")

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options generally have narrowed.[11] This is consistent with the general proposition that competition for listings will lead to narrower spreads. Indeed, one study has found that "[t]here are significant reductions in effective and quoted spreads after another exchange lists an exclusively listed option class. Effective spreads drop significantly – on the order of 30 to 40 percent – following multiple listing."[12]

The Exchanges Have Restricted Multiple Listing of Index Options

The value of removing artificial barriers to competition in the options markets is beyond question.[13] Nevertheless, one last stronghold of anti-competitive trading remains in the options markets – exclusive index licensing agreements that result in the licensee exchange being the sole venue for trading options on that index. Under these arrangements, the developer of an index will enter into an agreement with one exchange, granting it the exclusive right to trade options based on that index. If another exchange considers listing an option on an index for which it cannot obtain a license, it runs the risk of legal action.[14]

As a result of these exclusive licensing agreements, certain options exchanges have accomplished in the index options market what more than ten years of progress has eliminated in the stock options markets. They have taken away from the listed index options market the benefits that investors receive from multiple listing, including reduced spreads, increased volume, true price Competition, choice of execution venue to facilitate obtaining best execution for customers. competition among exchanges to provide better services to customers and members, and reduced transaction costs and fees By entering into exclusive licensing

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[11] *Id.*

[12] Patrick de Fontnouvelle, Raymond P. H. Fishe & Jeffrey H. Harris, *The Behavior of Bid-Ask Spreads and Volume in Options Markets During the Competition for Listings in 1999*. 58 Journal of Finance (December 2003) (forthcoming issue, available on-line at http://www.afajof.org/December_03.shtml).

[13] *See, e.g., Termination of the Options Moratorium – Policy Statement,* Securities Exchange Act Release No. 16701, 19 SEC Docket 998, 1005 (March 26, 1980), where the Commission noted:

> In addition to the direct effects of intermarket competition in terms of increased depth and liquidity, multiple markets provide broker; and dealers with alternative markets in which to execute orders for a particular options class, thereby assuring that securities market participants are given an effective means of influencing market centers to provide more efficient pricing, execution and clearing services Moreover. without the discipline provided through competition among marketmakers and among market centers resulting from multiple trading, the Commission would have to assume an undesirable oversight role in the allocation of securities to particular markets

[14] According to the Rule 19c-5 Petition The Options Clearing Corporation ("OCC") has informed the ISE that OCC would not permit an exchange to list these types of products without a license for fear that OCC might incur liability

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agreements, exchanges take deliberate action to prevent the multiple listing of options on the same index. The irony is that single stock options, for which exclusive listing was at one time considered appropriate and justifiable, are now free of such restrictions, while index options, to which the Cornmission always has been "inclined to extend its policy of permitting multiple trading,"[15] are subject to exclusivity.

While the Commission's 2000 Order stated that the exchanges' undertakings "shall not preclude a respondent exchange from exercising or enforcing an intellectual property right in an option, or a license of an intellectual property right in an option, if another exchange proposes to list or has listed the option and such respondent exchange has a good faith belief that the intellectual property right or license thereof exists and the action taken is consistent with the federal securities laws and the Commission's rules, regulations and orders,"[16] it **did** not authorize using such licenses to eliminate competition and cause the same result the order was designed to remedy. We respectfully submit that the type of licensing arrangements that the proposed Rule Change is designed to prohibit, run directly counter to the Commission's rules, regulations and orders regarding this subject. Unlike its position regarding stock options, the Commission has always advocated competition in the market **for** listed index option trading, and has never imposed any kind of limitation on multiple listing. In the Adopting Release, the Commission stated specifically that in approving new options products for trading, including index options, its position was that "competitive market forces should **be** allowed to shape the structure of the options markets to the maximum extent possible, and that multiple trading could benefit the market for these products through enhanced price competition, improvements in exchange services, and innovation in contract design."[17] These forces are retarded, and the spirit of the exchanges' undertakings with both the Commission and the Department of Justice is violated. by arrangements that are used to limit competition for listings

The ISE's Method for Eliminating Exclusive Licensing Arrangements is Sound and Fair

The ISE's proposed method for eliminating exclusive licenses generally is both sound and fair. It works to eliminate the ability of exchanges to restrict competition, but does not immediately take away from them the benefits of the bargains they already have struck. Instead, the ISE's proposal prohibits exchanges from reestablishing such restrictive agreements going forward, while providing a sunset period for ***existing*** agreements As noted in the 19c-5 Petition. the intent of the Rule Change is not to harm index providers or limit their ability to receive a fair

[15] *In the Matter Of American Stock Exchange, Inc., Chicago Board Options Exchange, Incorporated & New York Stock Exchange, Inc., Order Approving Proposed Rule Changes,* Securities Exchange Act Release No. 19264, 47 FR 53981, 53983 (November 30, 1982).

[16] 2000 Order at 537.

[17] Adopting Release at 23964 (footnotes omitted).

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return for their development of an index, but to eliminate a barrier to competition and benefit investors and other market participants. -We agree with the ISE's view that enhancing competition will result in increased trading of index and similar products, which will benefit all market participants including index providers.

As proposed, the sunset period would end on January 1, 2004. However, given the passage of time since the 19c-5 Petition was first filed, and the notice and comment period that will be required before enactment of the Rule Change, this date may no longer be appropriate. Moreover, certain agreements existing today or entered into between now and the date of such final approval may have expiration dates after the sunset date. The Rule Change would thus require the parties to renegotiate such agreements, which would probably result in considerable protest by parties to such agreements. Nonetheless, permitting all agreements in place on the adoption date, no matter their term, would enable exchanges to enter or extend agreements for long terms prior to the adoption date, effectively eliminating the benefits of the Rule Change We would suggest, as a reasonable compromise, that any rule, as adopted, provide that (1) the Rule Change apply to all agreements entered or extended by an exchange on or after the effective date of the rule change; and (2) that no exclusive licensing arrangement entered into by an exchange prior to the effective date may be enforced by the exchange beyond a date twelve months after the effective date of the rule change.

Conclusion

By eliminating the barriers to multiple listing of index options, the proposed Rule Change will add to the competitive atmosphere that has been proven to benefit investors and the markets The result should be the same narrowing of spreads and reduction of costs that investors have experienced in the market for single stock options. It will prohibit exchanges from using exclusive licensing arrangements as a means to imposing unnecessary and inappropriate burdens on competition, and will promote greater efficiency in the execution of transactions, as well as fair competition among brokers dealers and exchange markets. We therefore urge the Commission to move forward in publishing the proposed Rule Change for public comment.

Please do not hesitate to contact me at (212) 362-8193 if you have any questions or would like to further discuss our comments.

Sincerely.

Thomas N. McManus
Executive Director and Counsel

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cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Cornmissioner
The Honorable Roel C. **Campos,** Commissioner
The Honorable Cynthia **A.** Glassman, Commissioner
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