competition on the exchange floor, and the exclusivity of access to the limit order book on the exchange involved are factors that should be taken into account.

a. Primary and Secondary Exchanges

Since the primary exchange for an underlying security attracts more orders and is responsible for more volume in that security than any other market, it is likely to be the source of more material market information about that security than any other market. A more complete picture of the supply of and demand for an underlying security should be found on a primary stock exchange because, by definition, more transactions occur there than on other markets and because correspondingly more orders are likely to be sent there. The larger the percentage of total volume and order flow for an underlying security that a primary stock exchange is able to attract, the more likely it may be that that exchange will become an essentially exclusive reservoir for market information that might influence the price of the underlying stock. On the other hand, because options prices are generally based upon the price of the underlying stock, the primary exchange for an option class will, under most circumstances,

contain less market information that may effect stock, and consequently options, prices than the primary stock market. 260/

In light of the quality and quantity of market information that may be present at a primary stock exchange, integrating the trading of options and their underlying securities on such an exchange may result in greater improvements in stock and options market quality than may be obtainable on other exchanges. In addition, improvements in market quality that may result from integrated trading on a primary stock exchange may increase in direct proportion to the market share that such an exchange enjoys with respect to the underlying securities that are subject to integrated trading. At the same time, however, integrated trading on a primary stock exchange may (i) increase the market information and competitive advantages for market professionals on the floor of that exchange, (ii) create additional

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260/ This is not to suggest that secondary stock markets and primary and secondary options markets may not, at a particular moment, contain market information that may be relevant to the supply of and demand for an option or its underlying security. The execution of a large stock order on a secondary stock exchange, for example, may effect the price of that stock in all markets, and secondary stock exchange specialists may obtain indications of buying and selling interest in multiply traded stocks before transactions occur and before such information is known to other market participants. Similarly, options specialist and marketmakers will always have significant market information about the options they are trading due to their presence on an options exchange floor and may become aware of combined stock and options orders or imbalances in the supply of and demand for an options series that may suggest that changes in the price of an underlying security are going to occur.

opportunities to engage in manipulative and other improper trading activities, and (iii) make the monitoring of trading more difficult than would be the case on other exchanges. Moreover, the severity of these regulatory concerns may increase as the market share of the primary stock exchange increases.

On the other hand, since market participants on the floor of a secondary stock exchange will continue to depend heavily upon publicly disseminated quotation and transaction information from the primary stock exchange when making stock and options pricing decisions, improvements in market quality that may result from integration on such an exchange may be minimal and in direct proportion to the amount of underlying stock order flow that the exchange can capture. A secondary stock exchange that is also a primary options exchange, however, may be better able to improve the quality of its options markets than a secondary stock exchange that is also a secondary options exchange. These improvements may be obtained because options trading and quotation patterns and the presence of, and ability to execute, combined stock-options orders on a primary options exchange may provide marketmakers on such an exchange with more complete information than they currently have with regard to the markets for underlying securities, may enhance their ability to anticipate changes in the supply of and demand for a stock and to react to such

changes in market conditions more swiftly, and, as a consequence, may permit them to more accurately assess and adjust the risk of their trading activities. But again: to the extent that improvements in market quality can be achieved on a secondary stock exchange, whether such exchange is a primary or secondary options exchange, the severity of the regulatory concerns may be enhanced.

b. The Marketmaking Systems

Proposals to integrate the trading of options and their underlying securities may contemplate that marketmaking functions for the securities subject to the integration program will be performed by a unitary specialist, 261/ competing specialists, a group of competing marketmakers, 262/ or some combination of these systems. While it is difficult, if not impossible, to project or compare, in the absence of integrated trading experience, the potential that each of these marketmaking systems might have for improving market quality, the regulatory concerns that each system may inspire will clearly vary in nature and in scope.

A unitary stock specialist, for example, may already enjoy substantial market information and competitive advantages over other market participants.

261/ A unitary specialist may be an individual or a specialist unit. A specialist unit is a firm or other group of individuals that assumes responsibility for making markets in a single security or in a set of related securities.

262/ It should be noted that the CBOE Plan contemplated the implementation of a competing marketmaker system for stocks as well as options. See n.228, *supra*.

Such a specialist may have an "intimate knowledge of the past market action of the stocks in which he specializes." 263/ In addition, he may have "sole access to the specialist book showing outstanding orders both below and above the market" for his stocks 264/ and may derive substantial income for executing book orders as an agent. 265/ Further, as "the heart of the exchange market mechanism," 266/ a unitary stock specialist may be exposed to a constant flow of orders, inquiries, and trading in the trading crowd for his specialty securities. Together, these factors may

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263/ SEC, Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange, at 23 (1962), quoted in Special Study, *supra*, n.63, at 59.

264/ *Id*. With respect to the predictive value of the specialist's limit order book, for instance, it has been observed:

> The specialist's book has an importance beyond that of a mere repository of unexecuted agency orders. It serves as an indicator of public interest in a particular security. For example, a book containing many orders reasonably close to the market indicates that, at the time, the stock is an active one of wide interest. On the other hand, a light book may indicate that a stock is less active, or that if active, it may be volatile in character. * * * A book that has a great many sell-stop orders suggests that the stock will suffer a quick decline when these orders are reached. In addition, a large number of limit orders immediately below or above the market may indicate that, in the very short run, there is a floor or ceiling to the stock's price.

Special Study, *supra*, n.63, at 76.

265/ Concerning the portion of total specialist income that is derived from the execution of agency orders, see CBOE Letter, *supra*, n.87, at 34 and Table D.

266/ Special Study, *supra*, n.63, at 59.

permit a unitary specialist to assess market conditions and anticipate stock price movements and temporary imbalances in the supply of and demand for his specialty securities more accurately than other market participants. With this market information and the ability to adapt to shifting market conditions instantaneously and prior to the public dissemination of transaction or quotation information reflecting such shifts, the competitive advantages that a unitary stock specialist possesses may be numerous and significant. 267/

267/ In fact, in many circumstances, a specialist may have "the power to set and control [stock] prices, unilaterally." Special Study, *supra*, n.63, at 142, 136-142. As the Special Study pointed out and illustrated with reference to NYSE's unitary stock specialist system:

> Even in providing price continuity specialists' trading affects the balance that would otherwise result from the free play of public supply and demand. But the impact of specialists' activities on the market goes beyond this. To an extent not generally realized, the market on the NYSE is a "dealer's market" in which the specialist can at various times set and control the prices of a security.
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> This is particularly true in inactive stocks with thin books and few public orders. In these, the specialist acts as dealer in most transactions * * * and thereby sets the prices at which buyers and sellers trade. A specific example of this was observed by a member of the Commission staff on the floor of the Exchange. The specialist in an inactive stock had an order on his book to sell 200 shares at 84 1/2. The last sale of the stock had been at 84. A broker left the specialist a market order to buy 2,000 shares, and the specialist thus became the buyer's agent. The specialist decided to execute 1,000 shares of the market order by selling that amount for his own account at 84; he then executed 200 shares against the limit order at 84 1/2. Next the specialist decided to sell another 800 shares for his own account at 85, setting the price that the buyer paid. When the commission firm's broker returned to confirm

(footnote continued on next page)

Integrating stock and options trading may provide a unitary stock specialist with additional market information and competitive advantages. Information that he may ascertain from the options markets as a result of integration may enable him to assess better the supply of and demand for his specialty stocks and at the same time to anticipate price movements more accurately. To the extent that integration permits a unitary stock specialist to engage in options trading based on the market information that he has obtained during the course of performing his specialist functions, the competitive advantages of such a specialist will be further enhanced. If, for instance, a unitary stock specialist is permitted to trade options on the basis of his knowledge of the contents of a stock limit order book to which he alone has access, indications of buying or selling interest or unexecuted orders in his stock trading crowd, or stock quotation or transaction information that has not been publicly disseminated, the competitive advantages that such a stock specialist

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(footnote continued)

> the transaction, he brought with him an order to sell 1,000 shares of the same stock at the market. In this instance the specialist purchased the stock at 84 1/2 for his own account, a half point beneath the last sale. Although the broker involved had the right (and duty) to negotiate a price at arm's length, the inactivity of the stock and the size of the order gave the specialist broad discretion to set the prices at which these orders would be executed.

Id., at 136.

may have, in the markets for his specialty stocks as well as in the markets for related options, may increase substantially in relation to those that other market participants enjoy and that he now possesses.

Allowing a unitary stock specialist to use market information obtained in the performance of his specialist obligations as a basis for options trading may also present questions concerning the fairness of the securities markets. It might be deemed unfair, for example, if a unitary stock specialist with exclusive access to a stock limit order book were to purchase call options primarily because his stock limit order book indicated a temporary excess of demand over supply. While on the one hand the specialist might maintain that he anticipated that he would be called upon to supply stock and sought to hedge his projected stock sales by purchasing calls at advantageous prices, on the other his trading was based upon market information that other participants in the options markets did not have. Further, if some of the specialist's customers who had left stock purchase orders on his book were also purchasing call options on that stock, their orders to purchase options may be competing with the specialist's orders to purchase options even while the specialist was acting as the agent of these customers. Whether this or similar situations would amount to "undue advantage" 268/ or is justified by the "uses" 269/

268/ Special Study, *supra*, n.63, at 14.

269/ *Id*.

and "contributions" 270/ that a unitary stock specialist makes to the marketplace should be considered in connection with all integration proposals involving unitary stock specialists.

Integrating trading in options and their underlying securities may also provide a unitary stock specialist with additional incentives and opportunities to manipulate securities prices or to engage in other improper trading practices. To the extent that such a specialist is permitted to maintain options positions and to trade options on a regular basis, for example, he may have incentives to influence stock prices to benefit these positions. The derivative nature of option prices and the leverage inherent in options trading may be the primary sources of these incentives while the market information and competitive advantages of the specialist may provide him with opportunities and the ability to engage in improper conduct with minimal risk of loss or detection. 271/ In this connection, it must be kept in mind that profits may be derived from options positions as a result of relatively small movements in the price of an underlying stock, 272/ and that, at the same time, it is the "prosaic quarter and

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270/ *Id*.

271/ See, *e.g.*, discussion at 107-114, and 118-122, *supra*.

272/ See discussion at 107-114, *supra*.

half-point price changes" 273/ which occur relatively frequently that "provide the floor professional with the routine opportunity to gain a trading advantage." 274/

The potential conflicts in marketmaking obligations may be most acute when a unitary stock specialist is involved with an integrated trading proposal. As CBOE has observed:

> The question [of conflicting marketmaking obligations] is more theoretical than real where there is an effective competing market-maker system, because the affirmative obligation is there a shared one and, in any case, temporary disparities in supply and demand tend to be evened out by diverse strategies and judgments among the various marketmakers themselves. With a unitary specialist system and an exclusive book, on the other hand, the quality of performance of the affirmative obligation is dependent on a single specialist, and his ability and willingness to perform at highest levels in either stock or options market may depend on his ability to hedge in the other market. The already built-in conflict in the specialist's combined dealer-agency role may thus be seriously aggravated by the conflict between his possible obligation as a combined market-maker to have simultaneous "same side" transactions in both markets and his need to enhance his capacity in either market by "opposite side" transactions in the other. 275/

273/ AMEX Letter, *supra*, n.90, at 41.

274/ *Id.*

275/ CBOE Letter, *supra*, n.87, at 25. See also discussion at 114-118, *supra*.

It may appear, on the other hand, that surveillance tasks may be facilitated by the presence of a unitary stock specialist in an integrated trading environment since it may be easier to monitor the trading activities of a single specialist than of a group of competing marketmakers. Experience may prove this impression mistaken, however, since (i) the quantity and quality of the market information that such a specialist may possess, (ii) the relatively small stock price movements that may be necessary to make options positions and trading profitable, (iii) the possibility that such a specialist may obtain improper ends using small amounts of stock, and (iv) the numerous alternative economic explanations that may be given for particular trading activities, 276/ may combine to make the detection of trading improprieties in which a unitary stock specialist may engage extremely difficult 277/ and to frustrate successful enforcement of the securities laws in the event that an impropriety is suspected. Moreover, adequate market surveillance of a unitary stock specialist°s trading in an integrated environment could only be conducted if surveillance information relating to each of that specialist°s stock and options orders and transactions, as well as his positions in all related securities, were available for surveillance purposes and reviewed on a daily basis.

276/ See Chapter III and Chapter IV.

277/ See discussion at 118-122, *supra*.

Were a competing stock marketmaker system, as CBOE has proposed, 278/ to be involved in an integration proposal, the regulatory concerns may be less acute. Because stock inquiry and order flow may be dispersed among numerous competitors, the market information and competitive advantages of each marketmaker may be significantly less than those that may accrue to a unitary specialist. Further, if agency and dealer functions are separated and the stock limit order book is shared, competing stock marketmakers would not have the market information and brokerage income advantages associated with a unitary stock specialist's exclusive access to his limit order book. With lesser market information and competitive advantages and the presence of numerous competitors of relatively equal stature on the same exchange floor, a competing stock marketmaker system may present less opportunities to engage in manipulative activities and less potential for conflicts in marketmaking obligation than a unitary stock specialist system. 279/ Fairness concerns and the adequacy of market surveillance programs, however, may not be of lesser magnitude solely because a competing stock marketmaker system is proposed as part of an integration plan.

278/ See n.228, *supra*.

279/ See discussion at 129-135, *supra*.

The severity of regulatory concerns associated with the options market-making systems that an integration plan contemplates may similarly vary in accordance with whether a unitary specialist or competing marketmaker system is intended. 280/

B. Conclusions

1. The Gradual Approach

Proposals to integrate the trading of options and their underlying securities may take a wide variety of forms and involve a broad range of significant variables. Each proposal will be submitted from its own circumstances and at its own time, and each should be considered within this context. Because the securities markets are constantly evolving, issues concerning the extent to which stock and options trading should be integrated on an exchange floor should be addressed as they are presented and resolved within their particular confines. Integration decisions should

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280/ It must be kept in mind, however, that even while unitary options specialists and competing options marketmaker have market information and competitive advantages of their own, the derivative nature of the options markets may strictly limit the significance of these advantages in relation to the advantages of unitary stock specialists and registered stock marketmakers. Stated differently, because stock prices largely determine the prices of related options, market information concerning the supply of and demand for a stock may be substantially more valuable than information concerning the supply of and demand for options on that stock. Thus, while unitary stock and options specialists, as well as registered stock and competing option marketmakers, may have comparable market information and competitive advantages, their advantages are comparable only in kind and not in quality or value.

be made on a case-by-case basis and with a clear understanding that short-term and long-term answers to integration questions may be very different.

2. Principles of General Applicability and the Statutory Standards

Integration decisions, however, will generally require consideration and balancing of the same basic factors. On the one hand, integration may result in improvements in the liquidity, depth, and efficiency of the securities markets. On the other hand, it may provide market participants on exchange floors with additional market information and competitive advantages and new incentives and opportunities to engage in improper trading practices while creating potential conflicts in the marketmaking obligations of these market participants and increasing the difficulties of conducting adequate surveillance of the integrated markets. Thus, the essential balancing to be performed in connection with a review of integration proposals is the extent of expected improvements in market quality against the anticipated severity of accompanying regulatory concerns.

Both sides of this balance will be directly affected by two factors: The extent of the integration that is proposed and the characteristics of the exchange that has made the integration proposal. With respect to the character of the exchange submitting an integration plan, the competitive position of that exchange and the marketmaking systems that it intends to use upon implementing its integration program will directly influence the weight of the balance. As a consequence, these factors should be taken into account when integration proposals are evaluated.

The way in which these factors are likely to interact during the balancing process may be described with four principles of general applicability:

1. To the extent that improvements in market quality or efficiency that are expected to be derived from an integration plan will result from permitting members on the floor of one exchange to have market information and competitive advantages that exceed those available to other market participants, the magnitude of regulatory concerns that may accompany implementation of the proposal is likely to increase. This is because the regulatory concerns result primarily from the market information and competitive advantages that market participants on an exchange floor possess.

2. The greater the degree of integration that is proposed, the more opportunity there may be to obtain improvements in market quality or efficiency. At the same time, however, regulatory concerns are likely to become more acute as the degree of integration increases and to the extent that the first principle comes into play.

3. Because a primary stock exchange contains more material market information concerning stock prices than any other market, and since options prices are largely derivative from these prices, improvements in market quality or efficiency that may result from integration are likely to be most significant if integration occurs on the primary stock exchange. For the same reason, regulatory concerns are likely to be most serious on that exchange to the extent that the first principle becomes operative. In addition, the larger the percentage of stock volume and order flow that the primary stock exchange is able to capture with respect to stocks that are subject to its integration plan, the more material market information is likely to be present on that exchange and, consequently, the greater the potential improvements in market quality or efficiency and the potential seriousness of regulatory concerns.

4. Regulatory concerns are likely to be of greatest magnitude if integrated trading is permitted on an exchange that uses a unitary specialist stock marketmaking

> system in which the unitary specialist performs both principal and agency functions and has exclusive access to, and knowledge of, the stock limit order book. The rationale for this principle is the same as the rationale for the first principle.

As these principles are applied and specific integration proposals are reviewed, the requirements of the Exchange Act should be kept in mind. Decisions regarding these proposals should be consistent with the development of a national market system, 281/ the maintenance of fair and orderly markets, 282/ the public interest, 283/ the protection of investors, 284/ fair competition among brokers and dealers and among exchange markets 285/ economically efficient execution of securities transactions, 286/ and the practicability of brokers executing orders in the best market. 287/ In addition, when making integration decisions, the Commission should assure that an exchange

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281/ See, *e.g.*, Sections 2, 6(b)(5), 15A(b)(5) and 19(b) of the Exchange Act [15 U.S.C. 78b, f(b)(5), and s(b)].

282/ See, *e.g.*, Sections 9, 10, and 11A(a)(1)(C) of the Exchange Act [15 U.S.C. 78i, j, k-1(a)(1)(C)].

283/ See, *e.g.*, Sections 6(a), 11A(a)(1)(C) and 15A(c) of the Exchange Act [15 U.S.C. 78f(a), k-1(a)(1)(C) and o-3(a)].

284/ *Id.*

285/ Section 11A(a)(1) of the Exchange Act [15 U.S.C. 78k-1(a)(1)].

286/ *Id.*

287/ *Id.*

seeking to implement an integration proposal would have the ability to enforce compliance by its members with the Exchange Act in an integrated trading environment and that exchange rules would be designed to prevent fraudulent and manipulative practices 288/ and to promote just and equitable principles or trade. 289/ Further, the Commission should assure that implementation of an integration plan that would not impose unnecessary or inappropriate burdens on competition. 290/

3. The Principles Applied

Application of the integration principles provides some insights with respect to integration proposals such as those that the exchanges have made. The PSE and PHLX proposals to eliminate the physical barriers between their stock and options trading floors and the PSE and MSE proposals to permit registered stock marketmakers or alternate stock specialists to hold simultaneous marketmaker appointments in options and their underlying securities, for example, involved secondary stock exchanges that attract a small percentage of total stock volume and order flow. In fact, in 1977, PSE captured only 3.57 per cent, PHLX 1.40 per cent, and MSE 4.74 per cent

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288/ See Section 6(b)(5) and 15A(b)(6) of the Exchange Act [15 U.S.C. 78f(b)(5) and o-3(b)(6)].

289/ *Id.*

290/ See Sections 6(b)(8), 15A(b)(9), 19(b) and 23(a)(2) of the Exchange Act [15 U.S.C. f(b)(8), o-3(b)(9), and w(a)(2)].

of the total consolidated tape volume for common stocks traded on more than one exchange. 291/ In light of the small amount of stock order flow that these exchanges presently obtain, they may hold only minimal potential for improving market quality or efficiency by means of integrating their stock and options trading. However, regulatory concerns at these exchanges may be of relatively small magnitude because market information and competitive advantages that marketmakers on these exchange floors might obtain as a result of integration may be minimal. Moreover, insofar as these proposals contemplate that trading in options and their underlying stocks will not occur at the same trading post and that stock and options marketmaking functions will remain separated for stock specialists, they do not contemplate a complete integration of stock and option trading. As a result, the opportunities for improving market quality or efficiency and the extent of regulatory concerns may be less than would otherwise be the case. 292/ On the other hand, because each of these exchanges is also the primary options exchange for options classes that it lists exclusively,

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291/ NYSE, 1977 Annual Report of the Quality of Market Committee, Exhibit E. See also Table 22.

292/ This conclusion is not meant to suggest that integrated stock and options trading should be permitted on secondary stock exchanges. Indeed, as AMEX has suggested:

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allowing these exchanges to integrate the trading of these options and their underlying securities may enhance the quality or efficiency of the markets for these options classes and their underlying securities on these exchanges while concomitantly raising certain regulatory concerns.

NYSE's proposal to permit its stock specialists to trade options with respect to their specialty stocks and registered stock marketmakers to trade options for their own account presents far different concerns. During the first half of 1978, NYSE's median share of the total consolidated volume for stocks on which listed options were traded was 86.14 per cent. 293/ NYSE also uses a unitary specialist system of stock marketmaking in which

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> The proposals to integrate options and equity trading on certain of the regional exchanges * * * should * * * be approached by the Commission with extreme caution. Protection of investors and maintenance of public confidence in the fairness of our markets should be paramount in any consideration by the Commission of proposals which might give floor professionals advantage over other market participants.
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> While the need for a barrier between options and equities trading rooms on the regional exchanges may be of less concern than would be the case on the primary market for underlying stocks, we still believe such a requirement should be retained if for no other reason than to avoid even the appearance of unfair trading advantages being granted to floor professionals.

AMEX Letter, supra, n.90, at 46.

293/ Letter to Richard Weingarten, Special Counsel, Special Study of the Options Markets, from James W. Fuller, Senior Vice President, NYSE, dated August 21, 1978.

principal and agency functions are combined and the specialist has exclusive knowledge of, and access to, the limit order book. Accordingly, regulatory concerns are likely to be most severe, in absolute terms and relative to those that integration may cause on any other exchange, in the context of any NYSE proposal to integrate stock and options trading under existing conditions. By the same token, however, improvements in market quality or efficiency that may be obtained as a result of integration are likely to be most substantial, again in both absolute and relative terms, if integration takes place on NYSE under present circumstances.

The extent of integration that the NYSE concurrent trading proposal contemplated, however, was minimal. While seeking to allow NYSE specialists to trade options on their specialty stocks and NYSE registered stock marketmakers to trade options for their own accounts, the proposal would not have involved integration of stock and options marketmaking functions or the trading of options and their underlying securities at the same physical location on the NYSE floor. 294/ The practical result of the

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294/ Indeed, NYSE has recently stated that it does "not now contemplate [side-by-side] trading or dual market-making" in any form and characterizes its plans as follows:

> Our present plan is to trade options in a room physically separated from the equity trading floor, rather than to trade options side-by-side with their underlying stocks * * *. Moreover, we would want to gain actual experience with options trading before making any firm decision on the desirability of "dual marketmaking" -i.e., simultaneous market-making in a stock and its related options by the same person, or by different persons associated with the same firm.

NYSE Letter, *supra*, n.85, at 1. But see discussion at 207, 225-226, *infra*.

proposal would have been that NYSE stock specialists and registered stock marketmakers, like all other market participants who are not primary stock exchange specialists or marketmakers, would have been able to trade listed options on one exchange floor and their underlying securities on another. Because such a proposal would not entail a substantial degree of integration, regulatory concerns associated with it, while still quite serious, may be of lesser magnitude than those that may accompany other forms of integration that NYSE might propose.

It should be noted, however, that the NYSE concurrent trading proposal does not represent the least extent of integration that could be proposed. Indeed, numerous proposals were made in response to the Commission's release announcing its review of the prohibitions on stock specialist and floor trader options trading 295/ which would have permitted these market participants to engage in options trading only for "legitimate hedging" purposes. If an NYSE concurrent trading proposal were to contain such a limitation, the extent of integration that the proposal would be reduced and the severity of regulatory concerns that may be associated with the proposal may be lessened. Accordingly, NYSE and the Commission may wish to explore the feasibility of designing a workable

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295/ Securities Exchange Act Release No. 10312, supra, n.219.

and monitorable 296/ definition of "legitimate hedging" as part of any concurrent trading proposal that NYSE may submit. 297/

296/ Effective monitoring of NYSE stock specialist and registered stock marketmaker stock and options trading would, of course, require regular reporting of stock and options positions, transactions, and orders for these market professionals. Such reports may be necessary on a daily basis and should contain the time that each stock and options order was entered, executed, and a report of execution was received. Without such information, it would seem to be impossible to determine whether particular orders were entered or transactions occurred for heding purposes. See, *e.g.*, proposed MSE rule concerning "bona fide hedging," n.297, *infra*, at (c).

297/ The task of establishing a workable and monitorable definition of "legitimate hedging" is not an easy one. Commentators, however, have already proposed three possibilities, each of which is presented below. These proposals are set forth to demonstrate the types of definitions that may be devised and not to suggest that they are exclusive, correct, or the most viable for concurrent trading purposes.

1. MSE proposed the following rule and definition of a "bona fide" hedge:

> "(b) A member or member organization acting as a specialist, co-specialist or relief specialist (a "Specialist") may purchase and sell options issued by a registered clearing agency to establish a bona fide hedge of his position (net of any position in an investment account) in a stock in which he is a specialist (a "Specialty Stock"). An options position constitutes a bona fide hedge of a stock position if the options position was acquired for the purpose and is reasonably anticipated to have the effect of offsetting, in whole or in part, an adverse change in the market value of the stock position. A Specialist holding an options position in a Specialty Stock has the burden of demonstrating that his options position constitutes a bona fide hedge of his stock position.

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V. AN OVER-THE-COUNTER MARKET FOR STANDARDIZED OPTIONS

The NASD submitted a proposal to permit the display and insertion of quotations with regard to qualified and approved standardized options

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> "(1) A bona fide hedge may consist of long positions, short positions, or a combination of both, in which event it is the reasonably anticipated net price change of all option contracts in the combined options position that is relevant to whether that position is a bona fide hedge of a stock position.
>
> "(A) A long stock position ordinarily may be hedged by (i) a short position in call options, (ii) a long position in put options, or (iii) a combination of long and short positions in call options, put options, or both such that a decrease in the market value of the stock position caused by a downward change in the price of the stock is reasonably anticipated to be offset, in whole or in part, by a net increase in the market value of all options contracts held in such combined position. A long stock position may not be hedged by a long position in call options or a short position in put options, unless such position is held in combination with other options positions meeting the condition of (iii) above.
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> "(B) A short stock position ordinarily may be hedged by (i) a long position in call options, (ii) a short position in put options, or (iii) a combination of long and short positions in all options, put options, or both such that a decrease in the market value of the stock position caused by an upward change in the price of the stock is reasonably anticipated to be offset, in whole or in part, by a net increase in the market value of all options contracts held in such combined position. A short stock position may not be hedged by a short position in call options or a long position in put options unless such position is held in combination with other options positions meeting the condition of (iii) above.

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("NASDAQ options") on the NASDAQ securities quotation system. As is the case for all standardized options, the OCC would be the issuer

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> "(2) Under no circumstances may a Specialist establish an options position in a Specialty Stock unless the stock position to be hedged thereby is established and a report of each transaction giving rise to that stock position has been displayed on the Consolidated Transactions Tape or is available through an interrogation system. If an options position ceases to serve as a bona fide hedge of a stock position, either because it no longer may be reasonably anticipated to offset to any degree an adverse change in the market value of the stock position, or because the stock position has been liquidated, the options must be liquidated as promptly as practicable.
>
> "(c) Each specialist shall weekly file with the Exchange, in such form as the Exchange shall prescribe, a written report respecting his position at the end of, and his transactions during, that week in options in each Specialty Stock.

Letter to Sheldon Rappaport, Associate Director, Division of Market Regulation, of the Securities and Exchange Commission, from Michael E. Tobin, President, Midwest Stock Exchange, (undated), at Exhibit A, p. 3 (File No. S7-490).

2. An NYSE stock specialist, on the other hand, suggested that stock specialists and floor traders should be permitted only to hold options as hedges on the "opposite side" of the market with respect to stocks in which such market participants hold a position. "Opposite side" transactions refer to selling calls or buying puts against a long stock position, or buying calls or selling puts against a short stock position because stock price movements will effect these positions in an offsetting manner. This specialist also suggested that the use of options to hedge should be permitted only when a stock position exceeds 5000 shares and only if the call options are purchased or put options are sold that cover no greater number of shares than the position in the underlying security.

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and primary obligor of NASDAQ options, and such options would be standardized as to exercise price, expiration date and unit of trading. 298/

(footnote continued)

Letter to Ronald F. Hunt, Secretary, Securities and Exchange Commission, from Spear, Leeds & Kellogg dated September 26, 1973 at 1 (File No. S7-490).

3. In connection with the margin treatment of marketmaker hedging transactions, CBOE has proposed that a "bona fide hedge" might be defined in terms of a mathematical formula essentially derived from the Black-Scholes options pricing model. As CBOE has stated:

> Under a formula of this type, it is possible to estimate the rate of change in the price of an option with respect to small changes in price in the underlying stock — the estimate of the amount by which an option price would change upon a change of $1.00 in the stock price is commonly called the "dollar delta" and thus determine the amount of stock that would theoretically hedge a total options position against small changes in the price of the stock.

Letter to Robert S. Plotkin, Assistant Director, Office of Saver and Consumer Affairs of the Board of Governors of the Federal Reserve System, from Joseph W. Sullivan, President, CBOE, dated November 16, 1976, at 4. See also Letter to the Secretary of the Board of Governors of the Federal Reserve System, from Joseph W. Sullivan, President, CBOE, dated January 24, 1977, at 45-46, and discussion in Chapters II and VII *supra*.

298/ NASD Plan, *supra*, n.90. The Plan would require that securities underlying *qualified* and approved NASDAQ options be registered pursuant to Sections 12(b), 12(g)(1), or 12(g)(2)(6) of the Act [15 U.S.C. 78l(b), (g)(1), and (g)(2)(6)]. The Plan also required that the issuer of the underlying securities be in compliance with Sections 13 and 14 of the Act [15 U.S.C. 78m,n] and, among other things, have a net income, after taxes but before extraordinary items net of tax effect, of at least $1,000,000 in each fiscal year in three out of the last

(footnote continued on next page)