The NASD Plan contemplated the establishment of an over-the-counter ("OTC") market for the trading of standardized options. The Plan would have permitted the trading of options with respect to underlying securities traded exclusively in the OTC markets as well as underlying securities listed on the stock exchanges. In addition, the Plan envisioned trading options that are already listed and traded on the options exchanges and thus an expansion of multiple trading. The NASD also proposed to allow registered NASDAQ marketmakers to make simultaneous markets in NASDAQ options and their underlying securities. Accordingly, the NASD Plan presented three fundamental issues that must be considered when evaluating proposals to permit OTC trading of standardized options: (i) whether standardized options should be traded with respect to underlying securities traded exclusively in the OTC markets, (ii) whether the multiple trading of standardized options should be allowed to expand to the OTC markets,

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(footnote continued)

four fiscal years. In addition, the Plan required that (i) an issuer of underlying securities have at least 8,000,000 shares owned by persons other than those required to report their stock holdings under Section 16(a) of the Act [15 U.S.C. 78p(a)], (ii) there be at least 10,000 beneficial owners of the underlying security, (iii) aggregate trading volume reported to the NASDAQ system and/or on the exchange on which the underlying security is listed be at least 2,000,000 shares per year in each of the two previous calendar years, and (iv) a representative bid of at least $10 per share be recorded for the underlying security on NASDAQ or an exchange on each business day of the six calendar months preceding the date of selection. See NASD Plan, Proposed Article XVI, Section 3, Schedule D, Part IV, Section 6.

and (iii) the extent to which the trading of options and their underlying securities should be integrated in an OTC environment. This section will discuss these issues.

A. Standardized Options and Underlying Securities Traded Exclusively in the Over-the-Counter Markets

The NASDAQ system is a network of computers and communications devices designed to accept and distribute quotations for securities traded in the OTC markets. 299/ Quotations are publicly disseminated by means of display terminals that NASDAQ, Inc., a wholly owned subsidiary of the NASD, which operates NASDAQ, provides to system subscribers. 300/ Three levels of quotation services may be provided. Level 1, which is used primarily by registered representatives of broker-dealer firms, does not

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299/ Although only a small portion of OTC equity securities are included in the NASDAQ system, trading in those securities accounts for an overwhelming percentage of both the dollar value and share volume of equity trading in the OTC market. For its securities to be eligible for inclusion in the NASDAQ system, an issuer must have at least $1,000,000 in total assets and $500,000 in net assets, a minimum of 100,000 shares outstanding, and a minimum of 300 shareholders of record. NASD Bylaws, Article XVI, Section 3, Schedule D, Part II, B and C. In addition, the issuer must pay an issuer quotation fee if it wishes to have its securities quoted in the system. Id., at Part V.

300/ Anyone wishing to make a market in a NASDAQ-quoted security and to have his quotations for that security displayed on NASDAQ terminals is required to be an NASD member and to register with the NASD as a marketmaker. Registered marketmakers are subject to various obligations and restrictions set forth in the NASD's Bylaws. See NASD Bylaws, Article XVI, Section 3, Schedule D at Part IC3.

display the actual quotations of specified marketmakers. It displays, instead, for each security quoted in the NASDAQ system, a single "representative bid and ask" quotation ("RBA") consisting of the median bid price and the approximate median offer price of all registered marketmakers 301/ who have entered quotations for that security into the NASDAQ system. 302/ Level 2, which is generally used by traders and large institutional investors, displays, in a montage, with respect to each security quoted in the NASDAQ system, the bid and offer prices of each registered marketmaker who enters quotations for that security into the NASDAQ system. Level 3, which is available only to registered marketmakers, 303/ displays the same information as Level 2 and also permits NASDAQ marketmakers to enter and update bid and offer quotations.

301/ The nature of the RBA is described in the design specifications of the NASDAQ system as follows:

> Representative Bid and Ask -- The representative bid for a NASDAQ security is the median of all bids entered into the NASDAQ system by registered NASDAQ market makers. The representative ask for a NASDAQ security is the figure determined by adding the median of all spreads to the representative bid (a spread is the difference between the bid and ask of registered NASDAQ market makers).
>
> When there is an even number of quotes for a security, the median values are determined by rounding down both the bid and the spread.

302/ NASD By-Laws, Article XVI, Section 3, Schedule D, at Part IC2.

303/ Id.

NASDAQ. however, does no more than provide quotation information for stocks included in the NASDAQ system. It does not, for example, publicly disseminate information concerning transactions in NASDAQ stocks as these transactions take place. As a result, real-time last sale reporting with regard to stocks traded exclusively in the OTC markets is not available. 304/

NASDAQ options marketmakers would be required to submit continuous two-sided quotations for the NASDAQ options for which they would assume marketmaking responsibilities. Their quotations would be required to be firm for at least one contract and "reasonably related to the then prevailing market." 305/ The Plan, however, would not impose an obligation upon NASDAQ options marketmakers, similar to that imposed upon all exchange marketmakers, to deal when there exists a lack of price continuity, a temporary disparity between the supply of and demand for an option contract, or a temporary distortion of the price relationships between option contracts of the same class. 306/ In addition, NASDAQ marketmakers would be permitted,

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304/ Stocks that are traded on an exchange and are included in the consolidated transaction reporting system may be included in NASDAQ and traded in the OTC market. Transaction information with respect to OTC transactions in these securities is included in the consolidated system although not in NASDAQ. See 17 C.F.R. 240.17a-15(a); NASD By-Laws Article XVIII, Section 3, Schedule G.

305/ See NASD Plan, supra, n.90, Proposed Article XVI, Section 3, Schedule D, Part IV, Section 3(k).

306/ See, e.g., CBOE Rule 8.7(b); AMEX Rules 170 and 958; PHLX Rules 1014(f) and 1020(b); PSE Rule VI, Section 79(b); MSE Article XLVII, Rule 6(b). See discussion at 114-115, supra.

with the approval of the NASD, to suspend quotations upon a showing that their ability to enter quotations has been seriously impaired, 307/ and would be able to terminate their registration as a NASDAQ marketmaker in a particular option series voluntarily merely by withdrawing their quotations. 308/ Reregistration as a marketmaker would be permitted at any time upon the filing of an application for reregistration and NASD approval. 309/

1. The Absence of Real-Time Last Sale Reporting For Underlying Securities Traded Exclusively in the Over-the-Counter Markets

The absence of real-time last sale reporting of transactions in underlying securities traded exclusively in the over-the-counter market may present questions of fairness if options trading with respect to these securities is permitted. Because options prices depend upon and react to changes in the price of the underlying security, the lack of real-time transaction reporting for underlying securities may make it difficult to determine the value of an option at any given point in time or to adjust options or stock positions in accordance with price changes in the underlying security. In this regard, CBOE has stated:

307/ Such a suspension of quotations would not necessitate the termination of the marketmaker's registration as a NASDAQ marketmaker for the security involved.

308/ NASD Plan, *supra*, n.90, Proposed Article XVI, Section 3, Schedule D, Part IV, Section 3(k).

309/ The NASD Plan suggests that the same standards would be applied in evaluating applications for reregistration as would be utilized in connection with initial applications. NASD Plan, *supra*, n.90, Proposed Article XVI, Section 3, Schedule D, Part IV, Section 3(j)(4).

> Because of the derivative nature of options, * * * it is fair to say that the single most essential item of information for informed investing or trading is real-time information as to underlying stock prices. In a professional market, with large and relatively infrequent trades, there may be other means for providing adequate dissemination of price trends in underlying or related securities. But in an active, public options market, an investor (or his registered representative) lacking real-time information on underlying stock prices would necessarily be operating partly in the dark. The lack of this fundamental information on a continuous, real-time basis could therefore result in a public options market that was neither fair nor orderly. 310/

An example may help to illustrate these points. Assume that an institutional investor approached a NASDAQ marketmaker during the first week of January to buy 10,000 shares of XYZ. Also assume that the high sale price for XYZ during the previous day was $50 per share and the best bid currently displayed on NASDAQ Level 2 service is $49 7/8 and the best offer is $50 1/8. Also assume that January 40, 45, 50 and 55 put and call options, in addition to various April and July series, have been issued on XYZ. Were the NASDAQ marketmaker to sell 6,000 shares to the institution at a price of $51, knowledge of this transaction might have a significant effect upon the valuation of the January and other options by other marketmakers and market participants. Marketmakers, for instance, might increase their bid and offer quotations in the January 40 and 45 calls to reflect an increase,

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310/ CBOE Letter, *supra*, n.87, at 51 (footnote omitted).

perhaps in the amount of $1, in the intrinsic value of those options, or might decrease their bids and offers in the January 55 puts by a similar amount. In addition, other marketmakers and market participants might seek to adjust positions in accordance with the price increase. A market participant with a short position in the January 50 calls, for example, might execute closing purchase transactions or might purchase stock to hedge the short position. A marketmaker, on the other hand, with a long position in the January 50 calls might sell January 55 calls or April 50 calls to spread the risk of the long position. Without real-time last sale reporting of the transaction in XYZ, however, persons other than the institution and the marketmaker completing the trade would not know the size or price of the transaction or even that the transaction had occurred. As a result, they may not have an opportunity to adjust their quotations and positions to reflect the transaction.

Further, without real-time last sale reporting of underlying security transactions, investors may be compelled to rely exclusively upon underlying stock quotation information provided by the NASDAQ system in making pricing decisions concerning NASDAQ options. 311/ In this connection, it should be noted that NASDAQ marketmakers may not adjust quotations when transactions occur at prices away from the quoted prices but might adjust such quotes

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311/ It must be noted that NASDAQ quotations are required to be firm for only one round lot and do not indicate any greater number of shares for which the bid or offer will be firm.

if no transaction or significant market event were to take place. For instance, in the above example, the NASDAQ marketmaker that sold the 6,000 shares of XYZ may, at the time of the sale, have been bidding $49 7/8 and offering $50 1/4 for XYZ. If he were also making markets in the XYZ NASDAQ options, he may have been bidding $10 and offering $10 3/8 for the January 40 calls. After the sale, these quotations might not change and thus would not indicate that a transaction had occurred which might suggest that the January 40 calls should have an intrinsic value of $11. 312/ As a result, market participants, trading solely on the basis of quotations, may not have an opportunity to make an independent judgment concerning the prices at which XYZ and the XYZ options should trade in light of the 6,000 share transaction or to assess the risk associated with their stock and options positions in view of that transaction. 313/

NASD, however, has responded to the suggestion that it implement real-time last sale reporting on at least three occasions in the context

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312/ Similarly, real-time last sale reporting of option transactions may not provide market participants with sufficient information to allow proper option pricing. If, for example, the dual marketmaker were to purchase the January 40 calls at between $10 and $10 3/8, or at slightly higher prices, other market participants who did not receive real-time last sale reports of these purchases may have no reason to believe that such transactions may not reflect the value of those options since the purchases would be at prices reasonably related to the marketmaker's quotations.

313/ See Letter to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, from James F. Dalton, Secretary, CBOE, dated March 31, 1977, at pp. 5-6.

of its proposed options plan. 314/ NASD has stated that "trade reporting of transactions in over-the-counter securities underlying options in the detail it believes necessary would be unnecessarily burdensome and extremely time consuming to members if implemented on a real-time basis." 315/ In addition, NASD has pointed out that real-time last sale reporting of underlying security transactions might "create public confusion" since the "Consolidated Tape presently prints transactions at prices which are exclusive of any commissions or differentials charged" whereas last sale reports of transactions by over-the-counter dealers might, if not reported via the consolidated tape and in accordance with its rules, "reflect the actual or net price paid or received." As a result, it may be difficult for market participants to interpret last sale information. 316/ Further,

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314/ Letters to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, from Gordon S. Macklin, President, NASD, dated March 18, 1977, and October 19, 1977; Letter to Sheldon Rappaport and Martin Moskowitz, Division of Market Regulation, Securities and Exchange Commission, from Frank J. Wilson, General Counsel, NASD, dated May 31, 1977.

315/ See Letter to George A. Fitzsimmons from Gordon S. Macklin dated March 18, 1977, supra, n.314, at 2.

316/ Article XVIII of the NASD By-Laws and Schedule G thereunder initially required "net" price reporting for over-the-counter transactions in listed securities for the several months immediately after the implementation of Network A of the Consolidated Transaction Reporting System. Subsequently, the Commission approved an NASD rule change which, among other things provided that over-the-counter principal transactions in listed securities be reported in the Consolidated System at "gross" prices. In other words, the price reported to the Consolidated System, like all other prices reported to that system, does not include any commission, commission equivalent, or differential imposed in connection with the transaction. See Securities Exchange Act Release No. 12432 (May 12, 1976).

the NASD has suggested that requiring real-time last sale reporting for transactions in securities traded exclusively in the over-the-counter markets may result in reduced marketmaking capacity in those markets. 317/

2. Representative Bid and Ask Quotations For Securities Traded in the Over-the-Counter Markets

With respect to representative bid and ask quotations for securities traded exclusively in the OTC markets, the Commission recently observed:

> Information supplied by the NASD and representatives of the securities industry indicates that broker-dealer firms tend to supply their registered representatives who deal with the public with Level 1 service exclusively. Level 2 and 3 services are generally maintained by broker-dealer firms in their trading rooms for use in connection with trading and marketmaking activities. Because registered representatives of the larger wirehouses cannot for practical reasons communicate orally with the trading rooms of their firms on a continuous basis to obtain real-time quotations, retail customers of these firms generally do not have access to the information provided by Level 2 and 3 services. Moreover, many smaller, nonclearing firms do not subscribe to Level 2 or Level 3 service and thus are only able to supply their customers with information available on Level 1. Therefore, since most retail customers generally cannot obtain real-time quotations for NASDAQ securities other than through the registered representatives with whom they deal,

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317/ See, e.g., Testimony of Gordon S. Macklin, President, NASD, August 16, 1977, in response to Securities Exchange Act Release No. 13662, *supra*, n.124, File No. 4-180 at Transcript, pp. 978-981 and 1044-1045.

> the practical effect of displaying the RBA on Level 1 is that the vast majority of retail customers are informed only of the RBA. 318/

The Commission also stated its belief that "the behavior of some broker-dealers in executing their customers' orders may be affected by the knowledge that their customers do not have access to the best bid and offer then available." 319/ Moreover, the Commission expressed concern that "it is only feasible for a customer to police his broker's efforts to obtain best execution if he receives information as to the best bid or offer available at the time he places an order to buy or sell a NASDAQ-quoted security." 320/ Accordingly, the Commission proposed

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318/ Securities Exchange Act Release No. 15251 (October 20, 1978), 15 SEC Docket 1370, 1381-2 (November 17, 1978) (footnotes omitted).

319/ *Id.*, at 1382. To demonstrate this point, the Commission stated:

> For example, some commentators have noted that certain broker-dealers execute customers' orders at the RBA displayed on Level 1 without first attempting to obtain more favorable executions. Futhermore, at the Commission's hearings in August 1977 considering the amendment of off-board trading rules * * *, one commentator stated that an integrated firm may deal with its own retail customers at the RBA quoted on Level 1 despite the fact that the firm's quotations, as a marketmaker in NASDAQ, were at a better price.

Id. (footnote omitted).

320/ *Id.* In this connection, the Commission stated:

> A retail customer who is informed only of the RBA at that time cannot properly evaluate the quality of execution and price of services rendered by the

(footnote coninued on next page)

Rule 11Ac1-2 321/ which would require that every interrogation device providing quotation information with respect to OTC equity securities display, at a minimum, the highest bid and lowest offer for each such security. 322/ The proposed amendments would also prohibit the display of "any representative bid or offer for a security — i.e., any price for a security which is the mean, median, mode, or weighted average of two or more bids or offers or is the result of some other mathematical calculation based on the bid or offer of one or more marketmakers." 323/

The NASD Plan proposed to display representative bid and ask quotations for NASDAQ options. As a result, the concerns that led to

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(footnote continued)

> broker-dealer handling his order. This is particularly true when a broker-dealer had executed an order as principal and has confirmed the transaction "net" to the customer because there is currently no required disclosure of the amount of retail markup or markdown included within the "net" price. In addition, retail customers who are not knowledgeable about the operation of the over-the-counter markets may believe that the RBA quotation they generally receive for a NASDAQ-quoted security actually is the best bid or offer available for that security.

Id.

321/ See Securities Exchange Act Release No. 15251, supra, n.318.

322/ Id.

323/ Id., at 1383 (footnote omitted).

the pending proposal to prohibit such quotations for NASDAQ stocks would be equally present with regard to NASDAQ options if the NASD Plan were implemented as proposed. Moreover, RBAs for underlying securities traded exclusively in the OTC market may make it difficult for members of the public without access to Level 2 or Level 3 service to make informed investment decisions with respect to NASDAQ options. Without quotation information revealing the best prices bid and offered for an underlying stock, the range of bids and offers available, and the number of shares for which each bid and offer is firm, market participants receiving only Level 1 service may not be able, due to the derivative nature of option pricing, to determine effectively the value of NASDAQ options that they may wish to buy or sell or the prices at which they might be willing to trade such options. The absence of real-time last sale reporting on underlying securities traded exclusively through NASDAQ would compound a Level 1 user's difficulty. 324/ The following example that AMEX has provided may help to show these points:

324/ AMEX has described the concerns relating to trading options on underlying securities traded solely over-the-counter and as to which only representative bid and ask quotations are available as follows:

> The options market is a derivative of the market for the underlying stock, and options investment decisions are to a large extent based on available information concerning the value of the underlying stock, that is, the price at which it can currently be bought or sold. Investors normally determine the value of a stock by reference to a number of factors.

(footnote continued on next page)

[I]f the representative quote in an over-the-counter stock were 40 bid and 41 asked, the options investor would have no idea whether the stock is realistically to be valued at 40, 41 or somewhere in between. Furthermore, there will be no up-to-date last sale information to help him in making the valuation. This one point difference will affect the price of any option, and particularly one trading at or near parity where option prices normally fluctuate point for point with movements in the price of the underlying stock. With a quote of

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(footnote continued)

The most reliable indication is the current quotations, provided such quotations are firm and they represent sufficient depth to assure there will be no severe fluctuations in price on minimal volume. Last sale data is also a valuable source of information in determining value, provided it is current, accurate and complete. It indicates the latest price at which a transaction actually took place, the volume, the degree of price volatility, and the kind of price continuity characteristics of the market in the security.

Investors attempting to ascertain an appropriate value for stocks traded in the over-the-counter market, of course, do not have the benefit of such last sale information on a real-time basis. In addition, they are handicapped by the fact that the "mean" bid and asked quotations displayed in the NASDAQ system do not necessarily mean there is a market maker willing to buy or sell at those prices, but only that the quotations are <u>representative</u> of the various prices at which the market makers registered in the stock may be willing to deal. As a result, it will be almost impossible for an investor to make an informed decision with respect to an option on a stock traded solely over-the-counter, and uninformed decisions may be costly.

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(footnote continued on next page)

40 bid, 41 asked on an underlying stock approximately two weeks before the expiration date, a 35 call option trading at parity would be worth 5 if the stock could be realistically valued at 40, 5-1/2 if it were worth 40-1/2, and 6 if the stock could be realistically valued at 41. With such tenuous knowledge as to the stock's true value an investor might pay a price of 6 for an option worth only 5. It should be noted that this one point differential represents 20% of the option's value. When a low-price option is near expiration a moderate spread in the quote on the underlying stock could represent a differential in the options price of perhaps 50% or more. 325/

(footnote continued)

Even worse than the fact that the public investor will not have sufficient information on which to base an accurate appraisal of the worth of the option, is that the market professional will have greater access to such information, thus giving him a significant trading advantage over the public investor. The NASD plan contemplates that the same OTC market makers will make markets in both the underlying stocks and the related options. Such market makers will, therefore, have intimate knowledge of the price and volume at which the underlying stock has been trading.

The lack of real-time volume information in the underlying stocks traded over-the-counter may be as significant as the lack of real-time price information. In view of the fact that the real "size" of a dealer's quote also may not be ascertainable, investors will be unable to judge the depth in either market. Without adequate means to determine the depth and liquidity of the market for an underlying stock, the true risk of a position in the related option cannot be properly evaluated.

AMEX Letter, supra, n.90, at 77-80.

325/ AMEX Letter, supra, n.90, at 78-79.

It must also be recognized that market professionals with access to Level 2 and 3 service would possess information concerning the range and number of quotations for underlying NASDAQ stocks and thus would have significant trading advantages over other market participants. 326/

The Commission has recognized that the elimination of representative bid and ask quotaions may impose burdens on OTC marketmakers who must respond to customer inquiries concerning transactions that were executed at other than the best bid or offer available. 327/ In addition, the

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326/ See n.324, supra.

327/ In Securities Exchange Act Release No. 15251, supra, n.318, the Commission stated:

> The Commission is aware that a broker-dealer who has executed a customer's order at a price other than the best bid or offer may have had justifiable reasons for doing so (e.g., the best bid or offer may not have been firm for the size of the customer's order; the cost of execution and clearing with the market-maker responsible for the best bid or offer might off-set the price advantages to the customer; or the broker might have reason to believe it imprudent to deal with the dealer responsible for the best quotation). We are also aware that, in such circumstances, a customer's knowledge of the best bid or offer might necessitate an explanation by the executing broker-dealer of the facts and circumstances underlying his decision to execute the order at a price inferior to the best bid or offer. However, it would not appear that providing such an explanation would constitute an unduly heavy burden. Moreover, the Commission believes that the benefits to be achieved by dissemination of the best bid or offer would justify the imposition of such a burden.

Id., at 1382-3 (footnotes omitted).

Commission has solicited public comments with regard to the effects that eliminating RBA's might have on the OTC markets. In this connection, the Commission noted:

> It has been asserted on various occasions that, possibly because of inherent differences between dealer and auction markets, some innovations which improve the quality and efficiency of the markets for securities which are suitable for auction-type trading would have a deleterious effect on over-the-counter markets for other types of securities. For example, during the off-board hearings, the NASD suggested that last sale reporting of transactions in OTC securities might discourage market-making in those securities, thus decreasing liquidity in the over-the-counter market. It also implied that the display of best bid and ask prices on Level 1 of NASDAQ would have similar effects. 328/

B. Trading Exchange Listed Options in the Over-the-Counter Markets

To permit the trading of exchange listed options in the over-the-counter markets would involve an expansion of multiple trading. Accordingly, the factors discussed previously in connection with multiple trading should also be considered when evaluating proposals to allow options listed on the options exchanges to be traded in the OTC markets. 329/ Some additional factors, however, should also be considered due to the differences between

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328/ *Id.* at 1383 (footnotes omitted).

329/ See discussion at 65-92, *supra*.

OTC dealer markets and exchange markets. These additional factors will be presented in this section. 330/

1. Fragmentation and Internalization

Multiple trading of standardized options currently results in a dispersion of options orders among various exchange markets. 331/ Permitting an OTC market to develop for option classes already traded on one or more exchanges may provide numerous other markets to which these orders could be sent, each dealer making a market in the multiply traded class through NASDAQ representing an additional market center seeking to attract orders for that class. While such a situation would undoubtedly create the potential for further dispersion of orders for multiply traded options classes among market centers, fragmentation issues of another type must also be considered.

Dealers making markets through NASDAQ from their offices 332/ may be able to trade multiply traded classes as principal with their own

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330/ This section assumes that the rules of the options exchanges which preclude members of these exchanges from engaging in listed options transactions anywhere other than on an exchange floor would not be in effect. This assumption has been made because brokerage firms who are members of these exchanges would not be able to participate in an OTC options market for listed options if such rules were operative. Without the participation of these firms, the development of such a market may be unlikely. But see n.337, *infra*, and discussion at 271, *infra*.

331/ See discussion at 49-52, 61-65, *supra*.

332/ These dealers are sometimes referred to in this chapter as "upstairs dealers."

retail customers. If an upstairs dealer elects to trade a multiply traded option with his customer, the customer's order may not be sent to an exchange floor for execution. As a consequence, the customer's order may not be exposed to buying and selling interest that may have been present in the marketplace. This result, as CBOE has suggested, may "be contrary to the statutory goal of assuring an opportunity for orders to meet in an auction market without the participation of a dealer," 333/ and may "lead to a market divided into as many separate fiefdoms as there are major brokerage firms, each with its own captive order flow." 334/ Ultimately, a redirection of orders away from exchange floors may "impair the depth and liquidity of [the] markets [for multiply traded classes], and significantly impair the ability of such markets to provide public limit order protection." 335/ In addition, the ability of upstairs dealers to trade as principal with their retail customers without exposing their customers' orders to the auction market on an exchange may "raise the regulatory issues of overreaching and other conflicts of interest that were addressed in

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333/ CBOE Letter, *supra*, n.87, at 48. See also Section 11A(a)(1)(C)(v) of the Exchange Act [15 U.S.C. 78k-1(a)(1)(C)(v)]. It should be noted that this statutory goal is qualified in two respects. See n.27 and accompanying text.

334/ *Id.*

335/ AMEX Letter, *supra*, n.90, at 84.

connection with the Commission's consideration of off-board trading rules for stocks." 336/

Thus, many of the concerns that the Commission expressed in connection with its recent review of off-board trading restrictions may be as applicable to the options markets as they are to the stock markets. 337/ These concerns are factors that should be considered as proposals contemplating OTC trading of options listed and traded on the options exchange are evaluated.

2. Market Information and Competitive Advantages of Over-the-Counter Marketmakers

Over-the-counter marketmakers may have market information and competitive advantages that other market participants, including options

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336/ CBOE Letter, supra, n.87, at 49. See also Securities Exchange Act Release No. 13662, supra, n.124; No. 11628, (September 2, 1975), 7 SEC Docket 762 (September 16, 1978); and No. 11942, supra, n.210; and Report of the Securities and Exchange Commission on Rules of National Securities Exchanges Which Limit or Condition the Ability of Members to Effect Transactions on Such Exchanges, September 2, 1975.

337/ It should be noted, however, that the Commission has not sought to resolve issues that may be presented by the off-board trading restrictions currently in effect with respect to standardized options that are traded on a national securities exchange. See, e.g., CBOE Rule 6.49. See also Securities Exchange Act Release No. 13662, supra, n.124, at n. 157. The Commission, in the course of its continuing review of these restrictions, may wish to consider issues similar to those presented in connection with the proceedings concerning the removal of off-board trading restrictions for listed equity securities. See January Release, supra, n.176, at 41. See also File No. 4-180. See discussion at 271-272, infra.

marketmakers on options exchange floors, would not have. As CBOE has stated:

> First, such a firm would have access to a regular flow of orders through its retail department; it could either internalize these orders or send them to an exchange market for execution, depending on whether the firm believed it could realize more profit by acting as principal or agent. On the other hand, exchange market-makers have no comparable access to an order flow or comparable choice. Being deprived of the order flow that would be captured upstairs, their ability to function as market-makers would be impaired and trading profits would be more difficult for them to realize. Second, because the upstairs retail firm would have an assured source of orders, there would be no need for it to publish competitive quotations to attract orders. Exchange market-makers, on the other hand, must publish competitive quotations to stay in business, and these would be subject to being "picked off" by the upstairs market-maker. Third, * * * any upstairs market-maker having a significant percentage of aggregate order flow which it was permitted to internalize would have special access to significant nonpublic market information. 338/

Moreover, AMEX has observed:

> Specialists and other market makers on options exchanges would be at severe disadvantage vis-a-vis the market makers registered as such with the NASD. The NASD market makers will have no affirmative obligations to engage in transactions reasonably calculated to contribute to the maintenance of a fair and orderly market. This fact, plus the ease with which they will be able to suspend quotations

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338/ CBOE Letter, _supra_, n.87, at 49 (footnote omitted).

> or terminate registration as a market maker, will mean that NASD marketmakers need not commit to the market the amount of capital that is required of exchange market makers. With the leverage of market-maker "margin", they may seek to take whatever positions will bring them the maximum profit, because they will be confident they can liquidate their positions in the exchange market, thereby minimizing their risks. This will place a significantly increased burden on exchange market makers to maintain fair and orderly markets. 339/

It should also be kept in mind that if dual marketmaking is permitted in the over-the-counter markets, OTC options marketmakers may have access to information concerning underlying stocks that they are trading that would not be available to other market participants. Dual OTC marketmakers, for example, may be able to trade options on the basis of customer stock orders and transactions as well as indications of buying and selling interest for an underlying stock in which they are making markets. Such informational and competitive advantages may take on added significance and impact the competitive balance among options marketmakers profoundly if comparable integration is not permitted on exchange floors. In this regard, CBOE has contended:

> Obviously, if the NASD proposal for dual market-making were approved at the same time that dual market-making were not allowed in exchange markets, the result would be to provide OTC market-makers with a significant competitive advantage. Even more obviously, if at the same time an upstairs

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339/ AMEX Letter, supra, n.90, at 85.

> market-maker, unlike an exchange market-maker, were able to internalize its retail order flow by trading as principal with its customers * * * the combination of these two advantages would severely limit the capability of any exchange market-maker to compete. 340/

3. Over-the-Counter Markets and a National Market System Which Would Include Standardized Options

An over-the-counter market for options traded on exchanges does not exist at present. Should such a market evolve before national market system facilities for options trading are in place, the task of establishing a national market system which would include standardized options may become more difficult. The office of each upstairs options dealer, for example, would have to be connected to any system linking market centers in a national market system that included options. In addition, the differing principles that govern dealer and auction market options trading may have to be reconciled as may gross and net pricing differences that may develop. 341/ Further, the difficulties associated with maintaining accurately sequenced real-time transaction and quotation reporting and system-wide limit order protection may be exacerbated. 342/

340/ CBOE Letter, supra, n.87, at 50.

341/ See discussion at 159, 167-173, supra.

342/ See CBOE Letter, supra, n.87, at 47. With respect to the problems that may be encountered when attempting to assure public limit order protection in an OTC options market, CBOE has stated:

(footnote continued on next page)

C. The Integration of Trading of Options and Their Underlying Securities in the Over-the-Counter Markets

The NASD Plan contemplated that options and their underlying securities would be traded by the same persons or firms. The Plan proposed a complete integration of marketmaking functions and the trading of options and their underlying securities at the same physical location. With respect to the dual marketmaking aspects of its program, NASD stated:

> Firms most likely to become marketmakers in NASDAQ options are the same firms that currently make markets in the underlying securities on NASDAQ. It is unlikely that firms other than NASDAQ marketmakers will choose to be NASDAQ options marketmakers only or that a marketmaker in a given NASDAQ underlying security will choose to make a NASDAQ options market involving an underlying security with which it is unfamiliar, i.e., an issue in which it is not a NASDAQ marketmaker. Also, it would not be in the public interest for a NASDAQ market-maker to drop his marketmaking activity in a NASDAQ issue in favor of making a market in a NASDAQ option. In reality, it would not do so.

(footnote continued)

> It would be especially difficult to achieve system-wide limit order protection in such a market, not only because of the inherent difficulties of linking the many separate upstairs locations where limit orders would be held, but also because an upstairs firm's self-interest would encourage it to hold customer orders away from any central limit order file that might be created.

Id., at 48.

> In sum, if dual marketmaking is not permitted, it is unlikely that the NASDAQ options programs will be implemented. 343/

In its analysis of the issues relating to dual marketmaking, NASD stated that dual marketmaking through NASDAQ would "entail substantial benefits to investors and the marketplace" and noted its belief that "dual marketmaking in the closely regulated, highly visible NASDAQ market will not create significant new opportunities for manipulative abuses by marketmakers." 344/ In this connection, NASD was of the view that "the quality of the underlying securities [on which NASDAQ options would be issued], the number of competing marketmakers [entering quotations in the NASDAQ system], the volume of trading activity [in the underlying securities], and a requirement that there be a minimum number of marketmakers in both the underlying security and the [NASDAQ] option before anyone would be permitted to make a dual market" would be sufficient safeguards to minimize the ability of a dual marketmaker to manipulate an underlying NASDAQ security or its options. 345/ Additionally, a "comprehensive package of rules" to govern the operation of the NASDAQ

343/ National Association of Securities Dealers, "An Analysis of the Issues Relating to Dual Marketmaking on NASDAQ, May 14, 1976" ("Analysis"), at 29. This analysis was submitted in response to Securities Exchange Act Release No. 10312, supra, n.219.

344/ Id., at 2.

345/ Id., at 11-12.