

Operational efficiencies may also result from integrating the trading of options and their underlying securities. Options marketmakers, for example, may be able to execute orders in underlying securities more quickly and more economically if they are present on a floor where underlying securities are traded. 234/ Less costly and less time-consuming executions for combined stock-option orders may also be obtained. 235/ Further, brokerage firms may be able to utilize floor personnel more efficiently, to transfer more discretion for combined stock-option orders to their on-floor brokers, and to reflect such efficiencies in lower commission charges. Exchange order routing and processing facilities might also be adapted to an integrated trading environment to obtain routing and execution efficiencies for retail and other member firms. 236/

(footnote continued)

risks, stock and options marketmakers may be able to narrow the spreads in their quotations, and, by bidding and offering in greater size, to accumulate larger positions. This, in turn, may facilitate deeper and more liquid markets for both securities. Moreover, such increased depth and liquidity in the option markets may further contribute to the liquidity of the markets for underlying securities by improving the ability of market participants to shift risks associated with positions in underlying securities to the options markets.

234/ See, e.g., discussion at 102-105, 224-227, infra.

235/ See, e.g., discussion at 218-219, 232, infra.

236/ See, e.g., discussion at 232-233, infra.

2. The Regulatory Concerns

a. Market Information and Competitive Advantage

Market information is "information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power." ^{237/} Market professionals on the floors of the national securities exchanges, by virtue of their presence on the exchange floors, have access to certain market information that is not available to other market participants. These professionals, for example, may observe orders, transactions, and patterns of trading and quotations before such information is publicly disseminated. Indeed, significant pieces of market information that may be observable on a trading floor and suggestive of the supply of and demand for a security may never be publicly disseminated. Market participants who are not on an exchange floor, for instance, may never become aware of information concerning unexecuted orders, indications of buying and selling interest in a trading crowd, and the trading styles of particular market participants because no mechanism exists for publicly disseminating such valuable market information. In addition, stock and options specialists with essentially exclusive access to the limit order book for their

^{237/} Fleischer, Mundheim, and Murphy, "An Initial Inquiry Into the Responsibility to Disclose Market Information," 121 U. Pa. L. Rev. 798 (1973).

securities possess information concerning the supply of and demand for those securities that other market participants do not have because information regarding the contents of a specialist's limit order book need not be made publicly available. 238/

Access to these types of market information provides market professionals on exchange floors with competitive advantages over other market participants. Specifically, exchange members trading on exchange floors may use the market information that they possess as a basis for their trading activities. Further, the presence of these professionals on an exchange floor frequently permits them to react virtually instantaneously to the market information that they obtain and to enter, and perhaps execute, their orders before others can receive and act upon information that may be publicly disseminated. In addition, floor members do not pay brokerage commissions when executing their

238/ It should be noted, however, that the Commission has recently stated its belief that "one of the basic principles upon which a national market system must be based is the assurance that all agency orders in qualified securities, regardless of location, receive the benefits of auction-type trading protection." January Release, supra, n.176, at 40. Accordingly, the Commission encouraged the several self-regulatory organizations to "take joint action promptly to develop and implement a central limit order file (the 'Central File') for public agency orders to buy and sell qualified securities in specified amounts at specified prices ('public limit orders')." Id. In addition, the Commission stated that it was not "aware of any compelling reason why information as to all public limit orders in the Central File should not be made publicly available on a current and continuous basis, at least in summarized form." Id., at 41.

own orders and receive more favorable margin treatment for their positions than other market participants. 239/ Traditionally, market professionals on exchange floors have been permitted to enjoy these market information and competitive advantages because they have obligations to the markets for the securities that they trade and have made significant contributions to the continuity, liquidity, and depth of the markets for those securities. 240/

At present, options and their underlying securities are traded on different exchange floors. As a consequence, stock specialists and registered stock marketmakers are generally unable to observe option trading and options marketmakers cannot regularly observe stock trading. Market information and competitive advantages that these floor members enjoy extend primarily to the markets for the securities for which these marketmakers have explicit obligations. Integrating further the markets for options and their underlying securities may provide these marketmakers with market information and competitive advantages that exceed those that they now possess and which extend

239/ See Chapter VII.

240/ See, e.g., Special Study, *supra*, n.63, at 76-83, 90, 127-128, 135, and 203-242. See discussion at 114-115, *infra*, for a more detailed description of the obligations that marketmakers on exchange floors have assumed. Floor brokers, of course, have no such obligations because they act only as agents and do not engage in marketmaking.

into markets in which they have no responsibilities. Options market-makers, for example, may be able to observe, or otherwise obtain information concerning, unexecuted stock orders, indications of buying and selling interest for a stock, orders that are left with a stock specialist, patterns in stock trading crowds, and stock quotation and transaction information that these marketmakers cannot now observe or easily obtain because of the physical separation of stock and options trading floors. Similarly, integration may permit stock specialists and registered stock marketmakers to observe, or obtain information concerning, large option orders, indications of buying and selling interest for particular option classes, and patterns of option trading that may indicate imminent changes in the supply of or demand for a stock. Integration may also allow these market professionals to trade for their own account on the basis of this information before it is publicly disseminated and even if it is never publicly disseminated.

In light of the traditional balancing of the benefits derived from the market information and competitive advantages that have been granted to certain market professionals on exchange floors against the contributions that these market participants have made to the quality of the markets in which these advantages are enjoyed, it may be contrary to much of the regulatory philosophy that has evolved to permit professionals who have market information and competitive

advantages in one marketplace to use those advantages to achieve personal gain in a related marketplace to which they have no responsibility.

When a market professional uses market information and competitive advantages to trade in a market to which he has some obligations, any unfairness that may exist by virtue of his trading on such information may be justified on the theory that the market as a whole and the public are benefited by the professional's fulfillment of his obligations to that marketplace. This justification may not apply if a professional on an exchange floor derives market information with respect to the market for one security and uses that information to profit by trading in a market for another security.

In addition, when evaluating proposals to integrate the trading of options and their underlying securities on an exchange floor, the Commission should consider the extent of additional market information and competitive advantages that would accrue to stock and options marketmakers on the exchange that has proposed the integration and determine whether these additional advantages are consistent with the statutory mandate that the securities markets be "fair." 241/ In other words, integration proposals should be designed to assure that there will be no "undue advantage

241/ See discussion at 19-21, supra.

or preference among participants in the marketplace" and that "differences in opportunity and treatment" among market participants making different uses of, contributions to, and demands upon the market will be "held to the absolute minimum consistent with the recognized differences." 242/

b. Manipulation and Other Improper Trading Practices

The integration of trading in options and their underlying securities on an exchange floor may create opportunities to engage in manipulative and other improper trading activities that do not presently exist. The fact that substantial profits may be earned from options positions as a result of small movements in the price of an underlying security may also provide an incentive to engage in such conduct. Since it may be relatively simple to move the price of an underlying security a small amount and relatively difficult to detect improprieties associated with such small movements, the opportunities to profit from improper trading conduct may be substantial while accompanying risks may be minimal.

AMEX has provided two examples involving trading on nonpublic market information by market professionals on an exchange floor that might occur in an integrated environment and that may be considered improper. In this regard, AMEX stated:

242/ Special Study, supra, n.63, at 14.

First there is what might be described as "quote racing". Assume the underlying stock is quoted in the primary market at 59 to 3/8 (500 x 500), last sale 200 at 59. A broker enters the crowd with a limit order to buy 5,000 shares at 59-1/4 and leaves the order with the equity specialist. An options marketmaker (or his partner or colleague, if the underlying stock is traded some distance away from the option) observes the order being given to the specialist and immediately asks for the quote and size. The specialist advises him that the new quotation is 59-1/4 - 3/8 (5,000 x 500), and then sends the new quote for processing and dissemination over the quote network. The options market maker can react instantaneously to the significant increase in size on the bid side of the market and, in anticipation that this will cause the stock to trade up, take the offer in one or more series of the related option class, particularly a series the price of which, because of the relationship of its strike price to the current price of the underlying security, is likely to move in direct relationship.

One may, of course, ask what is wrong with that result? The investor who was offering options obtained the price he was asking, didn't he? Yes, of course, the investor obtained his asking price. But the floor professional got a jump on every other potential purchaser of those options based on his access to reliable market information projecting increased demand for the underlying stock and thus probable higher prices for the option. Moreover, there is a possibility (perhaps not very probable, but at least a possibility) that the investor whose offer was taken by the floor professional, would have withdrawn that offer and made an offer at a higher price when the information showing strength in the underlying stock became publicly available.

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[Second], "Tape racing" offers floor professionals perhaps even greater opportunities to gain trading advantages over off-floor market participants because there is even less "guess-work" involved. Being aware that a trade has actually taken place in the underlying stock amounting to a significant price movement, the floor professional can quite confidently hit bids or pick off offers in the related option, secure in the knowledge that once the stock trade is printed there is very likely to be a similar movement in the price of the option.

The price movement in the underlying stock need not be dramatic in order to offer the floor professional an attractive trading opportunity. For example, assume the market in the underlying stock is 99 to 1/4. An order is entered to buy 2,000 shares at the market. This order is executed—200 shares at 99-1/4, 500 at 99-3/8, 300 at 99-1/2 and one thousand at 99-5/8. This upward pressure will clearly be reflected in a strengthening of the buying interest in the related options, particularly those series that have a strike price close to the current market price of the stock or are "in the money". Therefore, the floor professional, observing this activity in the underlying stock (or being informed thereof by his partner or trading colleague), buys options at the offer before the stock trades appear on the tape. Once information concerning this trading activity in the underlying stock reaches the public and is displayed at the options post, it is very likely that the price of the various series of the related class of options will react in a corresponding fashion, and the floor professional will be able to liquidate his position at a profit.

These examples demonstrate how rather routine trading situations * * * can provide significant opportunities for floor professionals to gain trading advantages. All that is needed is a few seconds for the floor professional to react while the market information is being processed and disseminated. Moreover, a great deal of market information, although very valuable to the floor professional in predicting immediate price trends in a security, may never be disseminated publicly. The fact that a particular broker who has previously evidenced interest in a security

has become active in the trading crowd; knowledge that a large order is being "worked" by a broker; the amount of activity building up in a trading crowd; these and other "tell-tale" indications are easily perceived by the knowledgeable floor professional and, if acted on promptly, can be turned into a trading advantage in the options market. 243/

In addition, opportunities for stock and options marketmakers to trade stock or options while in possession of nonpublic information concerning block transactions may be enhanced in an environment in which stock and options trading is integrated. Permitting a stock specialist to trade options with respect to his specialty stocks or a registered stock marketmaker to trade options for his own account, for instance, may give these market professionals opportunities that they do not now possess to trade options on the basis of block information concerning underlying stocks that may be derived, in large part, as a result of their stock marketmaking functions. An example may help to illustrate this point: Assume that XYZ stock and related options are traded at the same physical location on the floor of an exchange. Also assume that the market for (i) XYZ stock is \$55 1/4 - \$55 1/2 (300 x 300), last sale at \$55 3/8, (ii) XYZ January 45 calls is \$10 3/8 - \$10 5/8 (10 x 5), (iii) XYZ January 50 calls is \$5 3/4 - \$6 (80 x 40) and (iv) January 60 puts is \$5 - \$5 1/4 (10 x 20), If a marketmaker, whether for XYZ stock or options or both or neither, on the floor of the exchange, hears a block

243/ AMEX Letter, supra, n.90, at 39-41.

positioning firm inquiring of certain stock marketmakers as to their interest in purchasing a portion of a large block of XYZ stock at a price substantially below the last sale price, he may be able to anticipate a drop in the price of XYZ. He may be able to profit from this knowledge by accumulating a short position in the January calls and a long position in the January puts. He may accumulate these positions merely by bidding \$5 or \$5 1/8 for the XYZ January 60 puts and offering XYZ January 45 calls at \$10 5/8 or \$10 1/2 and January 50 calls \$6 or \$5 7/8. Moreover, if the marketmaker is not able to attract sufficient interest by bidding or offering at existing prices or slightly improving the market, he may also sell at the bid in the January 45 and 50 calls or buy at the offer in the January 60 puts. Later, when the block transaction is executed and the price of XYZ is depressed, the marketmaker may be able to close out his option positions profitably by making closing purchases of the January 45 and 50 calls and closing sales of the January 60 puts.

Integrating the trading of options and their underlying securities may also facilitate the manipulation of stock prices to protect and make option positions profitable by allowing marketmakers to assess the risks that may be associated with manipulative activity more accurately. If side-by-side trading were permitted, for example,

an options marketmaker with a substantial short position of near term at- or slightly out-of-the-money call options might more easily sell stock short with the intention of preventing the stock from "breaking through" the strike price if he were able to assess, due to his presence on the floor and his resultant ability to observe stock orders, transactions, and patterns of trading and quotations, the buying interest for the stock in the crowd and on the book.

An example of manipulative conduct that might occur in a dual marketmaking environment may further illustrate these points. Assume that A is a specialist making simultaneous markets in XYZ stock and options on the floor of an exchange that is the primary market for XYZ and its related securities. Also assume that on June 1 (i) XYZ opened at a price of \$75, (ii) the July 70 calls were selling for \$6 and the July 80 calls for \$2, and (iii) A had a long position of 400 XYZ July 70 calls and 400 XYZ July 80 calls. To profit from the long call positions, A might utilize his knowledge of the supply and demand in the market for XYZ to cause the price of XYZ to move up a small amount in a short time and might use his knowledge of the market for the XYZ calls to liquidate the July 70s and 80s at a profit. Thus, A may quote a market for XYZ of \$74 7/8 bid and \$75 1/8 offered after the market opened, the \$75 1/8 offered price reflecting A's own quotation and

offers at $\$75 \frac{1}{4}$ being present on the book. If a market order to buy 200 shares of XYZ were to enter the market, A might sell 100 shares to the customer from his inventory at $\$75 \frac{1}{8}$, immediately raise his offer to $\$75 \frac{1}{4}$, and sell the remaining 100 shares to the customer from the book at a price of $\$75 \frac{1}{4}$. Subsequently, A might adjust his quotation to $\$75$ bid and $\$75 \frac{1}{4}$ offered. If a market order to sell 300 shares were to then come to the floor, A might purchase the shares at $\$75$ if there were no orders on the book or in the crowd at that price to assure that the bid price did not decline. As additional orders to buy or to sell XYZ entered the market throughout the day, A might continue to sell from the book until all book orders were filled at a particular price, adjust his quotations upwards, and buy at the bid price for his own account only to the extent necessary to assure that the bid did not decline. As a result of this trading, the price of XYZ might be raised to $\$76$ at the end of the day and A might be a net purchaser of XYZ. Assume, for the purposes of this example, that A was net purchaser of 1500 shares at an average price of $\$75 \frac{1}{2}$.

The following day, with A opening the market by quoting a bid price of $\$75 \frac{7}{8}$ and an offered price of $\$76 \frac{1}{8}$, A might liquidate his positions in the XYZ July 70 and 80 calls utilizing limit orders that may be in the book, and orders that may be in the trading crowd. The average premiums that A receives in this liquidation might be $\$7$ for July 70 calls and $\$2.50$ for the July 80 calls. If A is also

able to later liquidate his 1500 share position in XYZ at an average price of \$75 1/2, again using limit orders in the book and orders in the crowd, he would have obtained a \$60,000 profit on his option trading by causing a one point move in XYZ in one day. The derivative nature of option pricing and the leverage characteristics of options provide the dual marketmaker with the incentive to effect the transactions described in this example. Access to the market information in the limit order books and in the trading crowds for the stock and its options may facilitate his activities. Of course, the profitability of such conduct may depend upon the amount and price of stock that must be absorbed to move the stock price as well as upon the ability of the dual marketmaker to liquidate his option positions while the stock price is at an artificially high level and his stock positions without sustaining a loss that would significantly diminish his option profits.

c. Potential Conflicts in Marketmaking Obligations

The transactions of stock and options marketmakers who are registered with a national securities exchange are required to constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market, 244/ and such marketmakers may not enter into transactions or make

244/ See, e.g., CBOE Rule 8.7(a); AMEX Rules 170, 114(b) and 958(b); NYSE Rules 104, 107B(2); MSE Article XXX, Rule 9, Article XLVII, Rule 6(a); PSE Rule II, Sections 7(a), 9(g) and 10(d) Rule VI, Section 79(a) and PHLX Rules 215, 1014(a). See also 17 C.F.R. 240.11b-1(a).

bids or offers that are inconsistent with such a course of dealings. ^{245/}
 In addition, registered marketmakers generally have a "continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for their own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between option contracts of the same class." ^{246/}

Since specialists and marketmakers who are registered with a national securities exchange have obligations to the markets for the securities in which they are registered to deal for their own account, stock and options marketmakers on an exchange floor may be required to assume similar obligations with respect to both options and underlying securities in which they may be making markets if the integration of stock and options trading is permitted. ^{247/} This may create economic incentives and trading opportunities for these marketmakers to engage in conduct that might be considered inconsistent with their obligations to one or the other market. For instance,

^{245/} Id.

^{246/} CBOE Rule 8.7(b). See also AMEX Rules 170 and 114(c); PHLX Rule 1014(f); PSE Rule II, Sections 9(g) and 10(d), Rule VI, Section 79(b); MSE Article XXX (Interpretation and Policies (.01)) Article XLVII, Rule 6(b); NYSE Rule 104.01, 170B(3).

^{247/} See, e.g. CBOE Plan, supra, n.6, Proposed Rules 8.7(a) and 8.7(b).

were a marketmaker to acquire a substantial long position in a stock in order to alleviate a temporary excess of supply over demand and to write call options against that long position in order to hedge the position partially, the writing activity might be viewed, if measured by traditional standards, as inconsistent with the marketmaker's obligations to the options marketplace if supply in that marketplace also exceeded demand. 248/

248/ CBOE has summarized the potential conflict in marketmaking obligations as follows:

Traditionally, a unitary market-maker (specialist) in an auction market has been expected to trade for his own account as needed to even out temporary disparities in supply and demand (the so-called "affirmative" obligation), but not to trade in such fashion as to dominate or "lead" the market or destabilize it (the so-called "negative" obligation). Since the supply and demand balance for options generally tends to parallel that for the underlying stocks, it is likely that, by and large, a market-maker in stocks and a market-maker in options would be dealing on the "same side" of the market in fulfilling these obligations. On the other hand, particularly in an institutional market with many block transactions, one who is a market-maker in stocks alone would often want to hedge in the options market — an "opposite side" transaction — and an options market-maker likewise would want to hedge in the stock market, in fulfilling their respective obligations.

Side-by-side trading would not affect any of the foregoing, but dual market-making could raise a serious question of conflicting obligations * * * between [the] possible obligation [of] 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.

CBOE Letter, supra, n.87, at 24-25.

When evaluating proposals to integrate stock and options trading on the exchange floor, the Commission should consider the extent to which such integration may create incentives and opportunities for marketmakers to engage in activity that may be deemed to conflict with their obligations to the market for options or their underlying securities. Ultimately, the Commission should determine whether marketmaking activities that may be considered to be inconsistent with marketmaking obligations that may arise in connection with integration proposals should be permitted, and, if so, whether any inconsistencies that may result might be adequately resolved, lessened, or regulated by means of surveillance, disclosure, rulemaking, or otherwise.

It should be kept in mind, however, that certain forms of integration, most probably including dual marketmaking, may not be feasible if marketmakers are prohibited from engaging in transactions in an underlying security or its related options if the transactions were, or could be deemed to be, inconsistent with the marketmaker's obligation to the market for either security. In this regard, the Commission should consider the extent to which marketmaking capacity for options or their underlying securities may be reduced if marketmakers in an integrated environment were not permitted to engage in transactions that may be deemed to be inconsistent with their obligations to the market for either security.

d. Market Surveillance

The integration of trading in options and their underlying securities may increase the difficulty of detecting improper trading practices on an exchange floor. Additional market information and competitive advantages, increased opportunities to engage in manipulative and other improper activities, and potential conflicts in marketmaking obligations, however, enhance the importance of conducting adequate market surveillance in an integrated trading environment.

Market surveillance may become more difficult if further integration of stock and options trading is permitted for two primary reasons. First, much of the market information that may become a basis for making trading decisions in an integrated environment may never be publicly disseminated 249/ and, at least partially as a consequence, may not be routinely available for surveillance purposes. Unexecuted order information, indications of buying and selling interest, and the presence of a broker working a large order in a crowd are examples of such information. It is likely that trading on the basis of this type of market information would be more common if the trading of stocks and their related options were further integrated, and the extent to which exchange surveillance programs could be designed to monitor trading on the basis of such information should be evaluated as integration proposals are reviewed.

249/ See discussion at 102-103, supra.

Second, the ability to observe or otherwise obtain information concerning orders, transactions, and patterns of trading and quotations may permit stock and options marketmakers on exchange floors to more continuously and more accurately assess the risks that may be associated with improper trading conduct. ^{250/} Manipulations of stock prices to benefit options positions, for instance, may be undertaken with greater precision if a market participant on an exchange floor is able to evaluate accurately the supply of and demand for a security by observing the buying and selling interest in a trading crowd, the depth of orders on the book, and the trading patterns of market participants at a trading post. Such information may permit the effectuation of manipulative or other improper activities while buying or selling only the minimum amount of a security necessary to accomplish the intended purpose. In fact, this information may permit a market participant on an exchange floor to obtain the ends he seeks merely by placing orders with a floor broker or specialist. Since existing market surveillance systems often focus upon stock transactions involving more than a predetermined number of shares, it may become less likely that improper stock trading to benefit options positions will be detected if such trading may be successfully accomplished with smaller

^{250/} See discussion at 102-105, supra.

and smaller amounts of stock. Moreover, to the extent that improper ends can be achieved by means of orders, manipulative activity may be even more difficult to detect because the exchanges do not presently maintain and utilize for surveillance purposes records of all orders that are entered on their floors and because the availability and completeness of order information varies significantly among the exchanges. 251/

It should also be kept in mind that integrating the trading of options and their underlying securities may create surveillance difficulties that do not currently exist. For example, to prove that quote racing, tape racing, or front-running occurred in an integrated trading environment, 252/ it may be necessary to prove the time that a quotation was given or the time that a transaction took place rather than the time that the quotation or transaction was entered into the price reporting system. 253/ It may also be necessary to establish that a market participant had knowledge of a stock quotation or transaction prior to the time of his option quotation or transaction. Given the differences that may exist between the time

251/ See Chapter IV.

252/ See discussion at 108-111, supra.

253/ See Chapter IV.

that a quotation or transaction occurred and the time that it was reported, 254/ it may be difficult to prove the required knowledge simply by presenting evidence comparing the times that transactions or quotations were entered into a price reporting system, particularly if a market participant denies knowledge of the quotation or transaction that took place first. In other words, as a practical matter integrating stock and options trading may make it more difficult to determine precisely who did what with whom at what time and who knew about it.

This is not to suggest that adequate market surveillance cannot be conducted in an integrated trading environment. Rather, it is to emphasize that the increased market information and competitive advantages, opportunities to engage in manipulative and other improper trading practices, and potential conflicts in marketmaking obligation that may accompany the implementation of plans to integrate the trading of options and their underlying securities may, when coupled with the limitations of existing surveillance information, make more difficult the task of monitoring the markets for the securities being traded together. In light of the Commission's obligation to assure that the exchanges "enforce compliance by [their] members and persons associated with [their] members with the provisions of [the Exchange Act]" 255/ and that the exchanges have rules

254/ See Chapter IV.

255/ Section 6(b)(1) of the Exchange Act [15 U.S.C. 78f(b)(1)].

designed "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, * * * and, in general, to protect investors and the public interest," 256/ the Commission should specifically consider the adequacy of surveillance programs that exchanges proposing to integrate the trading of options and their underlying securities would use to monitor such trading.

3. The Extent of Integration

Proposals to integrate the trading of options and their underlying securities may contemplate various forms and degrees of integration. Integration may occur with respect to the physical environment in which trading would occur as well as with respect to the performance of market-making functions. For instance, integration plans that would allow specialists and marketmakers to trade options and their underlying securities while maintaining the physical separation between stock and options trading floors and a strict separation of stock and option marketmaking functions may involve the least amount of integration. 257/

256/ Section 6(b)(5) of the Exchange Act [15 U.S.C. 78f(b)(5)].

257/ It should be kept in mind that options specialists and marketmakers are already permitted to trade underlying securities without restriction and that stock specialists and registered stock marketmakers on secondary exchanges are not restricted in their ability to trade options. See discussion at 94-95, supra.

On the other hand, integration proposals that contemplate trading options and their underlying securities at the same physical location and simultaneous marketmaking in all related securities by an individual or firm would involve the highest degree of integration.

Between these ends of the spectrum, a wide variety of integration plans may be designed involving varying modes of integration. It may be feasible, for example, to remove physical barriers between stock and options trading floors without permitting (i) the trading of these securities at the same physical location, (ii) the trading of options by stock specialists or registered stock marketmakers, or (iii) the integration of marketmaking functions. Plans may also be designed to allow the trading of options and their underlying securities at the same physical location while maintaining existing restrictions concerning (i) stock specialist and registered stock marketmaker options trading and (ii) the integration of marketmaking activities. In addition, proposals may be submitted which would permit (i) the trading of options and their underlying securities at the same physical location, and (ii) stock specialist and registered stock marketmaker options trading, but would continue to separate stock and options marketmaking functions. Involving a still higher degree of integration, plans may contemplate (i) trading options and their underlying securities at the same location, (ii) trading in all related securities by all market participants, (iii) marketmaking in all related securities by a specialist or other marketmaking firm, but prohibiting simultaneous marketmaking in options and their underlying stocks by an individual.

These examples are not intended to, and of course do not, exhaust the possible forms that integration proposals may take. Rather, they have been provided to place the integration proposals that have already been made in perspective with regard to the degree of integration that they would entail. ^{258/} The form and degree of integration is an important factor to consider because the extent of improvements in the quality of markets and the severity of regulatory concerns that may result from such proposals may vary directly with the extent of integration proposed. The quality of the markets for options and their underlying stocks may improve in direct proportion to the extent that integration is permitted because each step that is taken toward complete integration may enhance the ability of stock and options specialists and marketmakers to limit the risks associated with their marketmaking activities, to obtain more complete information concerning the supply of and demand for related securities, and to act upon such information quickly. This, in turn, may increase the ability of these marketmakers to make deeper and more liquid markets. In addition, the greater the degree

^{258/} The CBOE Plan contemplated a complete integration of stock and options trading. See discussion at 97-98, *supra*. The NYSE concurrent trading proposal may, by comparison, result in a far lesser degree of integration. See discussion at 96, *supra*, and 145-147, *infra*. The secondary stock exchange proposals to remove the physical barriers between stock and options trading floors and to permit individuals to hold simultaneous marketmaker appointments in options and their underlying securities involve degrees of integration between those proposed by CBOE and NYSE. See n.8, *supra*.

of integration that is permitted, the greater the operational efficiencies that may result to retail firms and other market participants. At the same time, however, each step that is taken toward integrating the trading of options and their underlying securities may (i) provide more market information and competitive advantage to more market professionals on exchange floors, (ii) increase the opportunities to engage in manipulative and other improper trading conduct, (iii) increase the potential for conflicts in marketmaking obligations, and (iv) make effective market surveillance more difficult.

4. Characteristics of the Exchange

The characteristics of the exchange proposing to integrate the trading of options and their underlying securities may also directly impact upon the extent of improvements in market quality and the severity of the regulatory concerns that may result from integration. The role of the exchange making the integration proposal in the markets for the securities that would be subject to the proposal should be considered when any integration proposal is evaluated. More specifically, whether the exchange is the primary market for the securities involved, 259/ and, if so, the extent to which it is able to attract more order flow than competing markets may be relevant considerations. In addition, the type of marketmaking system that the exchange uses, the extent of marketmaking

259/ See n.111, supra.