THE NASDAQ OPTIONS PLAN: AN OVERVIEW

INTRODUCTION

The National Association of Securities Dealers, Inc. (the "NASD" or "Association"), has developed a program for the quotation display of put and call options written on certain designated NASDAQ securities and indexes. For purposes of this program, the securities upon which NASDAQ options will be written will be chosen from those which are designated as National Market System (NMS) securities pursuant to Securities and Exchange Commission (SEC) Rule 11Aa2-1 and certain exchange-listed securities which are trading pursuant to Rule 19c-3. In addition, certain NASDAQ and NMS indexes will be utilized for cash settled index options, including the NASDAQ composite index and sub-indexes such as the NMS industrial index.

The options eligible for NASDAQ display ("NASDAQ options") will be selected in accordance with criteria established by the NASD, the Options Clearing Corporation (OCC) and the Securities and Exchange Commission. As is the case with options listed on the various exchanges, OCC will act as the issuer of all NASDAQ options including NASDAQ index options. Rules which are applicable to NASDAQ options will also apply to NASDAQ index options, except where stated.

Standardized as to exercise price, expiration date, and unit of trading in accordance with NASD and OCC rules, continuous markets for NASDAQ options will be maintained by qualified NASDAQ options market makers registered as such with the NASD. In that connection, an essential element of the NASDAQ Options Program will be the ability of certain market makers in NASDAQ securities to make markets simultaneously in NASDAQ options written on those securities. This practice, referred to as "side-by-side" or "integrated" market making, will be permitted under very carefully supervised, rigorously surveilled conditions providing appropriate regulatory safeguards.

NASDAQ options will be registered under the Securities Act of 1933 and in the various states by OCC. Covered by OCC's prospectus and a risk disclosure document meeting the requirements of Rule 9b-1 of the Securities Exchange Act of 1934, as amended, each NASDAQ option will be exercisable through OCC, which will also serve as the obligor of all NASDAQ options.

In order to utilize the services and facilities of OCC, the NASD will acquire OCC stock subsequent to its plan being filed with and approved by the Securities and Exchange Commission and following the approval of such stock acquisition by OCC's Board of Directors and its existing participant owners.

In structuring the NASDAQ Options Program, the NASD determined to preserve the essential elements of a competitive dealer market and to incorporate standards comparable to those applied to exchange-traded options, including rules and regulations governing members' trading and sales practices. Included among these are a provision for the last sale price reporting of completed transactions in NASDAQ options contracts to the Options Price Reporting Authority (OPRA). In this connection, an automated execution system and other automated features are being designed for the NASDAQ Options Program. These features, which are discussed below, will create "locked-in" trades for price reporting and clearing purposes and advanced, automated market surveillance capabilities for NASDAQ options.

The NASDAQ Options Automated Execution System ("NOAES") is being designed to provide automated executions of options trades. Initially, this system will provide for automatic executions for trades up to three (3) contracts. NOAES will facilitate execution of such options trades against the best bids or offers for options in the system on a preferenced or non-preferenced basis. Only customer orders will be subject to automatic executions. NOAES will provide for "locked-in" trades and automatic confirmation of trades to both parties and reporting of trades to OPRA. In addition, NOAES will capture clearing data for timely submission to OCC at the end of the trading day.

In addition to automated execution of small orders, NOAES will also provide for a new transaction, the Order Confirmation Transaction ("OCT"). In this mode, transactions in options will take place along conventional lines, i.e., negotiated via the telephone. Immediately thereafter, the "seller" will enter the trade detail into his NASDAQ terminal and the message will be routed to the contra-party. When an OCT is entered into NOAES and the entry is accepted by the contra-party, both parties will have the advantages of the "locked-in trade" and the reporting features of NOAES. The OCT mode will be utilized by the options participants to execute and/or report negotiated trades not subject to an automatic execution.

All NASDAQ options transactions will be required to be executed or reported via NOAES. Therefore, all trades in NASDAQ options will be either automatic executions or negotiated transactions which are affirmatively accepted by both parties through an OCT. In either event, option trades will be "locked-in" for clearing purposes. For this reason, an options trade comparison processor for NASDAQ options will not be needed and awkward, inefficient and costly procedures associated with the reconciliation of options transactions will be eliminated.

UNDERLYING SECURITIES

The selection of the underlying securities eligible to be subject to NASDAQ options will be governed by the Association in accordance with established requirements.

Prior to securities being authorized by the Association as underlying securities for NASDAQ options, the issuer of the underlying security will be given the opportunity to approve or disapprove the use of its securities for options purposes.

The Association's eligibility criteria, designed to demonstrate and assure that each underlying issue meets the maxim of being "widely held and actively traded," will conform to the standards approved by the SEC and presently in force among OCC and its participant exchange owners. The NASDAQ Options Program will, of course, permit the writing of options on underlying issues traded in the NASDAQ National Market System (NMS). As of May 4, 1984, 872 NASDAQ securities were traded in the National Market System.

In addition to being NMS designated, issuers of underlying securities must be registered under the Securities Exchange Act of 1934 and subject to certain reporting and disclosure requirements of the Exchange Act, unless specifically exempted therefrom by the SEC. Further, the underlying securities must satisfy the following additional requirements which are identical to those to those of the options exchanges for underlying listed issues; a 7,000,000 share public float, a price per share of $10, cummulative net earnings of $1,000,000 for the preceding eight quarters, 6,000 beneficial shareholders, an annual trading volume of 2.4 million shares and no defaults by the issuer in the preceding year.

The Association also has established minimum requirements as maintenance standards for the continued approval of underlying securities previously selected for NASDAQ options. These standards conform to those approved by the SEC and adopted by the various exchanges.

There are currently 253 NASDAQ NMS issues named in the Association's options filing with the Securities and Exchange Commission. Of these securities, the Association has identified 94 issues which it believes would be suitable for inclusion in the NASDAQ Options Program during its initial phase.

NASDAQ OPTIONS CONTRACTS

The Association will establish classes of options (that is, all options contracts of the same type in the same underlying security) eligible for NASDAQ display. Within each class of options, there will be three or more series of options contracts. A series of options will include all options in an underlying security having the same exercise price, expiration date and unit of trading. A unit of trading for each NASDAQ option contract relating to common stock will cover 100 shares of the underlying security. The unit of trading for NASDAQ index options will be the stated value of the underlying index multiplied by an index multiplier specified by the Association. The Association currently intends to utilize an index multiplier of $10 for all NASDAQ index options. The expiration dates or cycles for NASDAQ options will be set at three, six and nine month intervals.

The exercise prices of NASDAQ options will be set at prices which are reasonably close to the market price of the underlying security or the most recent computation of the underlying index at the time a series is opened for display on the NASDAQ System.

A new series of options could be opened with the same expiration date but with a different exercise price to reflect price movements in the underlying security. Presently, it is contemplated that the exercise prices of NASDAQ options will be fixed at five-dollar intervals for underlying securities trading below $100 and ten-dollar intervals for underlying securities trading at or above $100. NASDAQ index options will have five point strike price intervals. By way of example, assume that options in XYZ are authorized by the Association in April for display on NASDAQ at a time when the last reported sale in XYZ securities is $52. The Association will authorize series of call options having strike (exercise) prices of

$50 and $55. Such options will expire in July, October and January. If the bid in XYZ securities moved to 55 1/8, additional series of options would be established with strike prices of $60 and with similar expiration cycles.

NASDAQ OPTIONS QUOTATIONS SYSTEM

The NASDAQ System will be technically modified to accommodate the display of NASDAQ options. Once modified, the NASDAQ options quotation system and the present NASDAQ securities quotation system will be substantially the same. Accordingly, the three levels of service described below will provide for similar registration, updating and retrieval techniques.

- Level 1 terminals will provide up-to-the-minute last-sale reports for each NASDAQ option.

- Level 2 terminals will display each NASDAQ option and list each registered options market maker with its most recently entered quotations, in addition to the last reported sales prices for both the option and its underlying security, daily high and low, daily volume, time of last sale and inside quotations.

- Level 3 terminals will provide registered NASDAQ options market makers with the ability to enter or update quotations in a particular NASDAQ option.

The NASDAQ System will provide for the last-sale price reporting of completed transactions in NASDAQ options contracts. The Association will interface with the Consolidated Options Tape administered by OPRA and last sale trade price information in NASDAQ options will be transmitted to OPRA and distributed by OPRA over the OPRA Tape. Last-sale reports for transactions which are automatically executed will be simultaneously and automatically reported to OPRA. Last sale price reports for OCT transactions will be reported at the time the OCT message is entered. The party currently responsible for NMS trade reporting, normally the seller, will have the responsibility for entering OCT's into the system.

NASDAQ OPTIONS AUTOMATED EXECUTION SYSTEM (NOAES)

As noted, the Association's proposed Options Program will provide for the automatic execution of orders in stock options and index options as an integral part of the service. The system will automatically execute entered trades creating a "locked-in trade" by reporting the trade to OPRA, forwarding confirmations to both sides of the execution, and producing clearing data and forwarding such to OCC.

This capability will be limited to small customer orders and will function in a manner which is similar to the Association's proposed Small Order Execution System ("SOES"). Additionally, a new transaction, the Order Confirmation Transaction, will permit trades which are not automatically executed to be captured by the system. When this type of transaction is entered into the system and the entry is accepted by the contra-party, both parties will have the advantage of a "locked-in" trade and the reporting features of the automatic execution system. The following describes, in general terms, features of the NASDAQ Options Automatic Execution System.

The NASDAQ Options Automatic Execution System will automatically execute orders in NASDAQ stock and index options. The system will permit the execution of orders initially for up to three (3) contracts in any NASDAQ stock or index option. NOAES orders will be executed against only one market maker and may be preferenced or non-preferenced. Preferenced market makers will receive a NOAES execution only if such market maker has the best displayed quotation. Non-preferenced orders will be executed on a rotating basis against market makers displaying the best NOAES quotation.

Participation in NOAES will be mandatory for all options market makers. Therefore, all NASDAQ options quotations displayed will reflect prices at which automatic executions may be effected. The automatic execution system will thus able to automatically execute transactions at the "best" displayed NASDAQ option bid or offer.

NOAES market makers may set exposure limits on individual option series which may be changed on-line during the trading day. When a market maker's exposure limit is exhausted, the market maker's quotations will be deleted from NOAES. However, the market maker's symbol identification will continue to be displayed.

In the event that there is only one market maker at the best NOAES bid or offer and such market maker's exposure limit is exhausted, the next best remaining quotation will automatically become the new best bid or offer for purposes of automatic executions.

In the event all market makers' exposure limits in a particular option are exhausted, NOAES will display the bid and offer of the last market maker whose exposure limit was exhausted and automatic executions will continue on a rotating basis among all registered market makers in the option at that price until new quotations and/or exposure limits are entered into NOAES by affected market makers.

ORDER CONFIRMATION TRANSACTIONS (OCT)

The Order Confirmation Transaction will allow an order entry firm to contact a NASDAQ options market maker via telephone and negotiate a trade which is not subject to an automated execution. The "sell" side of such transaction will then be required to enter an OCT message into the system within 90 seconds. Fields will be provided in the OCT to indicate information to be reported to the OPRA Tape and the trade will be reported to OPRA upon the entry of the OCT. The party receiving the confirmation message via the system will be given a time limit of 90 seconds in which to accept the message which will provide all the fields of trade information required to be "locked-in" for clearing purposes. If the message is accepted, the transaction becomes a "locked-in" trade to be reported to OCC at the end of the trading day. In the event a member fails to respond to an OCT message, such message will be retained in NOAES for reconciliation at the close of the trading day. The OTC feature conbined with the automatic execution system will permit both large and small orders to become "locked-in" trades.

SIDE-BY-SIDE MARKET MAKING

Secondary markets for NASDAQ options will be maintained in a manner comparable to the secondary markets for NASDAQ equity securities. Market makers, qualified and registered with the Association specifically for NASDAQ options, will create and maintain over-the-counter markets in NASDAQ options. They will purchase and sell (write) for their own accounts and maintain inventories in the NASDAQ options in which they make a market. Thus, a firm having a customer's order to buy or sell a NASDAQ option, whether acting as a broker or dealer, will go to a market maker to make the purchase or sale.

An essential element of the NASDAQ Options Program will be the ability of market makers in underlying securities quoted on the NASDAQ System to make markets simultaneously in NASDAQ options written on those securities. Such side-by-side market making was approved in principle by the Securities and Exchange Commission on September 24, 1976. In giving its approval, the Commission stated, in part, that:

> ". . . an options program along the lines discussed in the NASD's analysis would be consistent with the Securities Exchange Act of 1934 and that, in an environment of vigorous competitive market making, it would be appropriate to permit market makers, if they choose, to make markets in both the options and the underlying securities. In reaching that conclusion, the Commission recognized that the market operated through the NASDAQ System is relatively free of anti-competitive restraints and should therefore provide an opportunity to test the extent to which competition can be an effective regulator of a unified market for options and their underlying securities." 1/

The Commission went on to express concern over the environment in which side-by-side trading may be permitted, wishing to be certain ". . . that environment provides for appropriate regulatory safeguards." 2/

In connection with and in response to these concerns, the Association's rules will impose specific requirements on side-by-side market makers who will also be bound by rules which are applicable to all members. The special rules applying to side-by-side market makers are as follows:

- In order for a member to make a market simultaneously in an underlying security and the options relating thereto, there will have to be a total of at least ten (10) registered market makers in such underlying security and at least five (5) registered market makers in each option group in respect to which side-by-side market making is intended.

1/ Letter to Gordon S. Macklin from Roderick M. Hills, dated September 24, 1976.

2/ Id.

- Side-by-side market makers will be required to report information with respect to transactions and positions in conventional, over-the-counter options covering those securities in which NASDAQ options markets are being made.

- In effecting a NASDAQ option transaction with or for a customer, a side-by-side market maker will be required to disclose such function on the confirmation sent to the customer.

- Once side-by-side market making has begun, permission for further side-by-side market making in new options series will be withdrawn if there are fewer than seven (7) registered NASDAQ market makers displaying quotations on the NASDAQ System in the underlying security or there are fewer than three (3) registered NASDAQ options market makers displaying quotations on the NASDAQ System in the NASDAQ options group. Whenever the Association withdraws its approval for side-by-side trading in a particular options series, it will not reinstate side-by-side trading until there are again ten (10) market makers in the underlying security and five (5) in the option series.

The Association's plan will permit side-by-side market making only by members who agree to be "primary" market makers. "Primary market makers" will be those members who register as such with the Association and agree to be subject to the commitment and penalty rules discussed below.

Primary market makers will be obligated, upon undertaking this designation, to continuously quote all options in their primary markets through the completion of all expiration cycles which are open for trading in such markets at the time the member's registration as a primary market maker becomes effective. Such obligation will also apply to any new option series added in those expiration cycles during the term of the market maker's commitment. Thus, a member becoming a primary market maker in XYZ options at the expiration of the October options will be required to remain in the market through the expirations of all January, April and July XYZ options, a period of approximately nine months.

Further, should the primary market maker elect to commence quotations in options series in a subsequent expiration cycle, the market maker's commitment to continuously quote options will extend through the expiration of such options. This will extend the market maker's commitment for three additional months.

Thus, in the above-referenced example, if the primary market maker in XYZ options commences quotations in new October XYZ options upon the commencement of trading in these options in January, the member will be obligated to quote all XYZ options in the October expiration cycle until the end of that expiration cycle, i.e., for a period of nine months.

Any primary market maker failing to abide by these commitments will have its market maker registration revoked and will not be permitted to re-register as an options market maker in such options until the expiration of both the near term expiration cycle and the expiration cycle which follows. Thus, a primary market maker in XYZ options withdrawing quotations from the NASDAQ System for any open XYZ option contract in, say, September, will have its registration as a market maker in XYZ options terminated and will not be permitted to re-register as a market maker in XYZ options until the expiration of the January options.

In addition to the above-referenced penalties, primary market makers failing to abide by the commitment rules could have their market maker registration in the underlying security revoked for a period of time, subject to disciplinary procedures which will offer rights of due process to the member. In addition, primary market makers whose quotations are withdrawn during the fifteen (15) business days preceding the expiration of an option series may be found in violation of Article III, Section 1 of the Association's Rules of Fair Practice which obligates members to act in accordance with high standards of commercial honor and just and equitable principles of trade. The application of Article III, Section 1 in such situations will, of course, follow Association procedures providing members with due process and rights of appeal.

Other specialized rules have been developed to govern NASDAQ options trading, not only by side-by-side market makers, but also by other market makers, retail firms and their customers as well. These rules are comparable to the standards presently applied to options trading on the various exchanges. They are intended to prevent manipulative abuses in NASDAQ options and their underlying securities and to assist in the detection of manipulative activities. These rules include the following:

- Position Limits
- Exercise Limits
- Liquidation of Positions in Excess of Position/Exercise Limits
- Limits on Uncovered Short Positions
- Restrictions on Options Transactions and Exercises
- Reporting of Options Positions

MARKET AND MEMBER SURVEILLANCE

A key feature of the NASDAQ Options Program will be the unified surveillance and regulation of the trading markets for both NASDAQ options and their underlying NASDAQ equity securities. This simultaneous surveillance and regulation will be performed by the Association's Market Surveillance Section in a manner comparable to that in which NASDAQ equity securities are presently surveilled.

The locked-in trade features of NOAES will provide an unimpeachable audit trail for options transactions when NOAES trade data is integrated with clearing data. Thus, the Association will be able to capture and analyze all trade data for options in addition to all quotations and quotation changes.

An equity audit trail will be implemented which will allow the NASD to reconstruct transactions in underlying equities as well. The audit trail will be augmented by the SOES system which will create a significant volume of "locked-in" trades in underlying stocks.

From quotation and last-sale data for options and their underlying equity securities, a series of daily computerized reports will be produced by the NASDAQ System. The information on these reports will be displayed in such a way as to facilitate the review by a market surveillance analyst of every transaction and/or quotation for an option and its underlying security, particularly those which exceed pre-established parameters.

In addition to the reports produced in-house, the Market Surveillance Section will receive for review various reports produced by OCC and the National Securities Clearing Corporation (NSCC). From time to time, it will also receive various reports from members concerning options positions in various types of accounts. By means of these reports, the Association will have the capability to conduct a thorough and comprehensive monitoring of trading in both NASDAQ options and their underlying securities and to perform such surveillance on a comparative basis.

The comparative surveillance procedures developed by the Association will aid in the prompt and early detection of fraudulent activities in a NASDAQ option or its underlying security from quotation on the NASDAQ System. Because markets for options and underlying securities will be integrated, the problems of inter-market surveillance of options and underlying securities will be eliminated.

OPTIONS COMMITTEE AND BOARD OF GOVERNORS OVERSIGHT

Subsequent to the commencement of NASDAQ options trading, the Options Committee together with the Association's Board of Governors will closely monitor the operation of the NASDAQ Options Program and the initial package of specialized options rules as adopted. Based on such review and as deemed appropriate, alteration, amendment, supplementation or abrogation of certain rules will be made and filed with the Securities and Exchange Commission for its approval.

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NASDAQ OPTIONS FACT SHEET

The NASDAQ Options Program will provide quotation, execution, trade reporting and comparison facilities necessary for NASDAQ market makers to trade standardized put and call options on NASDAQ NMS securities and indexes in the over-the-counter market. The Program will also provide for comprehensive regulation of the NASDAQ options market and unified surveillance of markets for NASDAQ options and underlying equities.

Underlying Securities

The NASDAQ Options Program will permit registered options market makers to trade options on approved NASDAQ NMS securities. The selection criteria for these underlying securities, which are identical to those of the options exchanges, are:

- Annual trading volume of 2.4 million shares
- Public float of 7 million shares
- Price of $10 per share
- 6,000 beneficial shareholders
- Cummulative earnings of $1,000,000 for eight quarters preceding authorization
- No defaults by the issuer in the 12 months preceding authorization

Prior to the commencement of trading in options on eligible securities the issuer would have the right to approve the use of its securities for options.

NASDAQ Options

NASDAQ options will be standardized as to strike price and expiration. Expirations will be at three, six and nine month intervals and strike prices will be established in the same manner as listed options.

NASDAQ options will be issued by the Options Clearing Corporation ("OCC") and subject to OCC rules relating to their exercise and settlement.

Market Making in NASDAQ Options

Market makers in NASDAQ options will quote firm, continuous markets in options via NASDAQ. The NASDAQ system will be modified to permit market makers to enter and update options quotations through the system. Inside quotations will be disseminated to subscribers, the Options Price Reporting Authority ("OPRA"), vendors and wire services.

Integrated Market Making

Subject to special registration requirements and rigorous surveillance, members will be permitted to make markets simultaneously in both options and underlying securities, a practice referred to as "integrated" or "side-by-side" market making.

As a pre-requisite for side-by-side market making, there must be at least ten registered market makers in the underlying security and five market makers in related options. Integrated market making will not be permitted in new options series if the number of market makers in the stock and related options falls below seven and three, respectively. As NASDAQ options will be permitted only on the largest, most active underlying issues, dealer competition in the trading of these securities will deter abuses in the integrated trading of stocks and options.

Members who wish to make side-by-side markets must agree to continuously quote all options series through three expiration cycles, a period of approximately nine months. Members agreeing to the commitment rules are referred to as "primary" market makers.

If the primary market maker commences quotations in an options series subsequent to the initial three cycle commitment, the market makers' commitments will be extended through the expiration of that series.

Members who violate the above-referenced commitment rules may have their registration in an option suspended through the expiration of both the near-term options and the expiration cycle which follows. In addition, primary market makers violating the commitment rule may have their market maker registration in the underlying security suspended for up to 30 days. Unexcused absences from the system by primary options market makers during the fifteen business days preceding the expiration of an option series may result additional disciplinary actions against the member. The commitment rules will assure continuous, liquid markets for NASDAQ options.

Systems for NASDAQ Options

Advanced systems are being designed for NASDAQ options trading. In addition to modification to the quotation system to accommodate options, the NASDAQ Options Program will include an automated execution system for small customer orders and "locked-in" trades for larger transactions.

NASDAQ Options Automatic Execution System ("NOAES")

All NASDAQ options market makers will be required to participate in NOAES, which will provide for automatic executions of agency trades of up to three contracts in all NASDAQ options. NOAES will be the first automatic execution system of its kind for options.

Orders routed to the automatic execution system may be preferenced or non-preferenced. Preferenced orders will be executed against the preferenced market maker if that member has the best displayed NOAES quotation. Non-preferenced orders will be executed on a rotating basis against those market makers having the best displayed quotation.

Market makers will be permitted to set exposure limits on the number of automatic executions they will accept at their NOAES quotation. Once a market maker's exposure limit is exhausted, the member's quotes will be deleted from NOAES and the member will be taken out of the NOAES rotation until new exposure limits are entered. Such market maker's symbol identification will, however, continue to be displayed.

Automatic executions via NOAES will automatically generate contra-broker confirmations, trade reports and clearing information.

Order Confirmation Transactions ("OCT")

The OCT will permit principal transactions and orders exceeding three contract size to be "locked-in" for clearing and reporting purposes.

OCT's will be negotiated via telephone in the traditional manner. Within 90 seconds thereafter, trade detail will be entered into a NASDAQ terminal by the member who would be responsible for NMS trade reporting. The OCT entry will immediately generate a trade report.

The OCT message will then be transmitted to the contra-party. Upon acceptance of the OCT message by terminal entry, the trade will be locked-in for clearing purposes and confirmations to both parties will be automatically generated.

OCT messages which are not accepted within 90 seconds will be retained in the system for subsequent confirmation. The OCT facility will also be available after the close of trading for corrections and reconciliation of unconfirmed messages. Because all transactions in NASDAQ options will be locked-in by OCT or by automatic executions, the costly and inefficient procedures normally associated with the over-night settlement of options transactions will be eliminated.

Market Surveillance

The locked-in trade features of NOAES and OCT, together with the NASD's ability to capture and retain all quotations entered into the system, will create a complete record of NASDAQ options transactions, permitting the NASD to compare transaction reports with market maker quotation changes to determine if frontrunning and other abuses have occured.

To compliment its surveillance of the NASDAQ Options Program, the NASD will implement an audit trail for underlying equities which will integrate trade and clearing data, thus enabling the NASD to identify contra-brokers representing agency orders and to reconstruct trading activity through automated reports.

The NASDAQ options and equity audit trail data will be merged into automated surveillance reports which will enable the Association to readily detect stock/options manipulations, frontrunning and other potential abuses associated with options trading. The unified surveillance of markets for both NASDAQ options and underlying securities utilizing highly automated systems augumented by field surveillance will advance NASDAQ options surveillance procedures because one regulatory organization, the NASD, will have oversight responsibilities for both options and underlying equity markets.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-20853; File Nos. SR-NASD-80-10; Amex-83-33; CBOE-83-53; NYSE-84-4; PSE-84-2; and Phlx-83-27]

Over-the-Counter Trading of Standardized Options and Exchange Trading of Options on Over-the-Counter Securities

ACTION: Extension of comment period and request for additional comments.

SUMMARY: The Commission has published notice of proposed rule changes submitted by the National Association of Securities Dealers, Inc. and five securities exchanges to trade options on over-the-counter securities. In view of the significant issues raised by these proposals, the Commission has determined to extend to June 15, 1984, the period for public comment on the proposals and to solicit additional written submissions of data, views and comments from interested persons, particularly with respect to the issues discussed in this release.

DATES: Comments should be received by June 15, 1984.

ADDRESSES: Interested persons should submit 15 copies of their views and comments to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 450 Fifth Street N.W., Washington, DC 20549, and should refer to File Nos. SR-NASD-80-10 or Amex-83-33, CBOE-83-53, NYSE-84-4, PSE-84-4, or Phlx-83-27, as appropriate. All submissions will be made available for public inspection at the Commission's Public Reference Room.

FOR FURTHER INFORMATION CONTACT: Alden Adkins or Sharon D. Lawson, Division of Market Regulation, 450 Fifth Street N.W., Washington, DC 20549, (202-272-2843 and 202-272-2855).

SUPPLEMENTARY INFORMATION:

I. Introduction

On June 12, 1980, the National Association of Securities Dealers, Inc. ("NASD") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act") submitted to the Commission a proposed rule change to establish an over-the-counter ("OTC") market in standardized put and call options on certain individual securities.[1] On June 28, 1982, the NASD submitted to the Commission Amendment No. 1 to this proposed rule change. Amendment No. 1, among other things, proposed to establish an OTC market in standardized put and call options on certain stock indices.[2] On December 1, 1982, the NASD submitted to the Commission Amendment No. 2 to the proposed rule change. Amendment No. 2 provided for the OTC trading of additional stock indices.[3] In addition, on December 22, 1983, the NASD submitted to the Commission several documents describing the proposed rule change, as amended; proposing certain changes to the proposal; and discussing certain issues raised in previous comments on the proposal.[4]

From November 1983 to February 1984, the Chicago Board Options Exchange, Incorporated ("CBOE"); American Stock Exchange, Inc. ("Amex"); Pacific Stock Exchange, Inc. ("PSE"); Philadelphia Stock Exchange, Inc. ("Phlx"), and New York Stock Exchange, Inc. ("NYSE") filed with the Commission pursuant to Section 19(b)(1) of the Act proposed rule changes to permit the listing and exchange trading of standardized options on securities that are not listed and registered on a national securities exchange under Section 12(a) of the Act ("OTC securities") but are designated as national market system securities under Rule 11Aa2-1(b)(1) under the Act ("NASDAQ/NMS Tier I securities").[5] In connection with their proposed rule changes, the CBOE, Phlx and PSE have requested that the Commission amend Rule 12a-6 under the Act, which effectively bars exchange trading of options on OTC securities.[6] In a separate release the Commission has proposed amendments to Rule 12a-6.[7] Those amendments, if approved, would remove the Rule's effective ban on exchange trading of options on OTC securities; Commission approval of those amendments would not, however, authorize any exchange to list and trade such options. Authorization of the actual exchange trading of options on OTC securities can be provided only by Commission approval of the exchanges' proposals described and discussed in this release.

In this release, the Commission describes the NASD proposal and the proposals submitted by the exchanges to list and trade options on NASDAQ/NMS Tier I securities. The purpose of this release is to extend the comment period on these proposals to June 15, 1984, and to solicit additional written submissions of data, views and comment regarding these proposals.

II. The NASD Proposal

A. Overview

The NASD proposes to display quotations in standardized put and call options on designated stocks ("NASDAQ options") and stock indices ("NASDAQ index options"). These quotations, to be displayed in the NASD's NASDAQ System, would be made by options market makers registered as such with the NASD. The options would be standardized as to exercise price, expiration date, and unit of trading, and would be registered with the Commission under the Securities Act of 1933 and in various states by the Options Clearing Corporation ("OCC"). NASDAQ options and index options would be exercisable through OCC, which would serve as issuer and guarantor of these options. The NASD proposal includes a provision for last sale reporting of completed transactions in NASDAQ options and index options contracts. In addition, the NASD proposes to establish an automated small customer order (three contracts or less) NASDAQ options execution system, and an "order confirmation transaction" feature that will "lock in" customer trades for more than three contracts in NASDAQ options and index options for price reporting, surveillance and clearing purposes. The NASD proposes to allow one entity to make markets contemporaneously in both NASDAQ options and their underlying securities, so long as certain conditions are satisfied. In addition, the NASD proposes to implement special surveillance measures to monitor trading in its proposed options.

B. Specific Features of the NASD Proposal

1. *Eligible Underlying Securities.* To

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[1] Notice of the proposed rule change was given in Securities Exchange Act Release No. 16979, July 15, 1980; 45 FR 53295, August 11, 1980.

[2] Notice of Amendment No. 1 was given in Securities Exchange Act Release No. 18917, July 28, 1982, 47 FR 33575, August 3, 1982.

[3] Notice of Amendment No. 2 was given in Securities Exchange Act Release No. 19330, December 13, 1982, 47 FR 57812, December 28, 1982.

[4] Submission of December 22, 1983, accompanied by letter dated December 22, 1983 from Gordon Macklin, President, NASD, to Douglas Scarff, Director, Division of Market Regulation, SEC (the "December submission"). The December submission was not made pursuant to Section 19(b)(1) of the Act and Rule 19b-4 thereunder; while the changes it proposes to the proposed rule change will eventually have to be filed as amendment to the proposed rule change pursuant to Rule 19b-4, the contents of this submission are included in the description and discussion of the NASD proposal set forth below.

[5] Notice of CBOE's proposal was given in Securities Exchange Act Release No. 20471, December 9, 1983, 48 FR 55939, December 16, 1983; notice of Amex's proposal was given in Securities Exchange Act Release No. 20498, December 16, 1983; 48 FR 56875, December 23, 1983; notice of PSE's proposal was given in Securities Exchange Act Release No. 20538, January 6, 1984, 49 FR 1808, January 13, 1984; notice of Phlx's proposal was given in Securities Exchange Act Release No. 20690, February 23, 1984, 49 FR 4684, March 1, 1984; and notice of NYSE's proposal was given in Securities Exchange Act Release No. 20691, February 23, 1984, 49 FR 7682, March 1, 1984.

[6] Rule 12a-6 essentially allows an exchange to trade an option on a security without registering that security under Section 12(a) of the Act only if, among other things, the security is registered under Section 12(a) on some other national securities exchange. Amex and the NYSE also understand that an amendment to Rule 12a-6 is a necessary precondition to approval of their proposals.

[7] *See* Securities Exchange Act Release No. 20854 (April 12, 1984).

be eligible to underlie a NASDAQ option, a security must be (a) a designated national market system security under Rule 11Aa2–1 of the Act, (b) displayed on the NASDAQ system and (c) either registered with the Commission under Section 12(g)(1) of the Act or issued by an insurance company meeting the conditions of Section 12(g)(2)(G) of the Act.[8]

The security must also satisfy certain criteria identical to those established by exchanges for stocks underlying individual stock options; [9] and the issuer of the security must consent to the inclusion of that security in the NASDAQ option program.[10]

2. *Proposed NASDAQ Options Automated Execution System.* The proposed NASDAQ Options Automatic Execution System ("NOAES") would automatically execute orders in NASDAQ stock and index options. This system would permit the automatic execution at the best NASDAQ displayed bid or offer of customer orders for up to three contracts. Participation in NOAES for a particular NASDAQ options class would be mandatory for all NASDAQ market makers in that option. All NASDAQ options quotations displayed, therefore, will reflect prices at which automatic executions may be effected. Each market maker will be able to enter "exposure limits" that act to specify the maximum number of contracts that the firm will be willing to buy or sell via automatic execution. Until the exposure limit is exhausted, however (*i.e.*, reaches zero) the market maker must accept one automatic execution for up to three contracts at his stated quotation if such quotation is the best quotation in the system.

If more than one market maker is displaying the best bid or offer, orders entered without designating a preferenced market maker will be automatically executed on a rotating basis against each market maker at that price. Preferenced orders, *i.e.*, ones designating a particular market maker, would also be allowed. A preferenced order will be executed against the preferenced market maker if his quote is equal to the best NOAES price and his exposure limit has not been exhausted. A firm would not be allowed to designate itself as the preferenced market maker. If the preferenced order cannot be executed against the preferenced market maker, the system will execute against the next market maker in the rotation at the best NOAES price.

The NOAES system will also permit the entry of preferenced pre-opening orders. Preferenced orders entered before the NOAES opening (which will occur at approximately 10:00 a.m., subject to the opening of trading in the underlying security) will be stored in the system and, if executed, will be executed at the best NOAES opening price. Each NOAES market maker will also be given the opportunity to decide how many of the pre-opening orders preferenced to him he wishes to accept for automatic execution at the best NOAES opening price. In the event a participating market maker elects not to accept for automatic execution all pre-opening orders preferenced to him, those orders will be retained in the NOAES system and executed automatically after the opening on a rotating basis against other NOAES market makers.

The NOAES system will automatically forward trade data from execution reports to the Options Price Reporting Authority ("OPRA") for dissemination to the distribution vendors. In addition, NOAES will forward to the clearing facility execution reports for both sides of the trade, resulting in a "locked-in" trade for clearing purposes.

3. *NASDAQ Options Orders Not Automatically Executed.* Under the NASD proposal, use of NOAES for small customer orders is voluntary and, as noted above, the system may not be used for orders larger than three contracts. Under the NASD proposal, there would be established an order confirmation transaction ("OCT") feature by which these orders would be reported. The order entry firm would contact a NASDAQ options market maker by phone and negotiate a trade. The "sell" side of the transaction would then be required to enter into the NASDAQ System an OCT message within 90 seconds. The trade will be reported to OPRA upon entry of the OCT message. The "buy" side of the transaction will have 90 seconds in which to accept the message.

If the message is accepted, the transaction becomes a "locked-in" trade to be reported to OCC at the end of the trading day. If a member fails to respond to an OCT message, the message will be retained in NOAES for reconciliation at the close of the trading day. All OCT messages, whether accepted or not, would be captured by the system.

Each side to a transaction would also be able to "break" the trade by mutual agreement in the event an incorrect OCT message is inadvertently accepted by the contra-party. Such "broken" trades will also be captured by the system.

4. *Side-by-Side or Integrated Market Making.* Under the NASD proposal, market makers in securities underlying NASDAQ options would be able to make markets simultaneously in NASDAQ options to those securities. The NASD proposes to impose specific requirements on these "side-by-side" market makers who, in addition, would be bound by rules applicable to all members. The specific rules that would apply to side-by-side market makers are as follows:

(1) In order for a member to make a market simultaneously in an underlying security and the options relating to that security, there would have to be at least 10 registered market makers in the underlying security and at least 5 registered market makers in each option group [11] in respect to which side-by-side market making is intended.

(2) Once begun, side-by-side market making in new options series would not be allowed if there were fewer than 7 registered NASDAQ market makers displaying quotations on the NASDAQ system in the underlying security or fewer than 3 registered NASDAQ options market makers displaying quotations on the NASDAQ system in the NASDAQ options group. Side-by-side market making would not be allowed until there were again 10 market makers in the underlying security and 5 in the options group.

(3) Side-by-side market makers would be obligated to quote continuously markets for all options series in which they were also making markets in the underlying security through the completion of all expiration cycles open for trading when the market maker started side-by-side market making. Should a side-by-side market maker elect to commence quotations in options series in a subsequent expiration cycle, the market maker's continuous quotation obligation would extend through the expiration of the cycle. If any side-by-side market maker failed to abide by this commitment, his registration as an options market maker in the options group would be revoked and he would not be permitted to re-register as a market maker in such options until the expiration of both the near term expiration cycle and the expiration cycle which follows:[12]

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[8] The NASD also proposes to allow a security registered on a national securities exchange to underlie a NASDAQ option if that security is not a "covered security" under Rule 19c–3 under the Act and if the security does not at the time of qualification for NASDAQ options trading underlie an exchange traded option issued by the OCC. The NASD has agreed to a deferral of Commission consideration of this portion of its proposal. For this reason, the Commission is not at this time soliciting comment on this aspect of the NASD's proposal.

[9] These eligibility criteria require in general: (1) A minimum public float of 7 million shares; (2) at least 6,000 beneficial owners of the security; (3) aggregate trading volume of at least 2.4 million shares during the 12 months preceding authorization of the option; and (4) a closing price of $10.00 per share on each business day for the 3 months preceding authorization of the option.

The NASD also proposes "maintenance criteria" for stocks underlying NASDAQ options that are identical to those used by the options exchanges. These criteria require that no new series be introduced in an option if, among other things, the underlying stock falls below certain volume, float and price levels.

[10] In addition to commenting on the specific issues discussed below, commentators might discuss the competitive implications of this proposed provision that the issuer's consent be required before NASDAQ options are traded on an otherwise eligible security.

[11] Under the NASD proposal, an option "group" is defined as all options contracts of the same class of options having the same exercise price and unit of trading but separate expiration dates.

(4) Side-by-side market makers would be required to report information with respect to transactions and positions in conventional, over-the-counter options covering those securities in which NASDAQ options markets were being made.

(5) In effecting a NASDAQ options transaction with or for a customer, a side-by-side market maker would be required to disclose such function on the confirmation sent to the customer.

5. *Other Options Rules.* The proposed NASDAQ options rules incorporate a number of other provisions contained in exchange rules covering standardized options on individual stocks. These include rules establishing position and exercise limits (2,500 or 4,000 contracts, identical to those used by the options exchanges); authorizing the NASD to impose limitations on the total number of uncovered short positions in a given class of options; authorizing the NASD to impose limitations on transactions in, or exercises of, one or more series of options in the interest of fair and orderly markets for options or their underlying securities; prohibiting market makers from entering into any options contract with the issuer, or any controlling person or affiliate of the issuer if the option covers securities of the issuer; and requiring reports concerning each account (member, associated person or customer) having an aggregate position of 200 or more options contracts on the same side of the market.

The NASD also proposes to apply to trading in NASDAQ options the same prohibitions against fictitious and pre-arranged trades, manipulation, and front-running as currently apply to exchange trading in options.

6. *NASDAQ Index Options.* The NASD also proposes to trade options on stock indices. The proposal contains two broad or market indices—a NASDAQ composite index, to be comprised of all NASDAQ stocks, and an NASDAQ NMS composite index, to be comprised of all NMS stocks. The NASD also proposes six sub-indices of each of these two broad indices. The NASD has not yet specified the stocks that would be included in these sub-indices, nor has it indicated how these indices would be calculated.

The NASDAQ index options would be cash-settled. Market makers in these index options would be registered as such with the NASD. The NASD has proposed to apply to NASDAQ index options margin requirements that are identical to those applied to exchange-traded index options.[13] The NASD has not yet specified in its rule filing the specific obligations of index options market makers, or position and exercise limits for NASDAQ index options.

7. *Surveillance.* The NASD states that it intends to implement a fully automated options trail that would include the following: locked-in options transaction information including class, series, price, size, time, buyer and seller, and retail identifier, for all options trading; individual options market maker quotations, including all upticks and downticks in the actual time sequence they occur; trade reports containing information on options, including transaction price, size, time, buyer and seller, retail identifier, and class and series information; daily options reports for members showing proprietary and customer account information on all positions of 200 contracts or more; and opening and closing interest information as provided by OCC. The NASD states that a substantial portion of the options audit trail data would be collected through the proposed automated execution (NOAES) and order confirmation (OCT) facilities described above.

In its December submission, the NASD stated that it is developing its equity audit trail for NMS securities by combining information collected through its price reporting system and the clearing process. The NASD Board of Governors at a meeting on March 16, 1984, voted to implement an equity audit trail for all NMS securities. The NASD has not yet worked out the full details of this equity audit trail, but expects to complete an audit trail "concept document" by June 1984.[14]

The NASD also describes the monitoring systems and reports it would modify or create to use the data collected in these audit trails. These systems would be comparable to those designed by the options exchanges and would be designed to detect known violations. In addition, these systems would monitor for specific possible problems raised by side-by-side trading such as stock option manipulation and fair pricing of customer orders. This section of the NASD submission is not described in detail here, but is available at the Commission or the NASD for those who are interested in reviewing it.

C. Request for Comments

The Commission invites comment on the specific aspects of the NASD proposal discussed below. We also encourage commentators to comment upon aspects of the NASD proposal not addressed here. Commentators are requested to be as specific as possible in recommending any changes they believe may be needed to the NASD proposal. The Commission will, of course, also consider comments previously made[15] regarding the NASD proposal. Previous commentators are encouraged to take into account any pertinent changes in the over-the-counter market and in the NASD proposal in submitting additional comments.

One major development in the OTC market since the submission of the NASD's proposal has been the advent of last sale reporting for certain OTC securities. Under Rule 11Aa2–1 ("Rule") under the Act, adopted by the Commission in February 1981,[16] certain actively traded OTC securities were mandatorily designated as NMS securities, while certain aditional OTC securities meeting less stringent standards could be designated as NMS securities at the election of the issuer. The primary effect of designation as an NMS security at the present time is to require that transactions in the security be reported on a real time basis and that quotations in the security be firm for the size publicly displayed.

The first NMS securities were designated on April 1, 1982. Since that time, 831 securities have become designated and subject to last sale reporting in the OTC market. As the numbers of NMS securities have expanded, the NASD and the Commission have monitored the effects of the last sale reporting process[17] and have engaged in ongoing surveillance of trade reporting practices. In general, this monitoring has shown that market maker firms are meeting satisfactorily the Rule's reporting standards and that OTC last sale reporting it taking place in an accurate and reliable manner.

Despite the high overall quality of last sale reporting for NMS securities, the Commission believes that last sale reporting during peak periods of trading

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[12] The NASD also states that any side-by-side market maker who fails to abide by these commitment rules could have its market maker registration in the underlying security revoked for a period of time through the NASD's disciplinary procedures. The NASD also states that any side-by-side market maker whose options quotations in a side-by-side class were withdrawn during the fifteen days preceding expiration of an options series may be found in violation of Article III, Section I of the NASD's Rules of Fair Practice, which obligates members to act in accordance with high standards of commercial honor and just and equitable principles of trade.

Members who elect not become side-by-side market makers would not be bound by the commitment rule, and, while obligated to render firm quotations, would not be required to quote all open options series in options classes in which they were registered.

[13] *See* File No. SR–NASD–84–4, Securities Exchange Act Release No. 20719, March 6, 1984, 49 FR 9523, March 13, 1984. Under this proposal, margin for market or "broad-based" index options would be set at premium plus 10 percent of contract value minus out-of-the-money amounts, with a minimum required deposit of 2 percent of the contract value. Margin for industry or "narrow-based" index options would be 30 percent of contract value plus or minus in- or out-of-the-money amounts, with a minimum required deposit of $250.00.

[14] *See* letter dated March 22, 1984, from Frank J. Wilson, Executive Vice President, Legal and Compliance, NASD to Douglas Scarff, Director, Division of Market Regulation, SEC.

[15] *See* File No. SR–NASD–80–10.

[16] *See* Securities Exchange Act Release No. 17549 (February 17, 1981), 46 FR 13992.

[17] The NASD engaged in an extensive study of the results of last sale reporting during February through April 1983. *See* Securities Exchange Act Release No. 19797 (May 20, 1983), 48 FR 24823.

activity, such as the first and last hours of trading, can be further improved. The continued reliance by many firms on reporting by traders means that as the pace of trading accelerates during high pressure periods, the quality and timeliness of trade reporting may suffer at times. If options were to trade on an NMS security, it would be particularly important that last sale reports for the underlying security accurately reflect the activity and direction of the underlying market in that security. Consequently, the Commission urges that market makers in NMS securities to take steps to reduce their reliance on trader reporting, through greater use of existing alternative facilities or restructuring their reporting systems.[18]

The NASD staff, recognizing the special importance of ensuring the timeliness and accuracy of last sale reports in the context of options trading, has concurred in a Commission staff suggestion that the NASD should ensure that conditions conducive to accurate last sale reporting pertain for firms that propose to engage in side-by-side market making. In this regard, the NASD staff has agreed to submit to the NASD Board a Commission staff suggestion that firms seeking to engage in side-by-side trading submit for NASD review a detailed description of their reporting procedures and systems in order to ensure that these procedures will sustain accurate trade reporting.

In view of the NASD's tentative concurrence in these steps to ensure further reporting accuracy, and the generally satisfactory quality of OTC last sale reporting to date, the Commission preliminarily relieves that the information provided by NMS last sale reporting is sufficiently timely and accurate to support options trading on NMS securities. However, in addition to the comments requested below on specific aspects of the NASD's proposal, the Commission invites comment on the concept of prior review by the NASD of reporting facilities as a condition to registration as a side-by-side market maker.

In addition, the Commission requests comment on the following issues:

1. *Side-by-Side Trading.* Previous commentators have questioned the propriety of side-by-side market making in options and their underlying securities. The Amex, for instance, has stated that:

> A dual market maker would have strong economic incentives to trade options on the basis of non-public market information gained through his activity in the underlying stock (or vice versa), and to try to manipulate the price of the underlying stock in order to increase the profitability of his options positions. The dual market maker in stocks and options would also have a greater ability to act on those incentives than someone who functioned as a market maker only in one of the two types of securities. . . . At the same time that dual market making would increase the opportunities to engage in questionable practices, it would diminish the feasibility of performing effective surveillance.[19]

The NASD argues that the informational and competitive advantages of side-by-side market makers are greatly reduced in the competitive, over-the-counter market maker environment[20] and that existing regulatory and surveillance activities can be adapted to the regulation of options trading in a side-by-side market maker environment. Furthermore, the NASD argues that significant efficiencies are obtainable through the integration of market making in the underlying security and the related option. Finally, the NASD notes that the firms most likely interested in committing capital to NASDAQ options market making will be those who already have developed trading expertise and retail interest through market making activities in the underlying security. Therefore, the NASD states that if side-by-side market making is not permitted, it is unlikely that the NASDAQ options program will be implemented.[21]

We invite additional comment on this issue, and encourage commentators to address the following specific questions:

(a) Commentators are invited to address the concerns raised by Amex with regard to the informational advantages possessed by side-by-side market makers and the NASD's rejoinder that these concerns are not applicable in the context of its current proposal. Does the NASD proposal prescribe the conditions that must pertain in order for a market to be sufficiently "competitive" to overcome any informational and competitive advantages that might be attributable to side-by-side market makers over other market participants? In this connection, commentators should discuss the minimum number of stock and options market makers in the underlying security and the options group that should be required. In addition, commentators should consider whether there are other approaches to addressing this problem that might be employed instead of or in conjunction with the minimum market maker requirements, such as standards to assure that no single market maker dominated the market for the underlying security, or to assure that there were several market makers that were in fact active in the market for the underlying stock on a regular or continuous basis. Commentators might also consider whether the rules for eligibility for underlying stocks help assure that NASDAQ options will be traded only on those stocks that are traded in a competitive environment. In particular, the Commission requests comments on the usefulness of an initial pilot NASDAQ options program limited to the top 20 NMS stocks, in terms of volume or other criteria, that were eligible for side-by-side market making.

(b) Are the regulations the NASD proposes to impose upon side-by-side market makers adequate?[22] In this connection, commentators are encouraged to discuss the adequacy of the NASD's proposed commitment rule and the related penalties. In addition, commentators might address whether additional regulatory requirements might be imposed upon side-by-side market makers, such as are imposed

[18] The Commission notes that the NASD currently offers a computer-to-computer interface that allows trade reports to be simultaneously entered into a firm's in-house order handling system and submitted to the NASD for trade reporting purposes. The NASD has informed the Commission that several major firms use this interface now, and a number of others have recently expressed interest in using the interface. Firms using this interface thus are able to use their clerks for both the necessary input into their own systems, and for trade reporting. Alternatively, firms could employ additional clerks to relieve traders of the task of reporting trades through their existing NASDAQ terminals. Separately, the NASD is developing a Small Order Execution System that will automatically execute and report orders of 300 shares or less entered into the system. This system should significantly reduce the number of individual trades handled by traders, while improving the reliability of their reports.

[19] Letter dated November 29, 1980, from Richard O. Scribner, Executive Vice President, Amex, to George A. Fitzsimmons, Secretary, SEC.

[20] As the NASD points out, the 1978 Special Study of the Options Market (the "Options Study"), recognizing the competitive market making system used in the over-the-counter market maker is likely to have the market information and competitive advantages or opportunities to engage in manipulative or other improper practices of the nature and dimension of those that integration would create for a unitary stock specialist on a primary stock exchange with a centralized stock limit order book to which he has access." At the same time, the Options Study observed that "* * * the opportunity to trade against the orders of retail customers in an OTC market may present market information and competitive advantages and regulatory concerns that do not have counterparts in exchange markets." Report of the Special Study of the Options Market to the Securities and Exchange Commission, H. Rep. No. IFC-3, 96th Cong., 1st Sess. (Comm. Print 1978) at pp. 955–956.

[21] The complete NASD arguments on this issue are contained in the December submission which is available at the Commission for public inspection.

[22] In addition, commentators are requested to consider whether any of the conditions proposed by the NASD are excessive to control the informational and other concerns raised by side-by-side trading.

upon competitive market makers at the exchanges employing a competitive market maker system.[23] Market makers whos are not side-by-side market makers are required to enter firm quotes, but are not otherwise bound by the commitment rules and penalties to which side-by-side market makers are subject. Among other things, this means that such market makers are not required to make markets in all options series overlying a particular stock and that, if the stock is not eligible for side-by-side market making, some options series might not have published quotes from any market maker. Commentators should discuss whether non-side-by-side market makers should be required to enter quotes in all options series, and, if not, whether some other provision can be made to assure that continuous and competitive markets are available in all options series.

(c) Does the NASD proposal provide for the specific surveillance needs side-by-side trading would entail, both on the options and equity side?

(d) The NASD has stated that its NASDAQ options program would not have adequate support without side-by-side market making. The Commission solicits comment regarding whether NASD members would be interested in trading NASDAQ options in the event side-by-side market making were not permitted with respect to a large number of, or any, options classes.

2. *NOAES and OCT.* The proposed NOAES would be the first small order automatic execution system for options, and NASD has stated that it would provide a prime source of data for the NASD's options audit trail. Likewise, the "order confirmation transaction" feature would be a source of a substantial portion of the NASD's options audit trail.

Comment is requested regarding NOAES and OCT as proposed, both regarding these systems' merits as execution and confirmation systems, respectively, and with a view to the contribution such systems will make to the creation of an options audit trail data base. For example, the NOAES proposal would provide for the "preferencing" of orders, in which a particular firm would be designated for execution of automated orders. A firm would not, however, be allowed to preference itself, so that it could not use NOAES to capture retail order flow it originates.[24] The preferencing feature then, would appear to be useful primarily to permit firms to reduce any risk that they are trading with financially unsound market makers. Commentators might discuss the desirability of this preferencing feature, and whether the lack of ability to self-preference serves as an appropriate inducement to smaller market makers to participate in NOAES or rather is unfair to market makers with retail order flow.

Comment is also requested regarding the merits of the proposed NOAES opening procedures, under which preferenced orders not accepted by the preferenced market maker do not receive a guaranteed execution at the best NOAES opening, but instead are held in NOAES for a post-opening automated execution. In this regard, the NASD proposal would permit a market maker to adjust its exposure limits up to the time trading opens, *e.g.*, in response to orders above the three contract limit received prior to the opening. Commentators should address whether this could result in inferior executions for NOAES orders submitted before the opening. If so, consideration should be given to whether any alternatives are available that would not expose market makers to uncertain obligations or result in disadvantaging OCT orders submitted before the opening.

Finally, consistent with exchange stock small order execution systems, only customer orders can be entered through the NOAES system. This limitation appears to reflect concerns regarding potential market maker exposure if other market professionals possessing substantial market information are permitted to automatically execute against his quote. Comment is requested regarding the desirability of this limitation.[25]

3. *Surveillance.* The NASD states that it intends to establish complete options and equity audit trails and a surveillance system comparable to those of the options exchanges. Commentators might discuss the adequacy of the NASD's proposed overall surveillance system, particularly with a view to the special surveillance needs created in a side-by-side trading environment.

4. *Spreads and Other Multi-Part Orders.* The NASD has indicated that one advantage of side-by-side trading is that it might result in more efficient executions of combination stock/options orders. It should be noted that most stock/options and option spread, straddle and combination orders are entered at net debits or credits, rather than by separately pricing each component of the order. The NASDAQ options proposal includes no provision for the entry of quotes by market markers at net prices on such combination orders. Given the frequency of such orders in the exchange options markets, commentators are urged to consider whether it is feasible for the NASDAQ options program to incorporate quotations for combination orders and, if not, to assess the impact of the absence of such quotes on the efficiency of the NASDAQ options market.

5. *Warrants Precedent.* In discussing the utility and lack of manipulative concerns of side-by-side market making, the NASD relies substantially on the experience of the NASD and the exchanges in trading warrants side-by-side with the stocks to which those warrants relate. In particular, the NASD asserts that the absence of known problems involving manipulation, frontrunning or other abuses in trading warrants in a side-by-side environment, suggests that such problems are unlikely in similar options trading. While warrants differ from standardized stock options in a number of respects, including their terms to maturity, their relatively higher prices and the smaller amount of trading activity in them, they nevertheless possess essential characteristics that are largely the same as options. Commentators are requested to assess the usefulness of the warrants trading experience as a precedent for side-by-side trading, with regard to such matters as likelihood of or incentives for manipulation, misuse of market information and the efficiencies of side-by-side trading.

[23] CBOE and the PSE, which employ a competitive market maker system, as well as the options exchanges employing a specialist system, impose certain maximum spread and price continuity limitations upon their market makers. *See, e.g.*, CBOE Rule 8.7(b)(i) and (ii).

[24] "Self-preferencing" is also prohibited in SOES, NASD's automated small order stock execution system.

[25] A unique feature of the NASD proposal would be the use, for the first time in U.S. markets, of firm quotations for options. Quotations would be firm both with respect to orders entered through NOAES system and outside of NOAES.

In the past, the options exchanges have expressed the view that firm quotations are not feasible for options trading. *See, e.g.*, letter dated September 22, 1980, from Walter E. Auch, Chairman and Chief Executive Officer, CBOE, to George A. Fitzsimmons, Secretary, SEC (File No. S7-772). Commentators are requested to evaluate this position in light of the NASD proposal.

The NASD relies on firm quotations to impose price discipline on market participants and as a check against manipulation. Outside of NOAES, however, there appears to be no obligation for quotes to be firm for more than a single contract. Commentators are urged to consider whether firm quotations under these circumstances will accomplish the objectives intended by the NASD. It should be noted that, although quotations in size can now be entered in the NASDAQ system for stocks, virtually no market makers have taken advantage of this feature.

6. *Indices.* Previous comment has pointed out the lack of many essential ingredients in the index options portion of the NASD proposal, such as the absence of the list of component stocks in the subindices, the absence of a description of the way in which the indices will be calculated, and the absence of position and exercise limit rules.[26] Before the Commission may approve the NASD proposal, the NASD will have to submit to the Commission rules in these areas for publication under Section 19(b) of the Act. Commentators are invited to comment on those aspects of the index options proposal that the NASD has submitted, as well as any other matters involving NASDAQ index options. Comment is specifically requested regarding the appropriateness of trading options on broad and narrow-based indices that are comprised of stocks that do not have last sale reports available.[27] In addition, commentators might discuss the economic utility of having both NASDAQ and NMS sub-indices on identical industry sectors.

III. The Exchange Proposals

A. Introduction

The CBOE, Amex PSE, Phlx and NYSE propose to list options on OTC stocks that have been designated as national market system securities pursuant to Tier I criteria under Rule 11Aa2-1(b)(1) under the Act ("Exchange proposals"). Under the exchange proposals, OTC securities would qualify for options trading on an exchange if they meet both the Tier I criteria under rule 11Aa2-1 and the exchanges' existing numerical options eligibility standards.[28]

The CBOE, PSE and Phlx have also requested that the Commission amend rule 12a-6 under the Act.[29] Rule 12a-6 effectively prohibits the exchange trading of options on securities not listed and registered under section 12(a) of the Act and thus effectively bars an exchange from trading options on OTC securities.[30]

In 1976 and 1977, the CBOE, Amex, PSE and Midwest Stock Exchange ("MSE") also proposed to list standardized options on underlying securities traded exclusively in the OTC market.[31] These proposals, however, were voluntarily withdrawn pursuant to an agreement between the Commission and the self-regulatory organizations that were participating in a moratorium on the introduction of new options products.[32]

At the time the original proposals to trade options on OTC stocks were submitted, there was no real-time transaction reporting for OTC stocks. As indicated in the section relating to the NASD proposal, real-time last sale reporting is now required for transactions in NMS securities and the exchanges propose to trade options on NMS securities only. Although the changes in the OTC market brought about by the development of the national market system may alleviate some of the initial concerns the Commission had over exchange trading of options on OTC securities, the current proposals by the exchanges to list and trade options on NASDAQ/NMS Tier I securities presents a number of significant issues upon which the Commission is inviting public comment.

B. Request for Comments

The Commission invites comments on the specific questions presented below. Commentators are requested to be as specific as possible in recommending any changes they believe may be needed to the Exchange proposals. We also encourage commentators to discuss aspects of the exchange proposals not specifically addressed here.

1. *Allocation of Options.* (a) *Introduction.* The trading of standardized options with the same underlying security on more than one marketplace, with reliance on the market to allocate trading interest in those options to the various marketplaces, is referred to as "multiple trading". Beginning in February 1976, the Commission permitted limited experimentation in multiple trading. In aggregate, 22 options on individual listed stocks in the past have been multiple-traded and currently 12 stock options are multiply traded. Expansion of multiple trading of options on individual listed stocks has been prohibited since the commencement of the options moratorium in July 1977.

Neither the exchanges nor the NASD seek permission explictly to trade options on stocks on which options are traded in another marketplace. Nonetheless, the Commission feels that these proposals raise a number of questions with respect to the manner in and extent to which options on over-the-counter securities should be allocated among markets.

First, in the even that the Commission concluded that it was appropriate for options on NMS securites to be traded both by the NASD and the exchanges, this would raise questions as to whether and under what circumstances both the NASD and an exchange should be permitted to trade options on the same underlying NMS stock. Second, apart from that question, consideration must be given to whether, among the exchanges, the Commission should extend the ban on expanding, multiple trading of options on listed stocks to also cover options on NMS stocks.

(b) *Previous Commission Statements Regarding the Allocation of Options on Individual Securities.* In its 1980 release announcing the termination of the options moratorium, the Commission identified certain potential benefits that could result from relying on the market, rather that the Commission or the exchanges, to allocate options trading activity among the exchanges:

> [A]n expansion of multiple trading in options may be beneficial to public investors and market professionals. In addition to the direct effects of intermarket competition in terms of increased depth and liquidity, multiple markets provide brokers and dealers with alternative markets in which to execute orders for a particular options class, thereby assuring that securities market participants are given an effective means of influencing market centers to provide more efficient pricing, execution and clearing services. Moreover, without the discipline provided through competition among market makers and among market centers resulting from multiple trading, the Commission would have to assume an undersirable oversight role in the allocation of securities to particular markets.[33]

The Commission also noted certain concerns that historically have been

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[26] *See e.g.*, letter dated August 24, 1982, from Richard O. Scribner, Executive Vice President, Amex, to George A. Fitzsimmons, Secretary, SEC.

[27] The NASDAQ Composite Index and the sub-indices of the composite index presumably would be comprised of a large number stocks as to which there are no last sale reports.

[28] The exchanges' eligibility standards are described at n. 9 above.

[29] The NYSE and Amex understand that an amendment to rule 12a-6 is a necessary precondition to approval of their proposals as well as the proposals of the other exchanges.

[30] The Commission has published today a companion release seeking comments on proposed amendments to Rule 12a-6. *See* Securities Exchange Act release No. 20854. These amendments, if approved, would remove the current statutory ban on exchange trading of options on OTC stocks.

[31] Notice of CBOE's proposal was given in Securities Exchange Act Release No. 12703, August 12, 1976, 41 FR 35884, August 23, 1976; notice of Amex's proposal was given in Securities Exchange Act Release No. 13095, December 22, 1976, 42 FR 2145, January 10, 1977; notice of PSE's proposal was given in Securities Exchange Act Release No. 12539, June 11, 1976, 41 FR 24787, June 18, 1976; notice of MSE's proposal was given in Securities exchange Act Release No. 130406, March 25, 1977, 42 FR 19200, April 12, 1977.

[32] *See* Securities Exchange act Release No. 15026 (August 3, 1978) and Securities Exchange Act Release No. 14878 (June 22, 1978).

[33] Securities Exchange Release No. 16701 at pages 26-27, March 26, 1980 ("Moratorium Termination Release") (45 FR 21426, April 1, 1980).

associated with multiple trading of equity options. For example, the Commission noted that, to the extent multiple trading results in a significant dispersion of order flow among markets, it could raise concerns regarding market fragmentation, resulting in potential price disparities (particularly at the opening) and difficulties by brokers in obtaining best execution of their customer's orders. Moreover, the Commission stated that, because of the "primary market" phenomenon,[34] any meaningful order-by-order price competition resulting from multiple trading likely would be transitory at best.[35] The Commission also was concerned that expansion of multiple trading of equity options in the then current market environment might adversely affect to a material degree the financial condition of the Phlx and the PSE,[36] thereby jeopardizing the ability of these regional exchanges to participate as meaningful competitors in the continuing development of a national market system for stocks.[37]

The Commission concluded that, under appropriate circumstances, the benefits of multiple trading of equity options appeared to outweigh the potential adverse consequences. Nevertheless, the Commission expressed the view that the near term development of market integration facilities might create a fairer, more efficient market structure within which multiple trading could occur and deferred further action on multiple trading to afford the self-regulatory organizations ("SRO") an opportunity to examine whether and to what extent the development of such facilities would alleviate market fragmentation concerns and maximize competitive opportunities.[38] On September 2, 1981, a joint SRO task force formed to address the feasibility of such market integration facilities submitted its final report to the Commission, which, in general, concluded that market integration facilities for equity options are not feasible.[39] The Commission has not revisited its deferral decision since the receipt of the final report.

On December 2, 1981, the Commission issued a release in which it determined to permit the market, rather than the Commission or the exchanges, to allocate non-equity options.[40] In deciding to rely on the market to allocate options on non-equity securities, the Commission addressed industry concerns over market fragmentation and unfair competition. It concluded that the benefits of multiple trading of non-equity options outweighed the possible negative effects. First, the Commission stated that allowing multiple trading of non-equity options is the approach most likely to promote competition and result in the development of options contracts best suited to the economic needs of market participants. Second, the Commission stated that multiple trading should enhance price competiton among the exchange markets, at least until a primary market in a particular option emerged. Third, the Commission concluded that multiple trading of non-equity options could increase inter-market competition with respect to the quality of markets and the quality of execution and back office services. Fourth, since no potential market was substantially reliant on revenue flow from the trading of non-equity options, in the Commission's view the existing market structure would not be disrupted, and a marketplace's financial stability or ability to participate in other areas of the securities markets would not be jeopardized by the multiple listing of non-equity options. Fifth, the Commission found that fragmentation concerns associated with order-by-order price competition among competing markets would only be a short-term effect, because it was likely that a predominant market would emerge for each non-equity option.

The Commission, in its orders approving exchange proposals to trade options on stock indices, noted that the issues involved with respect to multiple trading of stock indices are substantially similar to those involved in the allocation of the previously considered non-equity options. Accordingly, the Commission stated that it was inclined to extend its market allocation policy regarding non-equity options to stock index options.[41]

Because options on individual NMS stocks are not currently traded, the multiple trading of options on such securities would not in the Commission's view radically disrupt the existing market structure. For the same reasons, no marketplace's financial ability to participate in other areas of securities markets would be jeopardized by the multiple trading of options on NMS securities. On the other hand, the NASD's entry into the listed options market is effectively barred by the existing ban on the multiple trading of listed options; the allocation of options on NMS securities might, therefore, impose insurmountable competitive burdens on the NASD's participation in the standardized individual stock options market.

Given the advantages the Commission has identified are obtained from multiple trading and the limited risk of significant long-term market fragmentation or radical effect on existing markets, the Commission preliminarily believes that its present position on the multiple trading of new options products should be extended to options on NMS securities.

The Commission is nevertheless requesting comment on this question.

(c) *Solicitation of Comments.* As noted above, two different types of market allocation issues arise in connection with the exchange and NASD proposals: trading both over-the-counter and on an exchange of an option on the same underlying NMS stock and trading on more than one exchange of options on the same underlying NMS stock. The Commission is soliciting comment on the issues raised by both of these types of multiple trading.[42] In

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[34] The primary market phenomenom refers to the tendency of one exchange ultimately to receive the preponderance of trading volume in a particular option. Since most large retail firms generally designate one market to which they automatically route virtually all of their retail order flow in a particular options class, largely on the basis of the relative trading volume attracted by each exchange, primary market designation in effect becomes a "self fulfilling prophecy," and accordingly, any real intermarket competition for public order flow occurs for the short term only. *See* Options Study, at 853.

[35] Moratorium Termination Release at 27–31.

[36] *Id.* at n. 47. At the same time, the Commission made it clear that it did no regard the perpetuation of any particular exchange or exchanges to be a legitimate objective of any options allocation policy. This view is supported by the Commission's mandate under the Act. Althought the Act requires the Commission to balance the perceived anti-competitive effects of a regulatory policy or decision against the purposes of the Exchange Act that would be achieved thereby and the costs of doing so, it does not impose an obligation on the Commission to justify its actions as the least anticompetitive approach to achieving its objectives. *See* Options Study at 870.

[37] These possible effects of multiple trading were also analyzed in detail in the Options Study. Options Study, at 800–843. The Options Study, however, declined to formulate any specific recommendations on the multiple trading issue.

[38] To assist the SROs and expedite their deliberations, the moratorium termination release contained a discussion of several possible options market integration facilities, including a system similar to the Intermarket Trading System ("ITS") and the individualized routing of retail orders, as well as possible implementation of an order exposure system for public options orders.

[39] *See* letter from Nicholas A. Giordano, President, Phlx, to George Simon, Associate Director, Division of Market Regulation (September 2, 1981).

[40] Securities Exchange Act Release No. 18297 (December 2, 1981); 46 FR 60376 (December 9, 1981).

[41] Securities Exchange Act Release Nos. 19264 and 20075, November 22, 1982 and August 12, 1983; 47 FR 53981 and 48 FR 37556, November 29, 1982 and August 18, 1983.

[42] The possible multiple trading of options on NMS stocks raises at least one question in addition

Continued

responding to the questions below, commentators are asked to specify how if at all their responses differ in regard to each of these two circumstances or a combination of them.

(1) In the absence of market integration facilities, what are the potential market fragmentation effects of the multiple trading of the options being proposed? What is the likely duration of any such effects? To what extent, if any, is the primary market phenomenon likely to occur if multiple trading of these options is allowed in the absence of market linkage facilities?

(2) Unlike the exchange options markets, the NASD proposal would require quotations in NASDAQ options to be firm for at least one contract. The Commission requests comment regarding whether the availability of firm quotations in at least one market enhances the feasibility of a market linkage system for OTC options.

(3) The NASD proposal contains elements of a market linkage system, such as electronic inter-dealer and dealer-broker communication linkages and a firm quotation policy, that would appear to have possible application between OTC and exchange markets. Please discuss the feasibility of extending the NASD's system and rules for competing market makers, as proposed or as they might be modified, between competing marketplaces.

(4) The multiple trading of options on NMS securities, if permitted, would result for the first time in direct competition in standardized options among exchange and OTC market makers. Comment is requested regarding the competitive and regulatory implications resulting from OTC market makers (including integrated retail firms) making markets in competition with exchange market makers.

(5) As with non-equity and stock index options, it would appear that no market has made substantial investments in a market for options on NMS stocks in reliance on an exclusive franchise for any such options, or that any existing market structure would be disrupted if the market were relied on to allocate such options. The Commission would appreciate any information that would support or dispute this conclusion. If the primary market phenomenom does occur, what financial effect would this have on the different exchanges and the NASD? Please quantify to the extent possible.

(6) NASD entry into the market for options on listed stocks is currently barred because of the existing system for the allocation of those options among exchanges. In light of this, what effect, if any, would the allocation of options on NMS securities have on the ability of the OTC market to be a competitive force in the market for individual stock options? Is the NASD placed at unfair competitive advantage if exchanges are permitted to trade options on OTC stocks while the continued deferral of multiple trading effectively bars the NASD from trading opitons on listed securities traded on options exchanges.

2. *Surveillance.* The New York Stock Exchange, Inc., which is the primary market for the vast majority of the stocks underlying individual listed stock options trading, is currently developing a complete audit trail for those underlying stocks. The Commission has indicated its belief that the availability of underlying stock audit trail information will greatly enhance the options exchanges' ability to detect intermarket manipulations. In light of the NASD's commitment to build an audit trail for NMS stocks, commentators are requested to discuss whether implementation of an adequate equity audit trail and equity surveillance system should be a precondition to any trading of standardized options on NMS securities.[43] Commentators should address any special surveillance problems which may arise if options on NMS stocks are multiply traded either on the OTC market and exchanges, or on several exchanges.

3. *Unlisted Trading Privileges.* Subject to a limited exception,[44] the Commission has not granted exchange applications for unlisted trading privileges on stocks traded exclusively over-the-counter. The Commission has indicated that this policy is to remain in effect pending resolution of the market structure issues raised by such trading.[45]

In another context, the Commission has observed that the trading of derivatives of securities can serve as a surrogate or alternative to investment in the security itself.[46] This would appear particularly to be the case where an option is deep-in-the-money. On the other hand, given the relative infrequency with which exchange-traded options are exercised, it would appear that investors generally are not now using stock options as a vehicle for actually acquiring or disposing of the underlying security.

Commentators are requested to address the relationship, if any, of the Commission's policy on exchange unlisted trading privileges of OTC stocks to the exchange proposals to trade options on NMS stocks.

All interested persons are invited to submit in writing no later than June 15, 1984, 15 copies of their views concerning the proposed rule change to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. All communications should refer to File No. SR-NASD-80-10 or Amex-83-33, CBOE-83-53, NYSE-84-4, PSE-84-2 or Phlx-83-27, as appropriate. All communications will be available for public inspection at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.

Dated: April 12, 1984.

By the Commission.

George A. Fitzsimmons,

Secretary.

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to those listed in the text above: *viz.* whether or not exchange off-board trading restrictions should continue to apply if multiple trading between the exchanges and the NASD is permitted. Some of the exchanges have rules that forbid the trading off the exchange of options on stocks on which the exchange offers options. *See, e.g.*, CBOE Rule 6.49. These off-board trading restrictions were initially adopted to assure that all transactions in standardized options (except accommodation liquidations) occurred on an exchange floor. By their terms, however, these rules could also be applied to prevent exchange members from trading multiple traded standardized options on the NASDAQ system. The Commission preliminarily believes that as a precondition to Commission approval of any exchange proposal to trade options on NMS stocks an exchange would have to amend any off-board trading restriction it may have to allow its members to trade standardized options over-the-counter. The Commission welcomes, however, any comments on this preliminary position.

[43] Aside from audit trail and surveillance considerations, it would appear that there are few if any obstacles to prompt implementation of the exchange OTC options proposals. Implementation of the NASD proposal, however, would appear to be several months away at the earliest. Commentators are urged to address the competitive implications of asynchronous Commission consideration of the exchange and NASD proposals, particularly in light of the "primary market phenomenon."

[44] *See, e.g.*, In the Matter of Pacific Resources, Inc., Securities Exchange Act Release No. 17584,

NASD
National Association of Securities Dealers, Inc.
1735 K St., N.W. • Washington, D.C. 20006 • (202) 728-8000

notice to members 84-28

May 22, 1984

TO: All NASD Members and Other Interested Persons

Attn: Direct Participation Programs Department

RE: Amendments to Appendix F Concerning Sales Incentives for Direct Participation Programs

The provisions of Appendix F to Article III, Section 34 of the Association's Rules of Fair Practice ("Appendix F") relating to the use of sales incentive arrangements in public offerings of direct participation programs have been amended.

The amendments were distributed to the membership for their comment and were subsequently approved by the Association's Board of Governors. The amendments were published in the Federal Register and subsequently approved by the Securities and Exchange Commission on April 11, 1984.

Background

The provisions of Sections 5(e) and 5(f) of Appendix F provide for an equitable evaluation of sales incentives under the underwriting compensation guidelines. They also require disclosure to the public investor of the use of sales incentive programs. Finally, they are designed to permit members participating in public offerings of programs utilizing such arrangements to appropriately supervise their salesmen and maintain required books and records.

The Association's Direct Participation Programs Committee proposed amendments to Appendix F to address concerns regarding the use of sales incentive arrangements in public offerings of direct participation programs. Arrangements for sales incentives have often been organized by direct participation program sponsors and have been offered directly to sales forces. Such arrangements may circumvent the member which is responsible for supervision of its salesmen and for maintainence of books and records. In addition, use of sales incentive arrangements may, in the absence of appropriate supervision of the sales force, undermine the affirmative suitability determination called for under Appendix F.

Explanation of Amendments

Section 5(f) of Appendix F has been amended to require that all sales incentives be paid to a member and that such incentives be paid only in the form of cash. Cash payment of sales incentives will require the sales incentive to flow through the books and records of the member. This provision is intended to place control over the disposition of the incentives with the member. The member could, therefore, distribute incentives to salesmen or retain them.

The remaining amendments to Sections 5(e) and 5(f) of Appendix F are technical and conforming in nature.

The text of amended Sections 5(e) and 5(f) of Appendix F is attached. Any questions regarding this Notice should be directed to Harry E. Tutwiler of the Corporate Financing Department at (202) 728-8258.

Sincerely,

Frank J. Wilson
Executive Vice President
Legal and Compliance

The Association is requesting comments on the proposed amendments prior to final Board consideration. All comments received during this comment period will be reviewed by the Direct Participation Programs Committee and changes to the amendments will be recommended as deemed appropriate. The Board of Governors will then consider the amendments again. If the Board approves the amendments, they must be filed with, and approved by, the Securities and Exchange Commission before they become effective.

All written comments should be addressed to the following:

S. William Broka, Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

All comments must be received by April 25, 1983. All comments received will be made available for public inspection.

Any questions regarding this notice should be directed to Dennis C. Hensley or Harry E. Tutwiler of the Corporate Financing Department at (202) 728-8258.

Sincerely,

Frank J. Wilson
Executive Vice President
Legal and Compliance

Attachment

DRAFT AMENDMENT TO

APPENDIX F

Amend Subsections 5(e) and (f) as follows: *

(e) No sponsor, affiliate of a sponsor (other than a member dealing with persons associated with that member), or program shall provide any sales incentive item~~, including, but not limited to, travel bonuses, prizes, and awards,~~ directly to a person associated with a member unless:

(1) the aggregate value of all such items to be received by each associated person during any year does not exceed $50;

(2) the value of all such items to be made available in connection with an offering is included as compensation to be received in connection with the offering for purposes of paragraph (b)(1) of this section; and

(3) the proposed payment or transfer of all such items to be made available in connection with an offering is ~~are~~ disclosed in the prospectus or similar offering document.

(f) No sponsor, affiliate of a sponsor, or program shall provide compensation to a member in the form of sales incentives or bonuses ~~items including, but not limited to, travel bonuses, prizes, and awards~~ unless all of the following conditions are satisfied:

(1) all sales incentives and bonuses are paid directly to the member in cash and the distribution, if any, of incentives or bonuses to associated persons is controlled solely by the member;

~~(1) a fair market dollar value of the incentive items has been established;~~

(2) the value of all ~~such items~~ incentives or bonuses to be made available in connection with an offering is included as compensation to be received in connection with the offering for purposes of subsection (b) of this section;

(3) arrangements relating to the proposed payment ~~or transfer~~ of all ~~such items~~ incentives or bonuses, including the formula or formulae used to determine

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* New language is underlined; deleted language is stricken.

AMENDMENTS TO APPENDIX F

Sections 5(e) and 5(f) of Appendix F to* Article III, Section 34 of the Rules of Fair Practice have been amended as follows:

. . . .

(e) No sponsor, affiliate of a sponsor (other than a member dealing with persons associated with that member), or program shall provide any sales incentive item~~, including, but not limited to, travel bonuses, prizes, and awards~~ directly to a person associated with a member unless:

(1) the aggregate value of all such items to be received by each associated person during any year does not exceed $50.00;

(2) the value of all such items to be made available in connection with an offering is included as compensation to be received in connection with the offering for purposes of ~~paragraph~~ subsection (b) ~~(1)~~ of this section; and

(3) the proposed payment or transfer of all such items to be made available in connection with an offering is ~~are~~ disclosed in the prospectus or similar offering document.

(f) No sponsor, affiliate of a sponsor, or program shall provide compensation to a member in the form of sales incentives or bonuses ~~items including, but not limited to, travel bonuses, prizes, and awards~~ unless all of the following conditions are satisfied;

(1) all sales incentives and bonuses are paid directly to the member in cash and the distribution, if any, of incentives or bonuses to associated persons is controlled by the member;

~~(1)~~ ~~a fair market dollar value of the incentive items has been established;~~

(2) the value of all ~~such items~~ incentives or bonuses to be made available in connection with an offering is included as compensation to be received in connection with the offering for purposes of subsection (b) of this section;

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* New language is underlined; deleted language is stricken. All other sections of Appendix F remain unchanged. The full text of Appendix F may be found in NASD Manual (CCH) para. 2192.

(3) arrangements relating to the proposed payment ~~or transfer~~ of all ~~such items~~ incentives or bonuses are disclosed in the prospectus or similar offering document; and

~~(4)~~ ~~the manner of receiving all such items and their subsequent disposition, whether to associated persons or otherwise, is controlled solely by the member in a manner which enables the member to properly supervise its associated persons; and~~

(4) ~~(5)~~ the value of all incentives and bonuses is reflected on the books and records of the recipient member as compensation received in connection with the offering.

NASD
National Association of Securities Dealers, Inc.
1735 K St., N.W. • Washington, D.C. 20006 • (202) 728-8000

notice to members 84-29

May 29, 1984

TO: All NASD Members and Level 2 and Level 3 Subscribers

RE: 46 Securities Mandated to Join NMS on June 19, 1984

An additional 46 securities will join the 926 trading in the NASDAQ National Market System on Tuesday, June 19, 1984. These 46 securities have met the SEC's voluntary designation criteria, which include six-month average trading volume of 100,000 shares a month and a minimum bid price of $5.

The 46 securities scheduled to join NMS on Tuesday, June 19, are:

Symbol	Company	Location
AAME	Atlantic American Corporation	Atlanta, GA
AVAC	Avacare, Inc.	Dallas, TX
LIFT	Aviation Group, Inc. (The)	Raleigh, NC
BART	Barton Valve Company, Inc.	Shawnee, OK
TRUK	Builders Transport, Incorporated	Camden, SC
BUSL	Businessland, Inc.	San Jose, CA
CBSS	Central Bancshares of the South, Inc.	Birmingham, AL
CWTE	Commonwealth Telephone Enterprises, Inc.	Dallas, PA
DSCC	Datasouth Computer Corporation	Charlotte, NC
DETX	Detector Electronics Corporation	Minneapolis, MN
DRAN	Dranetz Technologies, Inc.	Edison, NJ
EIPM	EIP Microwave, Inc.	Newport Beach, CA
ELDN	Eldon Industries, Inc.	Inglewood, CA
ENDV	Endevco, Inc.	Dallas, TX
FDPC	FDP Corporation	Miami, FL
FHSY	Family Health System, Inc.	Paramus, NJ
FLCO	Finalco Group, Inc.	McLean, VA
FAMR	First American Financial Corporation (The)	Santa Ana, CA

Symbol	Company	Location
FFSB	First Federal Savings Bank of California	Santa Monica, CA
FCOA	Foremost Corporation of America	Grand Rapids, MI
HCWH	Homecrafters Warehouse, Inc.	Birmingham, AL
INGN	Integrated Genetics, Inc.	Framingham, MA
IRND	Interand Corporation	Chicago, IL
ITCP	International Technology Corporation	Torrance, CA
LPAI	La Petite Academy, Inc.	Kansas City, MO
LEXI	Lexicon Corporation	Ft. Lauderdale, FL
LILY	Lily-Tulip, Inc.	Augusta, GA
LIND	Lindberg Corporation	Chicago, IL
MFED	Metropolitan Federal Savings & Loan Association of Fargo	Fargo, ND
NBAN	National Bancshares Corporation of Texas	San Antonio, TX
NGNA	Neutrogena Corporation	Los Angeles, CA
NBSC	New Brunswick Scientific Co., Inc.	Edison, NJ
PHXA	Phoenix American, Incorporated	Mill Valley, CA
SEEQ	SEEQ Technology Incorporated	San Jose, CA
SFEM	SFE Technologies	San Fernando, CA
SHAS	Shawmut Corporation	Boston, MA
SAGA	Software AG Systems, Inc.	Reston, VA
STBK	State Street Boston Corporation	Boston, MA
SISC	Stewart Information Services Corporation	Houston, TX
SUBC	SUBURBAN Bancorp	Bethesda, MD
TEMC	Temco Home Health Care Products, Inc.	Passaic, NJ
THPR	Thermal Profiles, Inc.	Plainview, NY
TSYS	Total Systems Services, Inc.	Columbus, GA
UBAK	United Bancorporation Alaska, Inc.	Anchorage, AK
USCF	USACafes	Dallas, TX
WFSA	Western Federal Savings & Loan Association	Marina del Rey, CA

Any questions regarding this notice should be directed to Donald Bosic, Assistant Director, NASDAQ Operations, at (202) 728-8043. Questions pertaining to trading reporting rules should be directed to Steve Hickman at (202) 728-8202.

Sincerely,

Gordon S. Macklin
President

NASD
National Association of Securities Dealers, Inc.
1735 K St., N.W. • Washington, D.C. 20006 • (202) 728-8000

notice to members 84-30

May 29, 1984

TO: All NASD Members and NASDAQ Subscribers

RE: Monthly Statistical Report Subscription Service

We are pleased to announce that the NASD is now offering a new NASDAQ data service. Subscribers to this service may receive copies of the Monthly Statistical Report (MSR) for all or a select group of NASDAQ issues on either an annual subscription or single-month order basis. Each MSR includes daily, weekly and monthly price, volume and market maker information for securities traded in the NASDAQ System and the NASDAQ National Market System (NMS). The report also recaps daily NASDAQ market data including index values and aggregate system volume.

MSRs are available either on microfiche or in printed form. Each month's MSR data for all securities traded in NASDAQ are recorded on 32 separate microfiche sheets and include a cross-reference index of NASDAQ company names and trading symbols.

The most economical service offered is the annual subscription. For a charge of $50 per year, subscribers will receive microfiche copies of MSRs for all NASDAQ issues each month, beginning with the January report. (A sample microfiche covering 207 NMS issues is included with this notice for your reference. A 42x magnification lens is the best size for viewing the film on a microfiche reader.) Therefore, for a modest annual subscription fee, subscribers will be able to build a complete historical record of every security traded in the NASDAQ System. Those who are interested in receiving MSR information for shorter periods may purchase monthly data at a cost of $10 per monthly set of microfiche.

Hard-copy reports are also available on individual NASDAQ securities on both a standing monthly and a single month order basis at a cost of $5 per security per month. Unlike the microfiche data, which is only available for reports beginning with January 1984, hard-copy reports may be purchased for any month as early as January 1980. A sample of a hard-copy MSR (for an NMS issue) is also enclosed with this notice.

If you are interested in receiving this new service, please complete and return the attached order form in the envelope provided. Please do not include payment with your order; you will be billed after you have received your first hard-copy report or set of microfiche.

Questions with respect to the MSR Subscription Service should be directed to Anita Baker at (202) 728-8025 or Celia Kramer at (202) 728-8026.

Sincerely,

John T. Wall
Executive Vice President
Member and Market Services

Enclosures

MSR SUBSCRIPTION SERVICE ORDER FORM

National Association of Securities Dealers, Inc.
1735 K Street, N.W. Washington, D.C. 20006
(202) 728-8000

FIRM NAME ______________________ ATTENTION ______________________

STREET ADDRESS ______________________

CITY ______________ STATE ______ ZIP ______ TELEPHONE ______

BILLING ADDRESS (IF DIFFERENT FROM ABOVE) ______________________

An invoice will be sent according to the instructions on this order form. **PLEASE DO NOT SEND PAYMENT WITH THIS ORDER.** An order form should be filled out for each location to which the reports will be sent. If you wish the mailings to go to separate addresses, this order form may be duplicated and filled out for each separate address. Also, if more space is required, please use an additional sheet.

MICROFICHE ORDER
(Available beginning with the January 1984 Reports)

( ) **Annual Subscription** (sent monthly)
($50 for January through December)

Indicate number of microfiche sets desired: ______

( ) **Single Month Orders**
($10 per monthly set)

Please send me the number of sets of microfiche for the month(s) indicated below:

	No. of Sets		No. of Sets		No. of Sets		No. of Sets
☐ Jan	______	☐ Apr	______	☐ Jul	______	☐ Oct	______
☐ Feb	______	☐ May	______	☐ Aug	______	☐ Nov	______
☐ Mar	______	☐ Jun	______	☐ Sep	______	☐ Dec	______

HARD-COPY ORDER
(Available beginning with the January 1980 Reports)

( ) **Standing Monthly Order**
($5 per report per month)

Please send me monthly the indicated number of copy(ies) for the securities listed below:

Issue Symbol	Company Name and Issue	Beginning Month/Year	No. of Copies

( ) **Single Month Order**
($5 per report per month)

Please send me the individual reports listed below.

Issue Symbol	Company Name and Issue	Month/Year	No. of Copies