trading system and "extensive examination and surveillance programs" were expected to have a "significant deterrent and preventative effect." 346/

When evaluating OTC market integration proposals such as NASD's, the same basic factors should be considered and balanced as when evaluating integration proposals made by exchanges. Because of the characteristics of the OTC dealer markets, however, analysis of these factors must be modified in two significant respects. First, as NASD has pointed out, 347/ an OTC options market may not be feasible without dual marketmaking. Concurrent and side-by-side trading in the over-the-counter markets, for example, may not be viable methods of trading stocks and related options in the over-the-counter markets due to the difficulty, if not impossibility, of separating trading functions where trading occurs in the offices of securities dealers. If this NASD perception is correct, 348/ consideration of improvements in

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346/ Id., at 12.

347/ See n.343, supra, and accompanying text.

348/ Although NASD has consistently maintained that an OTC options markets will not be feasible without dual marketmaking, it is not readily apparent why it is "unlikely that firms other than NASDAQ market-makers [would] choose to be NASDAQ options marketmakers only or that a marketmaker in a given NASDAQ underlying security [would] choose to make a NASDAQ options market involving an underlying security with which it is unfamiliar * * * ." Analysis, supra, n.___, at 29. Indeed, options marketmakers on exchange floors have made options markets without making stock markets since the inception of standardized options trading, and it appears that they have become "familiar" with the securities underlying the options that they trade without inordinate difficulty. In addition, if OTC options trading presents a potential for earning profits, economic theory suggests that market-making capital and talent should flow to such trading.

market quality may be limited to those obtainable as a result of dual marketmaking. Similarly, it may not be necessary to consider the extent of integration as a variable during the balancing process since only one form of integration may be feasible.

Second, consideration of the character of the market proposing the integration has different overtones when integration is proposed for the OTC markets. Because the OTC markets are composed of a network of competing dealers, each of whom makes independent markets from his office, and since each competing marketmaker maintains exclusive access to any limit orders that his customers may leave with him, no OTC marketmaker is likely to have 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 alone has access. Moreover, given the number of marketmakers that may be registered to make markets in an underlying security 349/ and that each of these marketmakers is essentially a market center, primary and secondary market determinations may be at best tenuous. As quotations change and customers provide

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349/ The average number of registered marketmakers for a NASDAQ security in 1977 was 7.6. 1977 NASDAQ/OTC Fact Book, at 9. The NASD Plan provided that at least 10 registered NASDAQ marketmakers would be required to be displaying quotations in a security underlying NASDAQ options prior to the commencement of dual marketmaking. NASD Plan, *supra*, n.90, Proposed Article XVI, Section 3, Schedule D, Part IV, Section 3(a).

orders, the NASDAQ marketmakers or group of marketmakers maintaining the best market, in terms of both prices quoted and number of shares or contracts to be bought or sold at quoted prices, may be "primary" in the sense of attracting more order flow than others at that time. These factors, of course, are highly dynamic, and, as a result, primary market determinations may not take on the same significance as in exchange markets. On the other hand, 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. 350/

Within this context, the regulatory concerns that may accompany dual marketmaking in the OTC markets will be discussed.

1. Market Information, Competitive Advantage and Improper Trading Practices

NASDAQ dual marketmakers may be exposed to substantial inquiry and order flow in NASDAQ options and their underlying securities. The absence of real-time last sale reporting with regard to stock transactions, when coupled with the ability of a NASDAQ marketmaker to complete stock transactions at prices other than those quoted in NASDAQ without adjusting quotations or otherwise indicating that a transaction has occurred, may enhance the ability of a NASDAQ dual marketmaker to utilize inquiry and

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350/ See discussion at 170-173, *supra*.

transaction information with regard to the underlying security to earn profits on option positions. 351/

The example discussed above in connection with real-time last sale reporting may illustrate some of these points. In that situation,

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351/ With respect to these points, CBOE has stated:

> The absence of publicly reported current transaction information would also give rise to many situations where particular dealers would have access to market information not generally available. For example, a dealer in an underlying stock traded on NASDAQ will commonly know of transactions that have actually taken place in the underlying stock and are not publicly reported. This information may be extremely important in evaluating the premium levels of options related to that stock, and its availability to only certain market participants suggests many possibilities for unfairness toward public investors.

CBOE Letter, supra, n.87, at 51.

Similarly, AMEX has observed:

> Dual market making in an over-the-counter options market may in some respects present even greater regulatory problems than it does in the context of an exchange market, due again to the absence of real-time last sale reporting of transactions in the underlying stock. When a transaction takes place in the underlying stock which could affect the value of the option, only the market maker knows about it. The public investor buying and selling the option may not be aware of the price change in the underlying stock until he reads about it in the financial tables the next morning. This increases significantly the period of time within which the market maker may act to profit from his inside knowledge of the market.

AMEX Letter, supra, n.90, at 81.

an institutional investor approached a NASDAQ marketmaker to buy 10,000 shares of XYZ. The high sale price for XYZ during the previous day was $50 per share and the best bid displayed on NASDAQ Level II service was $49 7/8 and the best offer was $50 1/8. The marketmaker sold 6,000 shares to the institution at a price of $51. If the marketmaker who sold the 6,000 shares of XYZ was also making markets in the XYZ options, he might purchase, after completing the stock sale, the January 40 or 45 calls at the prevailing bid price or by slightly improving the best bid. He may also be able to sell the January 55 or 50 puts at the prevailing offer price or by slightly improving the best offer. Assuming that the market were to adjust gradually to the sale price of $51, perhaps to indicate that XYZ was properly valued at $51 per share or perhaps because other transactions, involving other marketmakers and the other 4,000 shares that the institution sought to buy, were to occur at a price near $51 and other marketmaker quotations were adjusted accordingly, the dual marketmaker might liquidate the long call or cover the short put positions at a profit. 352/ Of course, the dual marketmaker's purchases

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352/ It should be recognized, however, that even when a NASDAQ dual marketmaker is aware of an imminent stock or options transaction, it may be difficult to profit from this knowledge again due to the absence of real-time last sale reporting and the fact that quotations may not be adjusted to reflect transactions. If, for example, (i) the institution that purchased XYZ from the NASDAQ dual marketmaker was unable to find another seller and withdrew from the market, (ii) the institution was able to buy the 4,000 remaining shares of XYZ quickly from other marketmakers at a

(footnote continued on next page)

of the January 40 or 45 calls, sales of the January 45 or 50 puts, and liquidating or covering transactions may be done with customers who are not aware of the dual marketmaker's other trading and without exposing these customer orders to other market participants in the OTC or exchange markets.

Dual marketmaking in the over-the-counter market may also provide NASDAQ marketmakers with incentives and opportunities to engage in manipulative and other improper trading practices. These incentives and opportunities, as on an exchange floor, may result from the inquiry and order flow that a dual marketmaker may possess and the ability to profit on options positions as a consequence of relatively small and rapid price movements in the underlying security. Trading practices analogous to those involved in the quote racing, front-running, and capping examples discussed previously 353/ may occur in an OTC dual marketmaking environment.

(footnote continued)

price not significantly higher than $51 and those marketmakers did not adjust their quotes to reflect the transactions, or (iii) additional sellers entered the market, the market for XYZ may not adjust to reflect the marketmaker's transaction or the institutional buying, particularly if information concerning the transaction was not publicly disseminated and the marketmaker did not adjust his quotations to reflect the transaction. Under these circumstances, the marketmaker might not profit from the options position that he had assumed although he may be able to liquidate that position without sustaining a substantial loss since the call options may have been properly valued when he purchased them and their prices may not have changed.

353/ See discussion at 107-114, supra.

A dual marketmaker, for example, may be able to trade options on the basis of changes he is about to make in his quotations for an underlying security. Similarly, he may be able to engage in options transactions as a result of customer or marketmaker orders or inquiries that he has received with respect to an underlying security prior to the time that NASDAQ quotations for that security change, if at all, to reflect the orders or inquiries.

Dual marketmaking in the OTC markets may also present additional opportunities to engage in improper trading practices. For instance, assume that the best bid for XYZ displayed on NASDAQ Level 2 is $50 and the best offer is $50 1/4. Also assume that A, a registered dual marketmaker has accumulated a long position of near-term put options with an exercise price of $55. Further, assume that the best bid for the XYZ 55 put options is $6 and the best offer is $6 1/4. If A were a prominent dual marketmaker and was currently bidding $50 and offering $50 3/8 for XYZ, a change in A's bid and offer for XYZ may significantly impact the bids and offers of other marketmakers and, at the same time, the bids and offers for the XYZ put options. Thus, if five marketmakers were bidding $50 for XYZ and A were to lower his bid to $49 1/2 and his offer to $49 3/4, the other marketmakers, particularly in the absence of real-time last sale reporting, may believe that A has effectuated a large transaction at a price substantially below his bid price or that A is in possession of market information concerning XYZ that reflected upon the company or the market for its securities adversely. As a result, these marketmakers may lower their bids and offers in a manner consistent with A's adjustments. 354/ Under these circumstances, the best bid for the XYZ 55 put options may increase to $6 1/2. If A is able to sell all or a portion of his long position in the XYZ 55 puts, he may be able to earn $1/2 for each put that is sold. Again, A may be able to sell these puts to his own customers, none of whom would have knowledge of A's activities or an opportunity to trade with any other market participant. In this example, A was able to earn a profit on his option position merely by changing his quotations for the underlying security. Of course, other market participants may purchase shares from A at his reduced offer of $49 3/4 and A would then be at risk that the market would return to its previous level and his profit from his options transactions may become a substantial loss.

In this connection, the NASD has stated that the potential for manipulating underlying NASDAQ securities will be minimal because those securities will be "widely held and actively traded," 355/ quotations

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354/ A's ability to influence other marketmaker's quotes may be enhanced because of a noted phenomenon in the NASDAQ market often referred to as "price leadership." "Price leadership" has been described by one commentator as follows:

> "* * * [W]hen a leading dealer breaks out of a prevailing price trend, competitors tend to fall all over one another in their scramble to match his price. This has produced wide price swings on relatively little volume." Bleakley, "Is NASDAQ Really the Answer?" Institutional Investor, July, 1971, at 25.

355/ Analysis, supra, n.343, at 12.

will be highly visible, 356/ substantial marketmaking competition will exist, 357/ and position and exercise limits and NASD rules and reporting requirements "would effectively prevent a marketmaker from achieving a large enough position in options to utilize the options in a meaningful fashion in any attempt at manipulation." 358/

356/ Id., at 15.

357/ Id., at 15-16. But see also discussion at 185-190, infra.

358/ Id., at 17. With regard to the rules and reports that NASD intended to utilize "to act as safeguards for the protection of investors and the public interest," the Association stated:

> (1) * * * in order for a member to simultaneously make a market in the underlying security and options relating thereto, there would have to be a total of at least five registered marketmakers in the underlying security and at least five registered marketmakers in each options series in respect to which dual marketmaking was intended. This provision would reduce the possibility of a given firm controlling activity in both the option and the underlying security, and, hence, reduce the possibility of manipulation. * * *
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> (2) Without prior approval of the Association, a NASDAQ options market maker would be prohibited from acquiring a position in its investment account, or the accounts of other members or investors, in any class or series of NASDAQ options in excess of specified limits. Specifically, these limitations would prohibit aggregate long or short positions in excess of 1000 options contracts of the same class of NASDAQ options or 500 options contracts of the same class and expiration date. This rule is designed to prevent a marketmaker from accumulating so large a position as to be able to manipulate prices by having "a corner on the market" in a given class or series of options.

(footnote continued on next page)

2. Marketmaking Obligations and Commitment to the Marketplace

The NASD Plan would not impose marketmaking obligations upon NASDAQ dual marketmakers which would be similar to those imposed upon exchange

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(footnote continued)

(3) There would be a limitation on the number of long positions in a given class of options which could be exercised within any five-day period by a NASDAQ options marketmaker buying for its investment account or the account of any of its officers, partners and employees, by any other members or by a public customer. The purpose of this proposal is to discourage manipulative activities in the underlying security by limiting the number of shares which may be acquired under options within a stated period of time and by minimizing the effect that the exercise of substantial amounts of options might have on the price of the underlying security.

(4) Dual marketmakers would have position and exercise limits as to their trading accounts in addition to the above limitations in connection with their investment accounts. Specific limits have not yet been determined but they are under active consideration, i.e., a position limit of 5 or 10% of the open interest; exercise limits comparable to those imposed for investment accounts.

(5) All marketmakers, dual or otherwise, would be required to file reports detailing the nature of the options position in excess of established levels (which would be substantially less than the established positions limitations) in each of its investment accounts and the accounts of affiliates. Reports as to dual marketmakers trading accounts would also be required. Reports would also be required from all members with uncovered short positions. These reporting requirements would establish an early warning system whereby concentrated positions in options which may be used in a potential manipulative scheme could be quickly identified.

(6) Where excesses over established position limits occur, prohibitions on further activity by the violative accounts would be imposed until the excesses are liquidated.

(footnote continued on next page)

marketmakers. 359/ The Plan would also permit NASDAQ dual marketmakers to suspend quotations, with the approval of NASD, upon a showing that their ability to enter quotations is seriously impaired. Moreover, the NASDAQ dual marketmakers would be able to voluntarily terminate

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(footnote continued)

(7) Transactions in so-called "conventional options" covering those securities in which NASDAQ options are being traded would be required to be reported. This provision will assist in the surveillance of all options activities in securities authorized for NASDAQ options.

(8) The principle of full disclosure is a paramount concern particularly in regard to those situations in which a member acts in the capacity of a dual marketmaker. In that connection, the Association is considering the desirability of a rule which would require disclosure of this fact on confirmations sent to customers.

(9) All NASDAQ options marketmakers, as well as all other members, would be prohibited from entering into any option contract with an issuer, controlling person or affiliate of the issuer if the option covered securities of the issuer. * * *

(10) Special requirements will govern the execution of options contracts in customers' discretionary accounts. A member would be required to obtain the written approval of the customer specifically authorizing options trading in the discretionary account and each NASDAQ options transaction would be required to be approved by a registered options principal. While these provisions are primarily for the protection of investors, they would also make it more difficult for members to create options trading activity through accounts over which they have control. The use of discretionary accounts has in the past assisted in the perpetuation of many manipulations.

(footnotes continued on next page)

their registration as a NASDAQ marketmaker in a particular option series merely by withdrawing their quotations. Reregistration would be permitted at any time upon the filing of an application for reregistration and NASD approval.

Expressing concern with regard to the ease of registering and withdrawing from options marketmaking responsibilities under the NASD Plan, CBOE has observed:

> A NASDAQ options market-maker will be permitted to register for and withdraw from that status with relative ease. Thus, market-makers in NASDAQ options could engage in a practice of registering for only those series which are or have become attractive (in the sense of trading activity) and avoiding unattractive series or terminating their registrations in series that become unattractive simply by withdrawing their quotations. With a number of market-makers avoiding or deserting a series

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(footnote continued)

(11) The Association would have broad authority to impose on its own motion restrictions upon transactions in any class or series of NASDAQ options or transactions in the underlying security as may be necessary and appropriate to maintain fair and orderly markets in the public interest. This would enable the Association to deal with special and unique trading situations the particulars of which cannot be foreseen in advance.

Analysis, supra, n.343, at 17-22 (footnotes omitted). See also NASD Plan, supra, n.90, Proposed Article XVI, Section 3, Schedule D, Part IV, Section 3(a) which, among other things, would increase the number of registered NASDAQ marketmakers who would be required to be displaying quotations in the underlying security to ten prior to the commencement of dual marketmaking activities.

359/ See discussion at 114-115, supra.

> which had become unattractive, an investor who had taken on a position in that series might be hard-pressed to close it out at a price he deemed reasonable. Dissatisfaction or disillusionment with loss of liquidity could well spill over from the NASDAQ options market to the listed options markets.
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> Our concern for loss of liquidity is heightened by the lack of restrictions on withdrawal from market-maker status as a particular series approaches expiration or moves into or out of the money. Although we recognize that no one can guarantee the continued existence of a secondary market for a particular series or class of options, the great strength of the listed options market has been the liquidity which exchange market-makers (with their attendant obligations) have brought to options trading. The NASD proposal should include features designed to encourage the development and continuation of a similarly liquid secondary market. 360/

Taking a slightly different approach, AMEX has stated:

> The NASD places great faith in the regulatory effect of competition among market makers, pointing to the fact that before a dealer is authorized to make markets in both an option and its underlying security, there must be a total of at least five other registered market makers in the underlying security and at least five registered market makers in each related options series. It is also true, however, that it will be extremely simple for a registered NASD market maker in options to terminate his registration as such, and it is not clear what will happen if resignations bring the total number of registered market makers under five. Would the

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360/ Letter to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, from Joseph W. Sullivan, President, CBOE, dated April 25, 1977, pp. 7-8. See also Letter to George A. Fitzsimmons from Wayne P. Luthringshausen, President, OCC, dated May 10, 1977, pp. 3-4.

> NASD then cease to allow dealers to make markets in the option, possibly leaving investors without a market for the securities they have purchased? Or will the NASD allow the remaining dealers to continue their dual market making, but without the active competition relied upon to control "overreaching" or possible manipulative abuses? 361/

On the other hand, requiring OTC marketmakers to contribute to, and not diminish, the fairness and orderliness of the OTC markets may result in burdens on competition that may be deemed unnecessary and inappropriate and thus inconsistent with the Exchange Act. 362/ Proposals to implement stringent registration and withdrawal requirements may be viewed in a similar light. Such requirements may be considered to be burdens on competition because they may act as barriers to entry into OTC marketmaking. Moreover, the imposition of such requirements may be inconsistent with a "fundamental" purpose of the national market system: "to enhance the competitive structure of the securities markets in order to foster the risk-taking function of market makers and thereby to provide free market incentives to active participation in the flow of orders." 363/

361/ AMEX Letter, *supra*, n.90, at 81-82.

362 See, *e.g.*, Sections 19(b) and 23(a) of the Exchange Act [15 U.S.C. 78s(b) and w(a)].

363/ Senate Report, *supra*, n.17, at 14. See also House Report, *supra*, n.21, at 50.

3. Market Surveillance in the Over-the-Counter Markets

Although transactions in underlying securities traded exclusively in the OTC markets are not reported as they take place, the NASD Plan contemplated that OTC marketmakers would be required to time stamp all trade tickets for transactions in such securities at the time of execution and to transmit reports of their trading activity to NASD on a daily or weekly basis. 364/ In addition, all transactions in securities traded on exchanges are reported daily to NASD. 365/ The NASD Plan also contemplated real-time last sale reporting of NASDAQ options transactions. 366/

364/ The Plan provided that NASD members would be required to time stamp all trade tickets on transactions in underlying over-the-counter securities at the time of execution and to transmit transaction information to the NASD on such transactions during the course of a trading day by 6:30 p.m. Eastern Time. NASD members would be permitted to make such last sale reports on a weekly basis where their transactions in all underlying over-the-counter securities did not exceed five hundred shares in any single trading day and had not exceeded five hundred shares for any five of the previous ten trading days. This last sale information would be used by the NASD strictly for surveillance purposes and would not be publicly disseminated. Aggregate daily volume for each security underlying NASDAQ options, however, would be released to the public. NASD Plan, supra, n.90, Proposed Article XVI, Section 3, Schedule D, Sections 3(g)(1)(d)-(g).

365/ See discussion at 154, supra. See also NASD By-Laws, Proposed Article XVI, Schedule D, Section 3(g)1(d)-(g).

366/ NASD Plan, supra, n.90, Proposed Article XVI, Schedule D, Section 3(g)(1)(a).

Under the NASD Plan reports of stock transactions would contain information regarding the time of execution, the price at which the transaction occurred, the number of shares bought or sold, and the identity of the reporting NASDAQ marketmaker, the marketmaker on the other side of the trade, and the clearing agency for both. Reports of options transactions would contain comparable information. In addition, registered NASDAQ marketmaker quotations for NASDAQ stocks and options would be readily available from the NASDAQ system. Using this information, NASD would conduct market surveillance activities. As NASD has stated:

> We will have sequentially timed transaction reporting for surveillance purposes of all transactions in underlying NASDAQ securities. Thus, we will, among other things, be able to construct an adequate audit trail and also be able to detect sequenced changes in options quotes and those in their underlying securities. We hasten to point out that the effectiveness of our surveillance program will be enhanced by the fact that we will have available to use on a continuous basis information on activity in both NASDAQ options and their underlying over-the-counter securities. As noted previously, sequentially timed transaction reports on all underlying securities trades will be submitted daily by all NASD members effecting such trades. Using this information, and the real time option trade reports, the Association's computer will be able to produce a printout which will show, side by side and in sequence, daily activity in NASDAQ options and their underlying securities. 367/

367/ Letter to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, from Gordon S. Macklin, President, NASD, dated October 19, 1977, at 4.

Further, NASD has suggested that "marketplace competition is, in and of itself, an effective regulating mechanism," and that "with a significant number of active participants in the NASDAQ options marketplace, the potential for manipulation as a result of one or two persons cornering or dominating the market in a particular security would be substantially lessened * * * ." 368/

It must be kept in mind, however, that OTC trading in options and their underlying securities would occur by means of telephone lines between the offices of upstairs dealers. As a result, there is no trading crowd or exchange employee to deter, and perhaps observe and report to exchange officials, trading improprieties. 369/ Moreover, the trade reporting process is completely manual and totally under the control and discretion of individual marketmakers, who, if improper activity were to occur, would be the perpetrators of such activity. 370/ Without the ability to assure that stock and options transactions are time-stamped as they

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368/ NASD Letter, supra, n.90, at 3.

369/ The primary method of detecting improper trading practices such as quote racing, tape racing, and front-running is by means of complaints from the options trading crowd. See Chapter IV.

370/ See Letter to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, from Joseph W. Sullivan, President, CBOE, dated April 25, 1977, at 2. See also Chapter IV.

occur and independent means, such as discussions with exchange employees and officials or members of a trading crowd who witnessed trading activities or a price reporting system that exchange employees operate, of conducting adequate market surveillance of related stock and options trading in the OTC markets may be at best difficult, and at worst impossible, particularly if dual marketmaking is permitted. As CBOE has stated:

> [W]e are convinced that the exceptional quantity and quality of market surveillance deemed essential for options markets could not be achieved in an OTC market. A fundamental short-coming of such a market * * * is that OTC transactions are privately negotiated instead of occurring in the public forum of an exchange's market place. Thus, any audit trail surveillance system that might be developed would have to rely upon trade information privately reported by the parties to each transaction, without the checks that are supplied in an exchange market, such as an independently-operated price reporting system and the presence of exchange officials and other exchange members to detect unusual activities.
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> This weakness of the OTC market would be especially detrimental to surveillance of such potential abuses as intermarket manipulation and misuse of nonpublic market information, since surveillance of these abuses calls for knowledge of the precise time that an options trade takes place in relation to a transaction in the underlying stock market. Because the reporting of OTC transactions is entirely within the control of the participants, transaction reports could easily be delayed or altered to conceal improper conduct. 371/

371/ CBOE Letter, supra, n.87, at 48.

D. Conclusions

1. Real-Time Last Sale Reporting and Representative Bid and Ask Quotations

The absence of a mechanism for reporting and publicly disseminating information concerning transactions in underlying securities traded exclusively in the over-the-counter markets as such transactions occur may make it difficult for market participants to make informed investment decisions with respect to options that may be traded on these underlying securities. Without access to information reflecting the prices at which recent trades in these underlying securities have occurred and the volume that these trades involved, public investors may not be able to determine accurately the intrinsic value that options that they hold may have or to assess the prices at which they may be willing to buy or sell options on these stocks. This concern arises primarily because the price of an option is to a large extent derived from the price of its underlying security. Additional sources of this concern, however, are the facts that (i) quotations for stocks traded exclusively in the OTC market need only be honored for 100 shares and thus may not themselves supply sufficient information to permit investors to determine option prices and values accurately, and (ii) members of the public may only have access to representative bid and ask quotations for such underlying securities and their related options and, as a result, may be unable to ascertain, for either the options or their underlying stocks, the best bid and ask price available or the number of shares or contracts that can be bought or sold at these prices.

The lack of real-time last sale reporting for stocks traded exclusively in the OTC markets and the use of representative bid and ask quotations may also provide OTC marketmakers with market information advantages that may be inconsistent with "the maintenance of fair and orderly markets," "the public interest," and "the protection of investors." 372/ Specifically, only NASDAQ marketmakers who are the parties to an underlying security transaction may know that a trade took place and the terms of that trade. In addition, only market professionals with access to Level 2 or 3 NASDAQ service may have, and be able to trade on the basis of, information concerning the number and range of bid and ask prices available with respect to an underlying security traded in the OTC markets exclusively and its related options. These "differences in opportunity and treatment" may be deemed to be unfair to the extent that they exceed "the absolute minimum consistent with the recognized differences" between NASDAQ marketmakers and NASDAQ Level 2 subscribers

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372/ See, *e.g.*, Section 11A(a)(1) of the Exchange Act [15 U.S.C. 78k-1(a)(1)].

and other market participants. 373/ Moreover, if the mechanisms of an OTC options market do not assure, to the greatest extent feasible that "the highest bidders and lowest offerors do not miss each other to the disadvantage of both," that market may not be orderly. 374/

NASD has recently stated that it "endorses the concept of a national market system that will feature real-time last sale reporting of transactions in qualified securities." 375/ The Association has also observed:

> If it can be assumed that there will be a probable tie or a correlation between qualifications of over-the-counter securities underlying NASDAQ options, we suspect that a resolution of this issue of real-time last sale reporting can and will be achieved with start-up of the national market system. 376/

In this regard, the Commission has stated:

> The Commission believes that listed equity securities included in the consolidated system and a number of equity securities currently traded exclusively in the over-the-counter market generally possess characteristics (including, in most cases, national investor interest and substantial assets and earnings histories) which justify their inclusion in the "qualified" category. The inclusion of securities now traded exclusively over-the-counter in the qualified category is contingent, however, upon the implementation

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373/ Special Study, *supra*, n.63, at 14. See discussion at 20, 160-166, *supra*.

374/ *Id.*, at 15.

375/ NASD Letter, *supra*, n.90, at 21.

376/ *Id.*

> of those technical elements of a national market system necessary to assure that trading in those securities occurs under competitively fair circumstances and in a manner consonant with the principles of a national market system.
>
> Upon completion of its rulemaking with respect to designation of those securities qualified for trading in a national market sytem, it is the Commission's intention to require last sale information with respect to completed transactions in all qualified securities traded exclusively over-the-counter to be included in the consolidated system, to require quotations in those securities to be collected and disseminated in accordance with Rule 11Acl-1 under the Act, and otherwise to ensure that trading in such securities can be effected by means of, and subject to the requirements of, the order routing and other systems which must be developed to realize national market system objectives. 377/

Because real-time last sale reporting with respect to underlying securities traded exclusively in the over-the-counter markets is likely to be obtained as a national market system evolves, a prudent course may be to defer the initiation of standardized options trading with respect to such securities until such time as they are included in the consolidated transaction reporting system and real-time last sale reporting is available. 378/

377/ January Release, supra, n.176, at 43 (footnotes omitted).

378/ The same rationale would seem to apply to proposals to permit exchange trading of options related to these stocks. See n.7, supra.

Similarly, the Commission has recently proposed amendments to Rule 11Ac1-2 379/ which would prohibit the use of representative bids and offers with respect to equity securities. 380/ It may be most appropriate to await the resolution of this rulemaking proceeding before permitting options markets to develop which would provide representative bid and ask quotations for standardized options and would rely upon such quotations for the securities underlying those options. Should the Commission determine that representative bid and ask quotations should be prohibited for equity securities, it should also consider whether such quotations should be prohibited for options.

2. An Over-the-Counter Market For Options Traded on Exchanges

The 1975 Amendments were designed to "facilitate the establishment of a national market system for securities." 381/ A primary objective of such a national market system is "the centralization of all buying and selling interest so that each investor will have the opportunity for the best possible execution of his order, regardless of where in the system it originates." 382/ The 1975 Amendments also had "as a fundamental goal the

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379/ 17 C.F.R. 240.11Ac1-2.

380/ Securities Exchange Act Release No. 15251, *supra*, n.318.

381/ Section 11A(a)(2) of the Exchange Act [15 U.S.C 78k-1(a)(2)].

382/ Senate Report, *supra*, n.17, at 7. See also House Report, *supra*, n.21, at 50-51.

elimination of fragmented markets for securities suitable for auction trading," 383/ and sought to assure, "fair competition among brokers and dealers" and, to the greatest extent practicable, economically efficient execution of securities transactions in the best available market without the participation of a dealer. 384/ The development of an OTC market for standardized options already traded on exchanges should be considered in light of various statutory objectives.

First, in order to be successful, OTC markets for options traded on exchanges would have to attract option orders that are presently directed to the options exchanges. If the OTC markets capture a significant portion of this order flow, the financial well-being of the secondary stock exchanges that also permit options trading may be threatened, and recent initiatives toward the establishment of a national market system may be jeopardized. 385/

Second, in OTC markets for listed options, each OTC marketmaker trading the multiply traded classes would in effect become a separate market for that class and would have the ability to trade with his customers without exposing these customer orders to other market participants.

383/ *Id.*, at 17.

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

385/ See discussion at 86-92, *supra*.

Consequently, the markets for listed options may become more fragmented, and it may become more difficult to assure that the orders of public investors for multiply traded options classes are exposed to the full forces of supply and demand, obtain the best execution available without the intervention of a dealer, and realize "the protections and benefits of [an] auction market." 386/

Third, the task of achieving the centralization of buying and selling interests through linking of market centers as the Exchange Act envisions may become more complex. The need to establish linkages with the offices of each OTC marketmaker trading an options class that is traded on an exchange, 387/ to reconcile the trading rules and price reporting techniques of the OTC markets with those of the exchange markets, and to assure maximum limit order protection and opportunities for the interaction of all orders for multiply traded classes may contribute to this complexity.

Finally, OTC options marketmakers may have market information and other advantages that may be deemed unfair when compared to the competitive position of options marketmakers on the exchange floors. OTC marketmakers,

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386/ Senate Report, supra, n.17, at 17. See discussion at 8-12, supra.

387/ Should the Commission, after weighing the considerations discussed herein, decide to permit the development of OTC markets for exchange listed options at this time, the Commission should assure that such markets are included in any plans to establish market linkages and order routing systems for multiply traded options classes. See discussion at 71-86, supra.