

quarter of 1979 to include the entire options trading Floor. 19/

The AMEX "pilot test" began on October 2, 1978. The AMEX is now studying the results and cautiously expanding and modifying the experiment. These constructive efforts to improve AMEX surveillance capabilities and to create an adequate audit trail for options transactions that take place on the AMEX floor should continue expeditiously.

Accordingly, the Options Study recommends:

THE AMEX SHOULD ESTABLISH A COMPLETE AUDIT TRAIL FOR EACH OPTION TRANSACTION THAT TAKES PLACE ON THE AMEX FLOOR IN ACCORDANCE WITH THE SCHEDULE THAT THE EXCHANGE PRESENTED. THE COMMISSION SHOULD REQUIRE THAT THE AMEX SUBMIT A COMPLETE REPORT ON THE RESULTS OF ITS "PILOT TEST" AS SOON AS THEY ARE AVAILABLE. THE DIVISION OF MARKET REGULATION SHOULD FOLLOW THE PROGRESS OF THE AMEX CLOSELY TO ASSURE THAT THE EXCHANGE ENHANCES THE CAPABILITIES OF ITS SURVEILLANCE SYSTEM AND ESTABLISHES A PROPER AUDIT TRAIL AS QUICKLY AS POSSIBLE. THE DIVISION SHOULD PRESENT A STATUS REPORT ON THE PROGRESS OF THE AMEX INITIATIVES TO THE COMMISSION WITHIN 180 DAYS.

IN ADDITION, EACH SELF-REGULATORY ORGANIZATION SHOULD CONSIDER THE FEASIBILITY OF IDENTIFYING THE ACTUAL TIME THAT A TRADE IS EXECUTED TO SUPPLEMENT SURVEILLANCE INFORMATION THAT IS CURRENTLY CAPTURED.

19/ Letter to Richard Teberg, Director, Special Study of the Options Markets, and Richard Weingarten, Special Counsel, from Robert Birnbaum, President, American Stock Exchange, dated August 29, 1978.

(2) NYSE Surveillance Information and Audit Trail

The NYSE is the primary market for virtually all stocks on which standardized options are traded. As a result, related stock and options trading that may be improper often involves stock trading on the NYSE. NYSE's ability to obtain essential surveillance information quickly and accurately is thus critical to the ability of all the self-regulatory organizations to obtain a complete picture, and to conduct effective surveillance, of the trading of options market participants.

In July, 1963, the Report of the Special Study of Securities Markets recommended that the NYSE evaluate its plans to modernize and automate its trading floor procedures "with the view to obtaining and preserving more market data at the time orders are executed than is presently the case." 20/ Seeking to implement this recommendation, members of the Commission staff met with representatives of the NYSE on October 31, 1963 to discuss "the NYSE's projected system of automation." 21/ On December 10, 1963, the Commission sent the NYSE a letter summarizing the results of the October 31 meeting and urging the exchange to design and implement, as it proceeded with its modernization plans, an automated market surveillance system with a complete audit trail. The Commission stated:

The purpose of the [October 31] meeting was to express the Commission's interest in obtaining transaction data which might be accumulated within the capacity of the Exchange's program

20/ Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 2, at 358 (1963) (the "Special Study").

21/ Letter to G. Keith Funston, President, New York Stock Exchange, from Ralph Saul, Director, Division of Trading and Markets, dated December 10, 1963.

and equipment. However, it would appear that the present plans of the Exchange for automation do not now provide for the input of such data. As a result, the following important market data with respect to each transaction are apparently not to be obtained:

- a. Identity of underlying brokers on both sides (that is, those whose phone clerks received the orders at the edge of the floor);
- b. Whether the sale was long, short or short-exempt;
- c. Whether the specialist acted as agent; and
- d. Whether the principal was a specialist, floor trader, odd-lot dealer, or member-off-floor.

Other desirable data not to be obtained are:

- e. Executing brokers (if different from underlying);
- f. Covering purchases; and
- g. Type of order.

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An automated system which accumulated some of all of the market data outlined above at the point of execution would . . . assist in important surveillance purposes, perhaps obviating or mitigating some of the trading problems which have traditionally occupied the energies of the Exchange and the Commission. Such a system could furnish immediately, for particular stocks, reliable and vital data as to prices, volume and market participants. Development of such a system affords a possibility for less restrictive rules than might otherwise be necessary.

We are sure that you also appreciate the contribution which automated equipment can make to the fulfillment of our mutual regulatory responsibilities. It is difficult to find any significant reason for not utilizing this equipment to take full advantage of its potential for these purposes.

In view of the statutory responsibility of both the Exchange and the Commission, we urge you to take steps to facilitate obtaining

the first 4 items listed above and, if practical, the last 3 as well. We believe that time is an important factor in the program and, as requested at the meeting on October 31, we would appreciate your specific advice on each of these items at the earliest possible date. 22/

On December 17, 1963, the NYSE responded. The exchange simply stated that its "present automation program has not contemplated the capturing of the additional information detailed in [the Commission's] letter." 23/ The exchange agreed, however, to keep "an open mind concerning the development of additional systems for the future and . . . welcome[d] the chance to discuss the problems involved with [the Commission and the staff]." 24/

The Senate Securities Industry Study of 1973 accurately summarized the course of events that followed:

For the next three years the SEC continued to urge and the NYSE continued to resist the prompt development of an automated . . . surveillance system. Finally in 1966 the SEC wrote to the NYSE: "We do not believe that the Exchange, without obtaining such [transaction] information, can fulfill its self-regulatory responsibilities" 25/ The NYSE did not respond specifically

22/ Id.

23/ Letter to Ralph S. Saul, Director, Division of Trading and Markets, from G. Keith Funston, President, New York Stock Exchange, dated December 17, 1963.

24/ Id.

25/ Letter to John R. Bermingham, New York Stock Exchange, from Irving M. Pollack, Director, Division of Trading and Markets, dated June 30, 1966.

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Other desirable data not to be obtained are:

- e. Executing brokers (if different from underlying);
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In view of the statutory responsibility of both the Exchange and the Commission, we urge you to take steps to facilitate obtaining the first 4 items listed above and, if practical, the last 3 as well. We believe that time is an important factor in the program

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to this assertion but stated once again: "The exchange would maintain an open mind as to the development of additional systems which may be able to capture such information." 26/

The SEC continued to raise the issue of automating . . . surveillance with the NYSE during 1967. The NYSE indicated that it had made no progress in this area but that it would keep the SEC informed on the status of its automation programs. 27/ The matter appears to have been dropped at that point. 28/

Although more than 15 years have passed since the Special Study made its recommendations, the NYSE has not yet implemented an automated market surveillance system or an adequate audit trail. The exchange still does not have the ability to identify, on a routine, automated basis, the participants in each trade on its floor. Nor does the exchange yet maintain a record, collected at the time that orders are executed, which indicates the parties, the execution or reporting time, and the terms of each trade. While the Options Study has not examined or analyzed the NYSE surveillance system as a whole, the lack of such essential surveillance information raises a substantial concern, as the Commission suggested in 1963 and in 1966, regarding

26/ Letter to Irving M. Pollack, Director, Division of Trading and Markets, from John R. Bermingham, New York Stock Exchange, dated August 8, 1966.

27/ SEC Memorandum of Conference between NYSE and SEC Officials, dated June 19, 1967.

28/ Report of the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, Securities Industry Study, 93d Cong., 1st Sess. 184 (1973).

whether the exchange has the ability to fulfill its statutory responsibilities on a daily basis for each stock that is traded on the NYSE floor. Moreover, despite the NYSE's recent initiation of a multimillion dollar "trading facilities upgrade project," the exchange has not indicated any intention of regularly obtaining the surveillance information that it lacks. 29/ In fact, on October 16, 1978, the NYSE stated:

While we are always looking to improve our surveillance capabilities, it may not be feasible to try to enhance audit trail capabilities at the point of execution in the short term, as this may be disruptive to the execution process with the systems that exist today since it would require adding reporting staff to the Floor, or burdening reporters with additional responsibilities. 30/

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD CONDUCT A COMPLETE INSPECTION OF THE NYSE MARKET SURVEILLANCE SYSTEM TO DETERMINE WHETHER THE EXCHANGE HAS THE ABILITY TO CARRY OUT THE PURPOSES OF THE ACT AND TO COMPLY AND ENFORCE COMPLIANCE BY ITS MEMBERS WITH THE ACT, THE RULES AND REGULATIONS THEREUNDER, AND NYSE RULES. SPECIFICALLY, THE INSPECTION SHOULD CONSIDER WHETHER THE NYSE CAN DETECT, ON A DAILY BASIS AND FOR EACH STOCK TRADED ON THE NYSE, TRADING PRACTICES THAT MAY BE INCONSISTENT WITH THE ACT, THE RULES AND REGULATIONS THEREUNDER, OR EXCHANGE RULES. THE INSPECTION SHOULD BE CONDUCTED AND COMPLETED AS EXPEDITIOUSLY AS POSSIBLE AND A COMPLETE REPORT SHOULD BE PRESENTED TO THE COMMISSION WITHIN SIXTY DAYS AFTER THE COMPLETION OF THE REVIEW.

29/ Letter to Harold M. Williams, Chairman, Securities and Exchange Commission, from William M. Batten, Chairman, New York Stock Exchange, dated October 16, 1978.

30/ Id.

IN THE EVENT THAT THE INSPECTION REVEALS THAT THE NYSE CANNOT FULFILL ITS STATUTORY RESPONSIBILITIES ON A DAILY BASIS, THE COMMISSION SHOULD TAKE APPROPRIATE REMEDIAL STEPS AND SHOULD SPECIFICALLY CONSIDER REQUIRING, BY COMMISSION RULE, THAT THE EXCHANGE COLLECT AND MAINTAIN ESSENTIAL SURVEILLANCE INFORMATION.

(3) Stock Market Reconstruction

Market reconstruction is the process of identifying the parties to a series of transactions, the time and sequence of the transactions, and the price and number of shares or contracts involved. It may also involve the identification of the buying and selling interest in a security at a particular time. The purpose of a reconstruction is usually to determine the effect that particular transactions or orders might have had on the market for the security being analyzed.

The NYSE has stock trading information at its disposal for conducting stock market reconstructions that exceeds the information available to any other self-regulatory organization. Using its Daily Transaction Journal, specialist and registered marketmaker and trader transaction reports, sheets from the specialist's limit order book, confirmation stubs, daily clearing sheets, ITS and DOT Journals, and order tickets obtained from member firms, the NYSE can usually identify the brokers, dealers, and clearing firms who participate in a particular trade, the time that orders enter and leave the floor, the time that trades are entered into the price reporting system, and the price and volume of each transaction. Some of these information

sources also contain information concerning stock orders that were present on the trading floor but that were not executed during a particular trading session. The NYSE reconstruction process, however, is still largely manual and, as a result, is costly and time consuming. In addition, the absence of an audit trail at the NYSE may make it difficult, if not impossible, to investigate potentially improper trading practices in particular cases because the exchange may be unable to determine definitively the parties to transactions that may be under consideration.

To help reconstruct option marketmaker stock trading, each options exchange obtains reports of the stock transactions of its marketmakers on a daily basis. The CBOE, MSE, and PSE obtain this information from the firms that clear their marketmakers' trades, and the AMEX and PHLX rely primarily upon stock activity reports that they require their specialists and RCTs to file. Using this information and obtaining order tickets from the clearing firms if necessary, each options exchange is able to determine the time that each marketmaker stock order was transmitted for execution, the amount of the order and its type, the time that it was reported as executed and the number of shares bought or sold. With this information and the NYSE Fitch Sheets, which are publicly available and contain the time that trades of stocks listed on the NYSE were entered into the price reporting system, the price, and volume for each transaction in a stock in any market, the options

exchanges may be able to estimate the impact that a marketmaker's stock orders and transactions may have had upon a stock. Viewing this information in conjunction with their records of options trading and positions, the options exchanges can generally conduct effective inquiries and investigations into related activity in stock and options by their marketmakers. Of course, if marketmakers do not clear their stock trades or carry their stock positions with the firm that clears their options trades, or if specialists and ROTs do not report their stock trades, it is more difficult, and may be impossible, for the exchanges to detect related stock and option trading by marketmakers that might be inconsistent with the Act or exchange rules. Improvements should be made to assure that such marketmakers can not evade self-regulatory organization surveillance systems by clearing stock trades or carrying stock positions at firms other than their option clearing firms.

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD REQUIRE THAT ALL SELF-REGULATORY ORGANIZATIONS ADOPT RULES REQUIRING ALL REGISTERED OPTIONS MARKETMAKERS TO REPORT, BY APPROPRIATE MEANS AND ON A DAILY BASIS: (1) THE TIME THAT EACH STOCK ORDER FOR THE MARKETMAKER'S ACCOUNT, OR AN ACCOUNT IN WHICH HE HAS AN INTEREST, IS TRANSMITTED FOR EXECUTION, (2) THE TYPE AND TERMS OF EACH ORDER, (3) THE TIME, VOLUME, AND PRICE OF ANY EXECUTIONS THAT ARE RECEIVED, AND (4) THE OPENING AND CLOSING STOCK POSITIONS FOR EACH ACCOUNT IN WHICH THE MARKETMAKER HAS AN INTEREST.

THE COMMISSION SHOULD ALSO (1) REQUIRE THAT THE SELF-REGULATORY ORGANIZATIONS ADOPT RULES REQUIRING ALL REGISTERED MARKET-MAKERS TO REPORT ALL ACCOUNTS, FOR STOCK AND OPTION TRADING, IN WHICH THEY HAVE AN INTEREST OR THROUGH WHICH THEY MAY ENGAGE IN TRADING ACTIVITIES, AND (2) PROHIBIT MARKETMAKER TRADING THROUGH ACCOUNTS OTHER THAN THOSE REPORTED.

(4) Firm Proprietary and Customer Trading Identification

While each of the options exchanges has developed methods of routinely obtaining substantial information concerning the stock and options activities of their marketmakers, information about related stock and options trading of customers and the proprietary accounts of member firms is not readily available for routine surveillance purposes. OCC, for example, maintains separate accounts for marketmaker, firm proprietary, and customer options trading. The stock clearing corporations do not distinguish among such accounts when clearing stock transactions. In other words, the stock clearing corporations keep one account for each clearing firm, and the task of allocating cleared trades among the various types of accounts is left to the firms. As a result, the stock clearing sheets that are used to determine who has been active in a stock reveal only the firms that cleared trades and not the accounts, nor the types of accounts, for which the trades were cleared.

This method of clearing stock transactions makes it necessary for the options exchanges to send an inquiry to the firms that cleared

stock trades each time that it appears that these trades may be related to options activity. Frequently, however, the options exchanges only need information concerning the trading of a firm's proprietary account. In a front-running, minimanipulation, capping, or pegging inquiry, for example, an exchange may know, due to the account information provided by OCC, that option trades were done in a firm's proprietary account and may wish to find out whether the same firm engaged in stock activity for its own account. A review of the stock clearing sheets may show that the firm cleared stock trades that might have some relationship to the option trades, but will not tell the analyst whether the stock transactions were cleared for the firm's account, for one customer, or for many customers. Consequently, a letter of inquiry must be sent to the firm asking it to identify the accounts that participated in the stock trades. This process is costly and time consuming for the options exchanges and for member firms and does not routinely provide the exchanges with member firm proprietary stock trading information comparable to that which is independently obtained for marketmakers.

The NYSE and SIAC have recently undertaken to determine the feasibility and cost of distinguishing between member firm proprietary and customer trades in the clearing process. The Options Study has been

informed that SIAC is initiating a study of this question and that a report should be available by March 31, 1979. 31/

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD REVIEW THE SIAC REPORT AS SOON AS IT IS COMPLETED. THE SELF-REGULATORY ORGANIZATIONS AND THEIR MEMBER FIRMS SHOULD WORK TO ESTABLISH AN ECONOMICAL METHOD FOR IDENTIFYING AND DISTINGUISHING MEMBER FIRM PROPRIETARY AND CUSTOMER STOCK ORDERS AND TRANSACTIONS. IN THE EVENT THAT THE SELF-REGULATORY ORGANIZATIONS DO NOT DEVISE A METHOD FOR EASILY IDENTIFYING MEMBER FIRM PROPRIETARY AND CUSTOMER TRADING, THE COMMISSION SHOULD CONSIDER WHETHER IT IS APPROPRIATE TO REQUIRE THAT THEY DO SO BY COMMISSION RULE.

The regular availability of information distinguishing member firm proprietary and customer stock trading should enhance the ability of the options exchanges to monitor related stock and options trading by firm proprietary accounts. It may also result in cost and time savings for exchanges and their members. Further, creating a system that will distinguish between principal and agency orders and trades will facilitate compliance with Section 11(a) of the Act and assure that self-regulatory organizations have the ability to detect potential violations of that section. 32/

31/ Letter to Richard Teberg, Director, Special Study of the Options Markets, from Robert M. Bishop, Senior Vice-President, New York Stock Exchange, dated September 28, 1978.

32/ See Securities Exchange Act Release No. 12055 (January 27, 1976). Securities Exchange Act Release No. 13388 (March 18, 1977); Securities Exchange Act Release No. 14563 (March 14, 1978); Securities Exchange Act Release No. 14713 (April 27, 1978); and Securities Exchange Act Release No. 14795 (May 24, 1978).

(5) Customer Account Identification

Neither OCC nor the stock clearing corporations presently maintains a record of specific customers for whom stock and options trades are executed. At OCC, each clearing firm conducting a public business has a customer account in which all customer options transactions are cleared, and at the stock clearing corporations all stock transactions for each firm are cleared in one account. To identify the customers for whom particular trades were effected, an exchange must ask the clearing firms which customers effected the trades and must await a response. This process is costly and time consuming for the exchanges and for the member firms. In addition, firm responses may require further inquiries of other broker-dealers and may not result in a complete picture of a customer's trading. If a clearing firm clears for another broker-dealer, for example, the clearing firm may respond to an inquiry asking about customer trading by providing the name of the broker-dealer for whom it is clearing. It would then be necessary to send an inquiry to that broker-dealer to determine the identity of its customer. Moreover, the response of one broker to a request for information about a customer's trading will not reveal transactions that the customer may have effected through other brokers and other accounts. Consequently, it may be extremely difficult, if not impossible, to detect improper trading practices or violations of self-regulatory organization rules in which a customer may engage if the customer trades through separate accounts at multiple brokers.

The Options Study recognizes that customer account information is maintained in numerous forms at member firms. The Options Study is also aware that the cost and time that would be necessary to design and implement a system that would establish a uniform method of identifying customers and would make complete customer information available for surveillance purposes on a routine, automated basis may be substantial.

The availability of customer account information on an automated, routine basis, however, would substantially improve the ability of the self-regulatory organizations to detect customer trading that may be inconsistent with the Act or their rules. The time and money that the self-regulatory organizations and their members expend making and responding to inquiries about customer trading could be significantly reduced if the self-regulators were able to determine easily the customer for whom a trade was executed. A large brokerage firm, for example, may respond to frequent requests from options exchanges about legitimate customer trading simply because its customer account at OCC has cleared trades that might be improper if done by one customer or a group of customers in concert. Usually, however, the exchanges find that numerous unrelated customers engaged in the trades. Such inquiries would not be necessary if an exchange were able to readily ascertain how many and which customers effected the transactions.

As self-regulatory organizations modernize their trading facilities and firms modernize their order routing and processing systems, it may become easier to create a standard format for identifying customers and obtaining customer account information for surveillance purposes. The NYSE and SIAC are currently studying the feasibility and cost of capturing customer information in the clearing process, and a full report is expected by March 31, 1979. 33/

Accordingly, the Options Study recommends:

THE COMMISSION SHOULD BEGIN TO STUDY THE MOST APPROPRIATE MEANS OF ESTABLISHING A UNIFORM METHOD OF IDENTIFYING STOCK AND OPTION CUSTOMERS ON A ROUTINE, AUTOMATED BASIS. THE COMMISSION SHOULD REVIEW THE NYSE AND SIAC REPORT ON THIS SUBJECT AND SHOULD DETERMINE THE STEPS THAT SHOULD BE TAKEN TO ESTABLISH A UNIFORM ACCOUNT IDENTIFICATION SYSTEM IN LIGHT OF THE REPORT.

(6) OCC Position Adjustments

During the trade match and comparison processes at the options exchanges, errors and omissions may occur when the terms and parties to a trade are entered into the computers of the clearing firms for clearing purposes. To correct these errors and omissions, clearing members submit position adjustments to the OCC. The adjustments

33/ Letter to Richard Teberg, Director, Special Study of the Options Markets, from Robert M. Bishop, Senior Vice-President, New York Stock Exchange, dated September 28, 1978.

are submitted in the form of purchases and sales and must be matched. In other words, for every purchase there must be a corresponding sale. Position adjustments may also occur between two clearing firms if a customer or marketmaker account is transferred from one firm to another or if one firm executes and compares trades for another firm on an exchange of which the first firm is not a member. These adjustments are referred to as transfer of account and Clearing Member Trade Agreement ("CMTA") adjustments.

Position adjustments, however, may also be used for improper purposes. Trade reversals, opening transactions by customers in restricted options, avoidance of the public priority rules, and off-floor trading may be accomplished by means of such adjustments. An effective options surveillance system must therefore contain sufficient information to permit a self-regulatory organization to detect position adjustments that may have been entered for improper purposes.

At present, OCC issues a report each day containing the adjustments that each clearing firm submits. The report does not identify the purpose of the adjustment or relate the adjustment to a particular trade. In fact, OCC does not require its members to indicate the purpose of particular adjustments, and it is difficult to trace some adjustments to trades because many firms do not reconcile their books to OCC records on a daily basis. Instead, they may balance their positions less frequently and submit one set of adjustments to correct any discrepancies.

The Options Study's inspections revealed varying degrees of sophistication among the options exchanges with respect to the review of position adjustments. At the CBOE and PSE, for example, certain types of adjustments with well-defined characteristics are reviewed. At the AMEX, on the other hand, questionnaires are sent on an essentially random basis to firms that enter large adjustments. These questionnaires ask the reasons that the adjustments were made. At the PHLX and MSE, the extent to which position adjustments are reviewed, understood, and monitored was not apparent. The inspections also demonstrated that firms are routinely able to trace most adjustments back to particular trades when asked and that order tickets containing the errors that caused the adjustments can generally be provided if requested.

OCC, however, intends to revise its adjustment procedures by the end of the first quarter of 1979. OCC plans to make three significant revisions in the adjustment process and describes these as follows:

The first change which would be accomplished . . . is the implementation of a separate transfer of account system which would provide an independent audit trail for transfers of account as opposed to other types of adjustments. Under the new transfer of account system, two sided input will be required. Both the transferor clearing firm and the transferee clearing firm must submit documentation to OCC on authorized Transfer of Account Forms No transfer will be permitted to go through the system unless both the transferor and the transferee firm agree to the transfer.

In addition, the transfer system would have such controls so as to make it impossible to transfer a market-maker position at one clearing firm

to a different market-maker account at another firm. In addition, transfers that do not match on the first day that input is submitted to OCC will be pending for a maximum of five business days, allowing the two Clearing Members time to reconcile any errors. At the end of five days, any pending items which have been transferred would be dropped from the system and the Clearing Members would be required to submit new input to OCC before the transfer of account could be accomplished.

The revised system would also change the present CMTA adjustment procedure. . . . No firm would be able to submit a CMTA adjustment unless they had a valid CMTA agreement on file with OCC. The system would be designed so that unless such an agreement was on file, any such adjustment would be rejected. . . . [In addition,] all CMTA adjustment input documents would require the Clearing Member to designate the Exchange on which the transaction occurred and the date on which the transaction occurred.

Finally, the Position Adjustment Form is also being revised so that a position adjustment may be effected only intra-clearing firm; that is, only open-close and account type errors may be corrected through the revised position adjustment form. . . . These adjustments would be submitted as a single line item input so that both the buy and the sell side of the adjustment could be clearly related.

In addition, the position adjustment system would be modified so that each potential open-close, buy-sell situation would be separately coded and identifiable. Accordingly, surveillance reports could and will be developed with the ability to recall for surveillance purposes each potential adjustment combination. This system should enable Participant Exchanges to determine whether potentially questionable practices may be taking place. 34/

34/ Letter to Sheldon Rappaport, Deputy Director, Division of Market Regulation, from Marc L. Berman, Vice-President and General Counsel of OCC, dated August 2, 1978.

The Options Study believes that implementation of these revisions will significantly improve the ability of the options exchanges to detect improprieties that may be effected by means of the adjustment process. By distinguishing transfers of account and CMTA adjustments from other adjustments, coding and identifying open-close and buy-sell adjustments, and proscribing adjustments between clearing firms, the potential for abusing the adjustment process will be reduced substantially. As importantly, the ability of the options exchanges to understand and investigate particular adjustments should be enhanced.

However, more could be done to reduce the number of adjustments that firms submit to OCC. Since many adjustments are the result of illegible handwriting and clerical errors in entering information into the clearing process, the number of adjustments may be further reduced if OCC were to introduce disincentives to the entry of adjustments. Reductions might also be accomplished, and the ability of firms and exchanges to relate adjustments to particular trades enhanced, if the OCC required its member firms to reconcile their accounts to OCC accounts on a daily basis.

Accordingly, the Options Study recommends:

OCC SHOULD IMPLEMENT THE REVISIONS IN
ADJUSTMENT PROCEDURES THAT IT HAS PROPOSED
AS SCHEDULED. OCC SHOULD ALSO CONSIDER THE
FEASIBILITY OF IMPOSING A SURCHARGE FOR
POSITION ADJUSTMENTS THAT FIRMS EFFECT

ABOVE A CERTAIN NUMBER OF CONTRACTS. THE NUMBER OF ADJUSTMENTS THAT A FIRM SHOULD BE PERMITTED WITHOUT THE IMPOSITION OF THE CHARGE SHOULD BE DETERMINED GIVING FULL CONSIDERATION TO THE NUMBER OF CONTRACTS THAT THE FIRM REGULARLY CLEARS. IN ADDITION, OCC SHOULD CONSIDER THE FEASIBILITY OF REQUIRING ITS MEMBER FIRMS TO BALANCE THEIR RECORDS TO OCC RECORDS ON A DAILY BASIS. THE COMMISSION SHOULD REQUIRE OCC TO STUDY THESE ISSUES AND REPORT ITS CONCLUSIONS AND RECOMMENDATIONS TO THE DIVISION OF MARKET REGULATION WITHIN 90 DAYS.

b. Surveillance Techniques

Each options exchange monitors its market to detect trading practices that may be inconsistent with the Act and its own rules. These exchanges have developed techniques to detect related option and stock trading that might be manipulative, prearranged and fictitious option trading, misuse of material market and inside information, and violations of certain other exchange rules. While the best of the techniques that have been developed would provide a self-regulatory organization with a general ability to detect such trading practices, improvements must be made to maximize the effectiveness of the self-regulatory organization market surveillance.

(1) Surveillance Techniques and Surveillance Information

First, the surveillance information that is available to each self-regulatory organization must be made more complete as recommended in

the previous section. This should improve the ability of the self-regulatory organizations to reconstruct their markets and the activities of their members more accurately, more quickly, and more economically than at present. Further, this should enhance the ability of the self-regulatory organizations to perform surveillance functions without requesting as much information from members as often as is currently the case.

(2) The Sharing of Surveillance Information and the Allocation of Regulatory Responsibility

Second, the surveillance data that exist at each self-regulatory organization must be made readily and economically available to other self-regulatory organizations that may need such data for regulatory purposes. Because the trading activities of a member are not necessarily confined to the marketplaces of which he is a member, and because standardized options trading has increased the opportunities for market participants to engage in related activities in numerous markets, the importance of data sharing and integration has increased.

To conduct surveillance of trading practices that involve stock and options, for example, the options exchanges rely heavily upon transaction and clearing information from the New York Stock Exchange. To monitor the activities of a member in an option that is traded on more than one exchange, transaction and clearing data from

all exchanges on which the option is listed must be gathered. At present, however, such information is generally available only on a request basis. Perhaps most significantly, the self-regulatory organizations do not always notify each other and share information concerning investigations and studies that they are conducting even though such studies and investigations often involve trading that took place in more than one market and market participants who are members of more than one self-regulatory organization. Moreover, studies and investigations may be duplicated, at the expense of the members, merely because the self-regulatory organizations do not inform each other routinely of their activities.

The self-regulatory organizations have recognized that they can enhance their surveillance capabilities and save time and money by sharing the surveillance information that each of them possesses, coordinating their regulatory efforts, and formalizing the channels of communication among them. In fact, the options exchanges, the NYSE, the NASD, OCC, and the Boston Stock Exchange (the "Self-Regulatory Conference" or the "Conference") have recently begun the process of integrating their surveillance and other regulatory systems. Since August, 1978, these self-regulatory organizations have held a series of meetings which "have focused upon the need for the creation

of an integrated regulatory system among the self-regulatory organizations which would enhance total industry regulatory capability by coordinating and interfacing existing regulatory data and programs through the sharing of available information, improvement of regulatory techniques, [and] the allocation of regulatory responsibility. . . ." 35/ The purpose of the meetings has been to "improve [the] overall regulatory capability of the SRO's," and to "eliminate overlapping efforts which may presently exist, to fill existing voids in regulatory programs and to promote the interchange of and access to information." 36/ Significantly, the Conference has acknowledged that "the establishment of a more fully integrated regulatory system is both necessary and desirable as a means of establishing more efficient and effective regulation which may be cost-effective to the industry and achieve minimum standards of regulation on an industry-wide basis thus assuring the protection of public investors." 37/

The Conference divided into subgroups for the purpose of focusing on specific issues. Each subgroup presented a report to the Conference, and the Conference presented a report to the Study. Two sections of

35/ Letter to Richard Teberg, Director, Special Study of the Options Markets, from the Self-Regulatory Conference, dated October 6, 1978. A copy of this letter is attached as Exhibit 9.

36/ Id.

37/ Id.