

**Regulatory Circular RG94-64****Date: September 2, 1994****To: Members and Member Organizations****From: Regulatory Services Division****Re: Options Market-Maker Limited Exemption From NASD Short Sale Rule**

As you may be aware, the National Association of Securities Dealers ("NASD") has received approval from the Securities and Exchange Commission for a short sale rule. The rule becomes effective Tuesday September 6. The NASD's rule imposes a bid test on NASD members in connection with short sales in Nasdaq National Market Securities ("NM Securities"). The NASD's rule exempts certain short sales of NM Securities executed by NASD members for options market-makers. The CBOE and other options exchanges have adopted conforming rules which require options market makers to identify sales of NM securities as *long sales, short sales, or bid test exempt sales*. The exemption is *limited* to the classes where a given market-maker trades *most actively*, and in general can only be utilized in conjunction with stock trades which hedge pre-existing or contemporaneously established options positions. The NASD Rule and the market-maker exemption are described below.

**THE NASD RULE**

Because trades are reported on the NASDAQ national market system from numerous disparate sources, and, therefore, such trades are not necessarily reported in exact order by time, the anticipated NASD short sale rule will utilize a *bid test, not a tick test*, which is used for exchange-traded stocks. Essentially, a short sale will not be executable in a NASDAQ NMS stock at a price equal to or below the current best (inside) bid if that current best bid is lower than the previous best bid. There are exceptions. The only exception which will be discussed herein is the exemption for options market-makers.

**THE OPTIONS MARKET-MAKER LIMITED EXEMPTION****Eligible Stocks**

Market-makers will be able to declare an exemption from the NASD short sale rule in the stocks underlying the options classes traded at **three** stations which are part of the market-maker's appointment. Class eligibility declarations will be handled in the same manner and at the same time that class appointment requests are made. Like class appointment requests, they may be changed once per calendar month, and are retroactive to the beginning of the month in which they are made. Short sale eligibility declarations and market-maker appointments are made at the Trading Procedures Office on the fourth floor.

The exemption extends to component stocks of certain indexes on which options are traded. The applicability of the exemption to index options is described in detail below.

In addition to the forgoing, NASD has interpreted that if a market-maker is eligible for the exemption in a security (stock T) that becomes the target of a merger or acquisition by another company (stock A), short sales in stock A by the market-maker are also eligible for the exemption. Class eligibility for the "deal" exemption is discussed in further detail below.

### **Eligible Transactions**

Market-makers may avail themselves of the exemption only in stocks for which they are eligible, as described above. In addition, the exemption may only be used for stock transactions executed for the purpose of hedging pre-existing or contemporaneously established options positions. The term "contemporaneously" is meant to include transactions occurring simultaneously as well as transactions occurring within the same brief period of time.

In addition, stock **positions** which result from sale transactions which utilize the exemption for equity options classes must be **eligible for good faith margin** treatment, whether or not such good faith margin is applied. This means that the offsetting options must be in- or at-the-money; the latter of which is defined as being within one or two strike price(s) of the current value of the underlying stock where the strike price interval equals or exceeds \$10, or is below \$10, respectively.

### **Eligible Index Options Classes**

It is recognized that the exemption is necessary and appropriate for the hedging of certain index options which have a significant proportion of the underlying value comprised by NASDAQ stocks. Therefore, for index options for which at least 10% of the market capitalization of the underlying index is comprised of NASDAQ stocks, the hedge exemption is available for the NASDAQ stocks in that index, subject to restrictions described below. The list of index option classes which are eligible for the exemption will be published from time to time in the *Regulatory Bulletin*, and generally will be reviewed on a quarterly basis. Once eligible, a class will become ineligible if at a quarterly review it is discovered that the market capitalization of the underlying index comprised by NASDAQ stocks has fallen below 8%. As of the date of this circular the qualified index classes are the following: BGX, CWX, EVX, NDX and RUT.

### **Restrictions Applicable to Index Options Classes**

The exemption can only be utilized to the extent that the short sale is part of a transaction which is for the purpose of hedging the corresponding index options and in fact serves as a hedge. The current aggregate value of the NASDAQ stocks sold short may not exceed the current aggregate underlying index value of the index options position being hedged. Again, the exemption can only be used if the market-maker has declared the appropriate station (which must be part of the market-maker's appointment), and must be used to hedge pre-existing or contemporaneously established options positions.<sup>1</sup>

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<sup>1</sup>Although the set or basket of stocks which may be sold to hedge an index options position exempt from the NASD bid test is not strictly defined, market-makers should be aware that partial stock baskets may not receive optimal haircut or margin treatment.

**FLEX index classes:** If an index class is eligible, then so are FLEX options on the same index, subject to the same restrictions. All index FLEX contracts will be considered to be traded at one station for purposes of the exemption.

### **Eligibility of Transactions in "Deal" Stocks**

If a market-maker declares an exemption in a stock (stock T) which becomes the target of a merger or acquisition by another company (stock A) then the exemption may extend to stock A to the extent that short sales in stock A constitute hedge transactions against options overlying stock T. Such trades in stock T qualify for the short sale exemption whether or not the resulting positions qualify for favorable haircut or market-maker margin treatment.

### **Applicable Only to Normal Market-Making Activity**

The purpose of the exemption is to facilitate normal options market-making activity. Transactions unrelated to normal market-making activity, such as index arbitrage or risk arbitrage that in either case is independent of a Market-Maker's normal market-making functions, are ineligible for the exemption.

### **Procedure for Using the Exemption**

All sales of NASDAQ NMS stocks must be identified as long, short or bid-test exempt. The term "short" means the same thing for NASDAQ stocks as for listed stocks.<sup>2</sup> Orders, whether recorded on paper or electronically, for short sales which are eligible for the market-maker exemption should be marked "B/X" (for "bid test exempt"). Such transactions are exempt from the bid test and may be executed as though the order were identified as "long". When executing an order marked "B/X", firms may rely on the implied assertion that the order is eligible for the exemption unless they otherwise have reason to believe that the order is not eligible.

### **IMPROPER USE OF THE EXEMPTION**

Orders must not be identified as bid test exempt unless 1) the market-maker is exempt for the corresponding options class, 2) the short sale transaction results in a hedge of a pre-existing or contemporaneously established options position, and 3) except for trades done in "deal" stocks or which are used to hedge qualified index options, the position resulting from the transaction must qualify for permitted offset treatment. Use of the exemption will be carefully monitored. Improper use of the exemption is a violation of Exchange Rules, and will be vigorously pursued and presented to the Exchange's Business Conduct Committee for disciplinary action. Violations could result in fine, suspension or other appropriate penalty. Further, repeated or egregious misuse of the exemption may result in suspension or permanent withdrawal of the exemption from the person(s) responsible for such misuse. Misuse of the exemption in connection with any form of manipulation would

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<sup>2</sup> See SEC Rule 10a-1; CBOE Regulatory Circular RG91-35.

be considered particularly egregious. Depending on the actual circumstances, misuse of the exemption could be deemed a violation of Exchange Rules 4.1, Just and Equitable Principles of Trade; 4.7, Manipulation; 8.7, Obligations of Market-Makers; and/or 15.10, Reporting Requirements Applicable to Short Sales in NASDAQ/NMS Securities. The Exchange and the NASD have committed to share all assistance and information necessary to enforce the Rules of the two organizations.

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The market-maker exemption is provided for in Exchange Rule 15.10, copies of which can be obtained from the Legal Department. Questions regarding the NASD's short sale rule should be directed to Thomas R. Gira, Office of the General Counsel, NASD at (202) 728-8957. Questions regarding the options market-maker exemption may also be directed to Jeffrey B. Schroer, CBOE Department of Market Surveillance at (312) 786-7716. Questions concerning margin or haircut treatment of index options offset by stock baskets or offsets between options and deal stocks may be directed to Richard Lewandowski at (312) 786-7183 or to Diane Malley at (312) 786-7924; they are in the CBOE Department of Financial Compliance.