

Regulatory Circular 95-40

DATE: May 10, 1995

TO: Members and Member Organizations

FROM: Regulatory Services Division

RE: Options Market Maker Limited Exemption from NASD Short Sale Rule

The purpose of this memo is to combine and supersede Regulatory Circulars 94-64 and 95-24 as they relate to the Options Market Maker exemption to the NASD Short Sale Rule. The National Association of Securities Dealers ("NASD") received approval from the Securities and Exchange Commission for a short sale rule effective September 6, 1994. 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 (see Exchange Rule 15.10) and other options exchanges have adopted conforming rules which require options market-makers to identify sales in NM securities as long sales, short sales or bid test exempt sales. The exemption is limited to the classes where a market maker is appointed, and in general can only be utilized in conjunction with stock trades which hedge pre-existing or contemporaneously established option positions.

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 NASD rule utilizes a bid test, not a tick test. 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 to be discussed herein is the exemption for option market-makers.

THE OPTION MARKET MAKER LIMITED EXEMPTION

All Appointed Classes

Market makers are eligible for the exemption from the NASD short sale rule in all stocks underlying the option classes which are part of the market-maker's appointment. This exemption extends to components of certain indexes on which options are traded. The applicability of the exemption to index options is described in detail below.

Nominees of the same member organization: A market-maker nominee may utilize the exemption in a Nasdaq/NMS security which does not underlie a class in his/her appointment provided that such security does underlie a class within the appointment of another nominee, if such other nominee is not also present on the floor or represented by a floor broker in the applicable trading crowd at the time of the bid test exempt sale. In other words, a market-maker nominee may rely on the fact that another nominee(s) has a given class in their appointment as long as such other nominee(s) are not also present on the floor or represented in the applicable trading crowd via order.

Companies involved in mergers and/or acquisitions: The exemption can be extended to the sale of stock of a company if it is involved in a publicly announced merger or acquisition of a company whose stock underlies a class in one's appointment, and such sale is made to hedge existing or prospective positions in such class of options. For example, if a market-maker has an appointment in class ABC and company ABC is the subject of a prospective publicly announced merger or acquisition by company XYZ (the stock of which is a Nasdaq/NMS security), then the exemption can be applied to sales of XYZ stock provided that they legitimately hedge options positions in class ABC.

Short sales to hedge certain trades outside one's appointment: The exemption can be extended outside stocks underlying appointed classes for the purpose of hedging trades which accommodate the execution of options or combination orders originating from off-floor. The order must originate from off-floor, but may be for the account of a customer, market-maker or other broker-dealer. The following procedures must be adhered to:

- 1) prior notification must be made to a Floor Official or Order Book Official,
- 2) the exempt short sale must be contemporaneous with the trade with the off-floor order,
- 3) the Floor Official or Order Book Official must file a report describing the transaction, giving a copy to the market-maker, and
- 4) the market-maker must maintain a copy of this report as his record that the sale of the stock was bid/test exempt.

The report shall contain a description of all relevant stock and option trades, including volumes, prices, and the time(s) of the trades, and shall identify the member firm representing the order originated from off-floor and the acronym of the Floor Broker executing such order. Floor Officials or Order Book Officials shall use standard Floor Official or OBO UAR forms for purposes of filing the reports. The reports will then be forwarded to the Department of Market Surveillance.

ELIGIBLE TRANSACTIONS

Market-makers may avail themselves of the exemption only in stocks for which they are eligible. In addition, the exemption may only be used for stock transactions executed for the purpose of hedging pre-existing or contemporaneously established option positions. The term "contemporaneously" is meant to include transactions occurring simultaneously as well 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 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 Option 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 stock, the hedge exemption is available for the NASDAQ stocks in that index, subject to the restrictions described below. The list of index option classes which are eligible for the exemption will generally be reviewed on a quarterly basis and published from time to time in the Regulatory Bulletin. Once eligible, a class will become ineligible if at a quarterly review the market capitalization has fallen below 8%. As of this date the index classes which qualify include the following: **BGX, CWX, EVX, GAX, GTX, ISX, and TCX.**

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.

FLEX Index Classes

If an index class is eligible then so are FLEX options on the same index, subject to the same restrictions.

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. 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 Exchanges'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 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-Market Makers; and/or 15.10, Reporting Requirements Applicable to Short Sales in NASDAQ/NMS. The Exchange and the NASD have committed to share all assistance and information necessary to enforce the Rules of the two organizations.

Questions regarding this circular can be addressed to Mr. Jeffrey B. Schroer, Vice President at (312) 786-7712 or Pat Sizemore at (312) 786-7752, of the Department of Market Surveillance.