SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–43086, File No. 4–429]

Joint Industry Plan; Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC

July 28, 2000.

I. Introduction

On January 19, 2000, pursuant to an order issued by the Securities and Exchange Commission (''SEC'' or ''Commission''),[1] the American Stock Exchange LLC (''Amex''), Chicago Board Options Exchange, Inc. (''CBOE''), International Securities Exchange LLC (''ISE''),[2] Pacific Exchange, Inc. (''PCX''), and Philadelphia Stock Exchange, Inc. (''Phlx'') filed with the Commission proposed plans for the purpose of creating and operating an intermarket options market linkage (''plans''). In accordance with Rule 11Aa3–2 of the Act,[3] Amex, CBOE, and ISE filed a plan (the ''Amex/CBOE/ISE plan''). Separately, PCX and Phlx filed with the Commission proposals for alternative linkage plans. Although the three plans are identical with respect to a majority of the issues pertaining to a linkage, the exchanges were unable to reach agreement—and the plans differ—on several significant matters. Specifically, the exchanges failed to agree about whether the linkage should require that orders be routed to exchanges based on price/time priority,[4] who should have access to the linkage, and the appropriate remedy owed when one market trades at a price inferior to that displayed on another market (known as a ''trade-through'').

On March 2, 2000, a detailed summary of the Amex/CBOE/ISE plan, the PCX plan, and the Phlx plan was published for comment in the **Federal Register**.[5] The Commission received comments on the proposed linkage plans from 24 market participants.[6] This Order approves the Amex/CBOE/ISE plan, thus authorizing the Amex, CBOE, and ISE [7] to act jointly to implement an intermarket linkage as a means of facilitating a national market system in accordance with the requirements of Section 11A of the Act.[8]

II. Background

In 1975, Congress directed the Commission to oversee the development of a national market system.[9] One of the principal purposes of the national market system is to assure ''the practicability of brokers executing investors' orders in the best market.'' [10] In the equity and options market, price transparency and the duty of best execution owed by brokers to their customers are central to achieving this and other national market system goals. In the equity market, the Commission's Quote Rule [11] and the Intermarket Trading System [12] (which requires exchanges to avoid intentionally trading through another exchange's displayed quote) are additional components of the national market system that have assisted customers in receiving quality executions of their orders. At the time these additional national market system mechanisms were developed in the equity markets, however, the trading of standardized options was relatively new.[13] As a result, the Commission deferred applying these initiatives to the options markets to give options trading an opportunity to develop.

The absence in the options markets of firm quotes and intermarket linkages makes it more difficult for broker-dealers to ensure the best execution of customer orders for multiply-traded options. The obstacles to access between the options exchanges makes reaching any better quotes displayed on another market difficult in many cases. Moreover, other than exchange rules

[1] On October 19, 1999, the Commission issued an order under Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 (''Act''), 15 U.S.C. 78k–1(a)(3)(B), directing the options exchanges to file a national market system plan within 90 days to link the options markets. *See* Securities Exchange Act Release No. 42029, 64 FR 57674 (October 26, 1999) (''October 19, 1999 Order'').

[2] The Commission's October 19, 1999 Order also requested the ISE to participate with the options exchanges in the development of an intermarket linkage plan. On January 19, 2000, ISE had not been approved as a national securities exchange. Therefore, the ISE was not able to be a signatory to a linkage plan at that time, even though it submitted a plan identical to that filed by Amex and CBOE. The ISE was subsequently registered as a national securities exchange for options trading on February 24, 2000. *See* Securities Exchange Act Release No. 42455, 65 FR 11387 (March 2, 2000).

[3] 17 CFR 240.11Aa3–2.

[4] Both PCX and Phlx proposed price/time priority as an element of the linkage. In general, a price/time priority rule would require an exchange that receives an order, but that was not the first exchange to display the best price, to route the order to the exchange that was the first to display the best price.

[5] *See* Securities Exchange Act Release No. 42456 (February 24, 2000), 65 FR 11402. At the same time, the full text of each of the plans was made available to interested persons on the Commission's website.

[6] Letters to the Commission from Salvatore F. Sodano, Chairman and Chief Executive Officer (''CEO''), Amex, dated January 19, 2000 and May 3, 2000 (''Amex Letter''); William J. Brodsky, CEO, CBOE, dated January 19, 2000, and two dated March 31, 2000 (''CBOE Letter''); U.S. Department of Justice to Commission (''DOJ Letter''); David Krell, President and CEO, ISE, dated January 19, 2000, and from Michael J. Simon, Senior Vice President and Secretary, ISE, dated April 3, 1999 (''ISE Letter''); Philip D. DeFeo, Chairman and CEO, PCX, dated April 3, 2000 (''PCX Letter''); William C. McGowan, Chairman, Options Committee, Securities Industry Association, dated April 11, 2000 (''SIA Letter''); Meyer S. Frucher, Chairman and CEO, Phlx, dated January 19, 2000 (''Phlx Letter''); Douglas J. Engmann, President and CEO, ABN–AMRO, dated March 24, 2000 (''ABN Letter''); Kevin M. Luthringhausen, Executive Managing Member, Botta Trading, LLC, dated April 10, 2000 (''Botta Letter''); George Brunelle, Brunelle & Hadjikow, dated April 25, 2000 (''Brunelle Letter''); Lon Gorman, Vice Chairman and President, Capital Markets & Trading Group, Charles Schwab & Co., Inc., dated April 18, 2000 (''Charles Schwab Letter''); Craig S. Tyle, General Counsel, Investment Company Institute, dated April 3, 2000 (''ICI Letter''); Thomas Peterffy, Chairman, and David M. Battan, Vice President and General Counsel, Interactive Brokers, The Timber Hill Group, dated April 3, 2000 and April 10, 2000 (''Interactive Letter''); Peter Hajas, CEO, Knight Financial Products LLC, dated April 3, 2000 (''Knight Letter''); Samuel F. Lek, CEO, Lek Securities Corporation, (''Lek Letter''); Terry Brookshire, President, OptiMark Options/Derivatives, OptiMark Technologies, Inc., dated April 3, 2000 (''OptiMark Letter''); Richard F. Brueckner, Chief Operating Officer, Pershing Division of Donaldson, Lufkin & Jenrette Securities Corporation, dated April 5, 2000 (''Pershing Letter''); Andrew Cader, Senior Managing Director, Spear, Leeds & Kellogg, dated April 6, 2000 (''Spear, Leeds Letter''); Joel Greenberg, Managing Director, Susquehanna Investment Group, dated April 3, 2000 (''Susquehanna Letter''); Judy A. Basham, dated April 17, 2000 (''Basham Letter''); F. Steven Donahue, dated March 27, 2000 (''Donahue Letter''); P. Robert Fenwick, dated April 1, 2000 (''Fenwick Letter''); Mike Ianni, dated March 19, 2000, March 26, 2000, April 1, 2000, April 3, 2000, and April 4, 2000 (''Ianni Letter''); and Goldman, Sachs & Co. and Morgan Stanley Dean Witter & Co., dated July 20, 2000 (''Goldman/Morgan Letter''). A summary of comments received on the proposed linkage plans is available in the Commission's Public Reference Room (File No. 4–429).

[7] The Commission's Order does not require those options exchanges that are not participants in the plan to become participants in the Amex/CBOE/ISE plan. The plan does, however, include express provisions pursuant to which other options exchanges may become participants by executing the plan, paying a fee applicable to new participants, and obtaining the Commission's approval of the plan as amended to reflect the new participant. *See* Amex/CBOE/ISE plan, Sections 4(c) and 5(c)(ii).

[8] In addition, as described below, the Commission is separately proposing for comment a Trade-Through Disclosure Rule and modifications to the Commission's Quote Rule to apply to the options markets. *See infra* note 33 and accompanying text.

[9] Pub. L. No. 94–29 Stat. 97 (1975).

[10] 15 U.S.C. 78k-1(a)(1)(C)(iv).

[11] Rule 11Ac1–1 under the Act, 17 CFR 240.11Ac1–1.

[12] The Intermarket Trading System (''ITS'') Plan is an effective national market system linkage plan linking the equity markets. The ITS Plan was first approved on an interim basis in 1978. Securities Exchange Act Release No. 14661 (April 14, 1978), 43 FR 17419 (April 24, 1978).

[13] The trading of standardized options on securities exchanges began in 1973, with the organization of CBOE as a national securities exchange. *See* Securities Exchange Act Release No. 9985 (February 1, 1973), 1 S.E.C. Doc.11 (February 13, 1973). Currently, Amex, CBOE, ISE, PCX, and Phlx are the only national securities exchanges that trade standardized options.

that require members' quotes to be firm for customer orders, market makers are not subject to a firm quote obligation. Thus, market makers' quotes are not required to be firm for broker-dealers' proprietary orders, or for agency orders routed from another exchange. Instead, options exchanges have adopted ''trade-or-fade'' rules, requiring market makers to move their quote if they are unwilling to trade at that price. Accordingly, firms representing customer orders cannot be certain that a better price quoted on another exchange is actually available to them.

Since the establishment of the options exchanges, the Commission has repeatedly called for market integration facilities for the options markets to achieve the national market system goals.[14] In 1991, in response to these calls, four of the five options exchanges[15] submitted a proposal for the development of a linkage.[16] The plan was never adopted, in part, because the exchanges did not agree on the feasibility of implementing a single linkage plan. More recently, Chairman Levitt wrote to the options exchanges emphasizing the need for the options markets to develop mechanisms, such as linkages, firm quotes, and trade-through protections, to protect customer orders.[17] Finally, because of the growing practice by the options exchanges of multiply trading options classes previously listed on a single exchange, the need for measures to ensure that such customer orders are not executed at prices inferior to prices quoted on another options exchange has become more acute. For this reason, on October 19, 1999, the Commission ordered the markets to submit a linkage plan within 90 days that, at a minimum, included uniform trade-through rules and expanded firm quote obligations to cover agency orders presented by competing exchanges.[18] In response to this Order, on January 19, 2000, Amex, CBOE, and ISE submitted the Amex/CBOE/ISE plan and PCX and Phlx each filed separate plans.

III. Description of the Amex/CBOE/ISE Plan

The Amex/CBOE/ISE plan proposes an intermarket linkage for the following three types of orders:

- Customer orders, where the market maker chooses not to ''step up'' to match a better price displayed on an away market;
- Principal orders of eligible market makers [19] and
- Orders intended to satisfy trade-through liability.

The means of routing these three types of orders, along with certain limitations on their routing, are discussed below.

A. Customer Orders Where Market Makers Choose Not To Step Up

The Amex/CBOE/ISE plan would permit an eligible market maker representing a customer order to transmit through the linkage a new type of order—a principal acting as agent order (''P/A Order'').[20] If the size of the P/A Order is no larger than the Firm Customer Quote Size,[21] the Amex/CBOE/ISE plan provides that an eligible market maker that chooses to route the order away can send it through the linkage for execution in the automatic execution system of a participating exchange at the best price (''NBBO'').[22] The exchange receiving the P/A Order through the linkage must execute it in its automatic execution system, if its disseminated quote is equal to or better than the limit price attached to the P/A Order (''reference price'') [23] at the time the order arrives at the receiving exchange.

If the size of the P/A Order is larger than the Firm Customer Quote Size, the Amex/CBOE/ISE plan provides two alternatives to an eligible market maker that chooses to route the order. First, the eligible market maker can send a P/A Order representing the entire customer order through the linkage. If the receiving exchange's disseminated quote is equal to or better than the reference price of the order, the receiving exchange must execute that order for at least the Firm Customer Quote Size and, within 15 seconds of receipt of such P/A Order, inform the sending exchange of the amount of the order that was executed and the amount, if any, that was canceled. Second, an eligible market maker can send as a P/A Order that portion of the customer order equal to the Firm Customer Quote Size. Then, 15 seconds after reporting the execution of this P/A Order, if the receiving exchange continues to disseminate the same quote, and that quote is the NBBO, the market maker may send a second P/A Order. This second P/A Order must be for the lesser of 100 contracts or the entire remainder of the customer order the sending eligible market maker is representing. Under either alternative, if the receiving exchange does not execute the entire P/A Order, it must move its

[14] *See* Report of the Special Study of the Options Markets to the SEC, 96th Cong., 1st Sess. (Comm. Print No. 96–IFC3, December 22, 1978) (examining the major issues of market structure in standardized options markets, including multiple trading); Securities Exchange Act Release No. 16701 (March 26, 1980), 45 FR 21426 (April 1, 1980) (deferring expansion of multiple trading to afford the options exchanges an opportunity to consider the development of market integration facilities); Securities Exchange Act Release No. 22026 (May 8, 1985), 50 FR 20310 (May 15, 1985) (urging options market participants to consider the development of market integration facilities); Directorate of Economic and Policy Analysis, ''The Effects of Multiple Trading on the Market for OTC Options'' (November 1986); Office of the Chief Economist, ''Potential Competition and Actual Competition in the Options Market'' (November 1986); and Securities Exchange Act Release No. 26871 (May 26, 1989), 54 FR 24058 (June 5, 1989) (requesting comment on three measures, including an intermarket linkage). In 1990, then Chairman Breeden requested that the options exchanges develop an intermarket linkage plan. *See* letter from Chairman Breeden to the registered options exchanges dated January 9, 1990.

[15] At that time, the five options exchanges were the CBOE, PCX, Amex, Phlx, and the New York Stock Exchange (''NYSE''), which later sold its options business to the CBOE. *See* Securities Exchange Act Release No. 38542 (April 23, 1997), 62 FR 23521 (April 30, 1997).

[16] *See* Securities Exchange Act Release No. 30187 (January 14, 1992), 57 FR 2612 (January 22, 1992) (soliciting comments on an intermarket linkage plan submitted by Amex, CBOE, NYSE, and PCX).

[17] *See* letters from Arthur Levitt, Chairman, SEC, to Richard F. Syron, Chairman and CEO, Amex; William J. Brodsky, Chairman and CEO, CBOE; Robert M. Greber, Chairman and CEO, PCX; and Meyer S. Frucher, Chairman and CEO, Phlx, dated February 10, 1999. *See also* letters from Chairman Levitt, to Salvatore Sodano, Chairman and CEO, Amex; William J. Brodsky, Chairman and CEO, CBOE; Philip D. DeFeo, Chairman and CEO, PCX; and Meyer S. Frucher, Chairman and CEO, Phlx; dated October 1, 1999.

[18] *See* note 1, *supra.*

[19] An ''eligible market maker'' is defined in the Amex/CBOE/ISE plan as a ''market maker'' that: (1) Is assigned to provide, and is providing, two-sided quotations in the eligible option class; (2) is participating in its market's automatic execution system in such eligible option class; and (3) is not prohibited from sending ''principal orders'' in such eligible option class through the linkage pursuant to the plan.

[20] A P/A Order is defined as an order for the principal account of a market maker authorized to represent customer orders, which reflects the terms of a related unexecuted customer order for which the market maker is acting as agent.

[21] Under the Amex/CBOE/ISE plan, the Firm Customer Quote Size is the lesser of: (1) The number of contracts the exchange sending the P/A Order guarantees it will automatically execute for customer orders that are entered directly in that market; or (2) the number of contracts the receiving exchange guarantees it will automatically execute for customer orders that are directly entered in that market. However, in no event, would a P/A Order be guaranteed fewer than 10 contracts.

[22] The term ''NBBO'' is defined as the national best bid and offer in a series of an eligible option class calculated by a participating exchange. Currently, a consolidated NBBO does not exist for the option markets. Instead, each options exchange separately calculates the best bid or offer for each multiply-traded options class.

[23] Except with respect to a satisfaction order, the reference price is equal to the quotation disseminated by the receiving exchange at the time the linkage order is transmitted. With respect to a satisfaction order, the reference price is the price to which the member in the sending exchange is entitled pursuant to the linkage plan. *See* Section III.C, *infra* for a discussion of satisfaction orders.

quote to a price inferior to the reference price of the P/A Order.

In addition, an eligible market maker that sends a P/A Order through the linkage and who does not receive a reply within 30 seconds may reject any response received thereafter purporting to report a total or partial execution of that order. The eligible market maker that sent the P/A Order must inform such executing exchange within 15 seconds that it is rejecting the execution.

Finally, the Amex/CBOE/ISE plan provides that the linkage should not be used as an order delivery system through which all or a substantial portion of a participant's customer orders are executed using P/A Orders routed through the linkage.

B. Principal Orders of Eligible Market Makers

The Amex/CBOE/ISE plan would allow eligible market makers to send proprietary orders through the linkage. Such orders must be at the NBBO. If the principal order is not larger than the Firm Principal Quote Size,[24] the exchange receiving such order through the linkage must execute it in its automatic execution system, if its disseminated quote is equal to or better than the reference price at the time the order arrives. If the principal order is larger than the Firm Principal Quote Size, the receiving exchange must execute the order in its automatic execution system for at least the Firm Principal Quote Size and, within 15 seconds of receipt of such order, inform the sending exchange of the amount of the order that was executed and the amount, if any, that was canceled. In addition, if the receiving exchange does not execute the entire principal order, it must move its quote to a price inferior to the reference price of the principal order. An eligible market maker may not send a second principal order in the same eligible option class for at least 15 seconds after it sent the first principal order, unless the receiving exchange changes its quote and that quote is the NBBO. If the receiving exchange's disseminated quote does not change for one minute after the automatic execution of the first principal order, the exchange that initially sent the principal order for automatic execution may send only principal orders for greater than the Firm Principal Quote Size.

As with P/A Orders sent through the linkage, an eligible market maker that sends a principal order through the linkage and who does not receive a reply within 30 seconds may reject any response received thereafter purporting to report a total or partial execution of that order. The market maker that sent the principal order must inform the receiving exchange within 15 seconds that it is rejecting the response.

As a limitation on eligible market makers' access to the linkage for sending principal orders, the Amex/CBOE/ISE plan would impose an ''80/20 Test.'' Under this test, a market maker that effected 20 percent or more of its market maker volume by sending principal orders through the linkage in a calendar quarter would be prohibited from sending principal orders through the linkage for the next calendar quarter (*i.e.,* would not be an ''eligible market maker'' for that period). Outgoing P/A Orders would not be included in this calculation.

C. Satisfaction of Trade-Through Liability

The Amex/CBOE/ISE plan provides that members of participant markets should avoid initiating trade-throughs, subject to certain exceptions, absent reasonable justification and during normal market conditions. Any member of a plan participant that does initiate a trade-through would be liable to the market maker who complains that its quote was traded through. Under the plan, there are a number of proposed exceptions to this trade-through liability, which include systems malfunction, failure of the receiving market to respond to a P/A or principal order within 30 seconds, complex trades, trading rotations, and non-firm quotations on the market that was traded through.

The Amex/CBOE/ISE plan provides that if a market that had its quote traded through complains within the specified time period, the member that initiated such trade-through would have to satisfy the complaining market by adjusting the price or canceling the trade. If customer orders constituted either or both sides of the transaction involved in the trade-through, each customer order would receive whichever of the following is most beneficial to the customer:

- The price of the trade that caused the trade-through;
- The satisfaction price, if the trade-through was satisfied; The satisfaction price would equal the bid or offer, unless the transaction that constituted the trade-through was a block trade,[25] in which case satisfaction would be the price of the transaction that caused the trade-through; or
- The adjusted price, if there was an adjustment.

The member initiating the trade-through is responsible for any differences.

With respect to the appropriate size of satisfaction, in the absence of disseminated size, the Amex/CBOE/ISE plan would limit the satisfaction of a trade-through to the verifiable number of customer contracts that were included in the disseminated bid or offer of each exchange that was traded through, subject to certain limitations. In particular, if the number of contracts to be satisfied in one or more exchanges exceeds the size of the transaction that caused the trade-through, satisfaction will be limited to the size of the transaction that caused the trade-through.

IV. Discussion

A. Introduction

In Section 11A of the Act,[26] Congress directed the Commission to facilitate the development of a national market system consistent with the objectives of the Act. In particular, Section 11A(a)(3)(B) of the Act[27] authorizes the Commission ''by rule or order, to authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under this title in planning, developing, operating, or regulating a national market system (or a subsystem thereof) or one or more facilities.'' Rule 11Aa3–2 establishes the procedures for filing, amending, and approving national market system plans.[28] Pursuant to paragraph (c)(2) of Rule 11Aa3–2, the Commission's approval of a national market system plan is conditioned upon a finding that the proposed plan ''is necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market

[24] Under the Amex/CBOE/ISE plan, the Firm Principal Quote Size means the number of contracts that a receiving exchange guarantees it will execute at its disseminated quote for incoming principal orders, but in no event shall this number be fewer than 10 contracts.

[25] The term ''block trade'' is defined as a trade that: (i) is of block size, defined as 500 or more contracts and a premium value of at least $150,000; (ii) is effected at a price outside of the NBBO; and (iii) involves either a cross (where a member of the exchange represents all or a portion of both sides of the trade) or any other transaction that is not the result of an execution at the current bid or offer on the exchange.

[26] 15 U.S.C. 78k–1.

[27] 15 U.S.C. 78k–1(a)(3)(B).

[28] 17 CFR 240.11Aa3–2.

system, or otherwise in furtherance of the purposes of the Act.''[29]

After carefully considering the proposed linkage plans and the issues raised by the comment letters, the Commission has determined to approve, pursuant to Section 11A(a)(3)(B) of the Act,[30] and Rule 11Aa3–2 thereunder,[31] the Amex/CBOE/ISE plan, thus authorizing the Amex, CBOE and ISE to act jointly to implement the plan's intermarket linkage.[32] In approving the Amex/CBOE/ISE plan, the Commission finds that, as discussed in greater detail below, the Amex/CBOE/ISE plan is consistent with the Act in that it provides, among other things, a mechanism for assuring price priority for published quotes and obtaining the quoted price for customer orders, and therefore, would enhance investor protections and the maintenance of fair and orderly markets.

Specifically, the Commission believes that the continuing growth in the number of options classes traded on more than one exchange has significantly increased the need for a vehicle to assure price priority for published options quotes. Without an efficient linkage between the options markets, it is difficult for one options exchange to access better prices on another exchange. Given the recent increase in multiply-traded options classes, the absence of an efficient mechanism allowing one market to access a better price displayed by another exchange heightens the Commission's concern that better priced quotes may not be honored and that investors may not receive the best price available for their orders. The Commission believes that the Amex/CBOE/ISE plan, if implemented, would help reduce the frequency of intermarket trade-throughs of published quotations.

The Commission recognizes the limited scope of the Amex/CBOE/ISE plan. Notably, the Amex/CBOE/ISE plan does not attempt, among other things, to give priority to customer limit orders across markets or to encourage quote competition by rewarding market makers who establish the NBBO. The Commission, however, believes that it would be premature at this time to require the inclusion of either customer limit order protection or price/time priority as elements of a linkage between the options markets.

Moreover, while the Commission has determined at this time to approve the Amex/CBOE/ISE plan, the Commission recognizes that there may be a number of equally acceptable means of achieving the Commission's goal of encouraging price priority by limiting intermarket trade-throughs of customer orders. To that end, the Commission has separately proposed modifications to its Quote Rule to apply to the options exchanges and options market makers the same obligations, with certain modifications, currently imposed on equity markets and market makers. The Commission is also proposing a rule that would require a broker-dealer to disclose to customers when the customer's order is executed at a price inferior to the best available quote, unless the order is routed only to options exchanges that participate in a plan that limits trade-throughs.[33] The Commission believes that its approval of the Amex/CBOE/ISE plan, coupled with the rulemaking separately proposed, should minimize the probability of intermarket trade-throughs involving customer orders.

B. Price/Time Priority

One way to encourage market makers to quote competitively is through a rule that gives priority to quotes based on price and time. Generally, priority among orders and quotes within an exchange is based on price and time.[34] A requirement that priority across markets be based on price and time has also been suggested as a way to reward market makers who are the first in time at the best quote. In general, an intermarket requirement of price/time priority would require an exchange that receives an order, but that was not the first exchange to display the best price, to route the order to the exchange that was first at the best price. The PCX[35] and Phlx[36] each incorporated price/time priority as an element of their proposed linkage plans. As discussed above, the Amex/CBOE/ISE plan does not include price/time priority and instead, would allow the exchange initially receiving an order to step up to match the better price being disseminated by another market.

In addition to the PCX and Phlx, several commenters supported the notion of price/time priority as an element of an intermarket linkage plan. One commenter noted that without price/time priority, there is no incentive

[29] 17 CFR 240.11Aa3–2(c)(2).

[30] 15 U.S.C. 78k–1(a)(3)(B).

[31] Pursuant to paragraph (c)(2) of Rule 11Aa3–2 under the Act, the Commission designates up to 180 days from the date of publication of notice of the filing of a national market system plan for its approval of the Amex/CBOE/ISE plan. The Commission finds that, due to the complexity of issues relating to an intermarket linkage between the options markets, it is necessary and appropriate in the public interest, for the protection of investors, and the maintenance of fair and orderly markets to designate this longer period. 17 CFR 240.11Aa3–2.

[32] The Commission's approval of the Amex/CBOE/ISE plan should not be construed as a rejection on the merits of either the Phlx or the PCX submissions. Neither of those submissions could be approved as a national market system plan pursuant to Rule 11Aa3–2 under the Act, 17 CFR 240.11Aa3–2, because neither was filed by two or more sponsors, as required by the Rule. In fact, the Commission would consider approving other national market system plans relating to intermarket linkages between the options markets, submitted by two or more markets.

[33] *See* Securities Exchange Act Release No. 43085 (July 28, 2000) (Firm Quote and Trade-Through Disclosure for Options Proposal). The Commission's proposal would require a broker-dealer to disclose to its customer when a transaction in listed options was effected at a price that trades through a better published price, and the better published price. The broker-dealer would be excepted from the disclosure requirement of the proposed rule if the transaction is effected on an options exchange that is a participant in an effective national market system options linkage plan that includes provisions to limit customer orders from being executed at a price that trades through a better published price, including prices published other than by a linkage plan participant. In addition, the Commission is proposing amendments to its Quote Rule, 17 CFR 240.11Ac1–1, to require quotes for listed options to be firm.

[34] The exchanges, however, have rules that grant certain market participants priority based on other factors. For example, exchanges' rules permit specialists, under certain circumstances, to trade ahead of others in a trading crowd with a certain percentage of every order, known as specialist guarantees. See CBOE Rule 8.87; ISE Rule 713(e); PCX Rule 6.82(d); Phlx Rule 1014(g); see also Securities Exchange Act Release No. 42964 (June 20, 2000), 65 FR 39972 (June 28, 2000) (File No. SR–Amex–00–30). In addition, some exchanges' rules, subject to certain requirements, grant order entry firms priority over members of the trading crowd to trade as principal with up to 40% of each of their customers' orders above a certain size, known as facilitation guarantees. See Securities Exchange Act Release Nos. 42894 (June 2, 2000), 65 FR 36850 (June 12, 2000) (File No. SR–Amex–99–36); 42835 (May 26, 2000), 65 FR 35683 (June 5, 2000) (File No. SR–CBOE–99–10); and 42848 (May 26, 2000), 65 FR 36206 (June 7, 2000) (File No. SR–PCX–99–18). Finally, all of the exchanges have automatic execution systems for small public customer orders that execute such orders against the accounts of market makers at each exchange's disseminated quote on a rotational basis without exposing such orders to the auction on the floor and its price/time priority rules.

[35] The PCX proposed that customer orders of 20 contracts or less would be automatically executed by the exchange that initially received the order only if that exchange was disseminating a quote with price/time priority, or if the exchange was at the NBBO (although not first in time) and provided price improvement for the order. If the exchange was not quoting at the NBBO at the time it initially received the order, it would be required to automatically generate a P/A Order and send it to the away market that was disseminating a quote with price/time priority, so long as the away exchange provided a firm customer quote of at least 20 contracts in the particular options class.

[36] The Phlx proposed a linkage plan that incorporated a strict price/time priority feature. The Phlx plan would require each exchange to build a front-end system to route all customer orders that would be eligible for automatic execution, as P/A Orders, either directly through the linkage or to the facilities manager if the exchange that initially received the order was not the first to disseminate the best price.

for market makers to show their best markets, thus making bid-ask spreads wider.[37] Other commenters argued that the best linkage plan would limit the imposition of price/time priority to small, non-contingent orders.[38]

A number of commenters stated, however, that strict price/time priority would undermine market competition by eliminating the ability of the exchanges to compete with each other on service factors, including: quick turnaround on fills, low costs, superior order handling systems, low-error rates, investor education, and enhanced liquidity and depth of the markets.[39] One commenter asserted that the price/time priority proposals were intended more to advance the perceived competitive positions of the exchanges supporting the proposals, than to benefit investors.[40] Another commenter suggested that the price/time priority proposals were actually anticompetitive because they would eliminate all forms of competition except one—the race to the quote.[41]

Other commenters contended that imposing an intermarket price/time priority rule would require the creation of a routing switch or consolidated limit order book (''CLOB'') that would consist of a single execution facility, with a single point of failure, and that such a development would reduce incentives for the markets to innovate.[42]

Several commenters argued that decimalization, which may create pricing increments as small as a penny, would undermine a price/time priority requirement.[43] These commenters suggested that if a price/time priority requirement were imposed, an exchange could easily step ahead of another exchange or customer limit order by improving the NBBO by just a penny. This ability to improve the NBBO by as little as a penny could lead to competition based on which computer could update its quotes faster.[44]

At this time, the Commission believes that the proposed options intermarket linkage, even without a price/time priority component, is consistent with the requirements of the Act. The Commission does not, however, currently have sufficient information to satisfy itself that the potential benefits of a mandatory price/time priority requirement justify the potential drawbacks.

For example, the implementation of decimals is expected to have a dramatic impact on the minimum pricing increments in the options markets and may affect the behavior of market participants. At this point, however, before the U.S. securities markets have actually begun trading in decimals, it is impossible to gauge the impact of decimalization on the options markets. Because the Commission cannot reliably predict the effect of decimals on the quoting practices in the options markets, it would be premature to mandate a requirement that dictates order execution practices based on quoting practices that have not yet developed. Further, the Commission believes that it is prudent to wait until decimals are implemented to consider whether, in a decimals environment, an intermarket price/time priority requirement would or would not reduce competition among the exchanges.

Finally, the issue of whether price/time priority could negatively impact liquidity in a given market by requiring the routing of orders based on price alone, without consideration of the size demands of the order or an exchange's ability to execute the full size of the order, should be considered. For these reasons, the Commission believes that a price/time priority requirement is not a prerequisite to approval of an intermarket linkage plan in the options market. The Commission, nevertheless, continues to consider further ways to strengthen price competition and price priority within existing market structures.[45] In addition, the Commission is concerned about the impact on quote competition of payment for order flow and other non-price competition practices. To better inform the Commission about the nature, scope, and prevalence of payment for order flow and internalization arrangements and their influence on order routing patterns, the Commission's Office of Economic Analysis along with the Office of Compliance Inspections and Examinations plans to conduct a study of the development of these practices in the options markets since multiple listing.[46]

C. Customer Limit Order Protection

In its transmittal letter, the ISE proposed an alternative approach for handling P/A Orders that would provide a means of protecting customer limit orders. Under this alternative approach, if one market executes an order at another market's quoted price without quoting at that price, and if the other market's quote was for a customer limit order, the other market can require the first market to honor its displayed customer limit order. Also, under this alternative approach, if the exchange receiving an order decides to route an order to another market instead of stepping up to match the better quote, it would be required to route the order through the linkage based on price/time priority.

The Commission received three comments in support of a customer limit order protection component to a linkage.[47] One of these commenters believed that the Commission should not approve a linkage unless customer limit orders have the opportunity to interact with the flow of orders on other markets.[48] In addition, two commenters supported a customer limit order protection rule that would protect customer limit orders while continuing to allow a market maker to step up to match the NBBO.[49]

On the other hand, seven commenters either opposed or expressed serious reservations about the potential competitive impact, cost, feasibility, or utility of a customer limit order protection rule.[50] These commenters believed that such a rule would be tantamount to a CLOB, which could eventually turn the options markets into a single execution facility, with a potential single point of failure, rather than a system of competing markets.[51] Several commenters believed that this would create a disincentive for dealers to commit capital, disrupt trading, stifle innovation, and discourage firms from offering new services.[52]

In addition, two commenters expressed concern that a customer limit order protection rule could expose market makers who step up to match the NBBO to increased risk because such market makers could have to satisfy customer limit orders on another

[37] Ianni Letter.

[38] DOJ Letter and Goldman/Morgan Letter.

[39] Amex Letter; Susquehanna Letter; Spear, Leeds Letter; Pershing Letter; SIA Letter; Charles Schwab Letter; and CBOE Letter.

[40] ISE Letter; *see also* Charles Schwab Letter.

[41] ISE Letter.

[42] Botta Letter; Charles Schwab Letter; and Knight Letter.

[43] Optimark Letter and Charles Schwab Letter.

[44] *See also* Spear, Leeds Letter.

[45] *See* Securities Exchange Act Release No. 43084 (July 28, 2000) (Disclosure of Order Routing and Execution Practices Proposal) and *supra* note 33.

[46] SEC Press Release No. 2000–97 (July 19, 2000) (Commission To Study Effect of Payment for Order Flow and Internalization in the Options Markets).

[47] Optimark Letter; Ianni Letter; and Pershing Letter.

[48] Optimark Letter.

[49] Ianni Letter and Pershing Letter.

[50] CBOE Letter; Botta Letter; Susquehanna Letter; Knight Letter; Spear, Leeds Letter; and Charles Schwab Letter; *see also* Amex Letter.

[51] CBOE Letter; Susquehanna Letter; and Charles Schwab Letter.

[52] Susquehanna Letter; Botta Letter; and Charles Schwab Letter.

market.[53] Therefore, one commenter stated, there would be less incentive for a market maker to provide liquidity, which could result in wider spreads or in market makers leaving the options exchanges' floors.[54] In addition, one commenter believed that for a customer limit order protection rule to be feasible, size would have to be disseminated to allow market makers to make informed decisions about whether to price match or route an order.[55]

Several commenters believed that the issue of limit order protection could be addressed by the exchanges imposing a customer limit order protection rule on their own members or allowing each specialist to determine the level of intermarket limit order protection it wishes to provide to limit orders sent to its market.[56] Commenters believed that, as a result of competitive pressures and exchanges' concerns about assisting firms in satisfying their best execution responsibilities, the markets would achieve the appropriate level of limit order protection without the Commission mandating it as part of a linkage.[57]

Finally, several commenters noted that adopting a customer limit order protection rule should not be allowed to delay an options market linkage.[58] In addition, some commenters believed that a customer limit order protection rule should be addressed in the context of the broader market structure debate.[59] In that regard, at least three exchanges committed to studying the idea of incorporating a customer limit order protection rule into an intermarket linkage plan.[60]

As discussed above, the Commission has determined, at this time, that a customer limit order protection requirement is not a prerequisite to approval of an options market linkage plan. While the Commission believes that such a rule could enhance limit order protections, the Commission believes that it is important not to delay the implementation of a linkage while resolving the issues raised by protecting limit orders across markets.

D. Access to the Linkage

1. General Limitations

The Amex/CBOE/ISE plan provides access [61] to the linkage to eligible market makers on behalf of customer orders and by market makers and specialists on behalf of their principal accounts. Non-market maker broker-dealers would not have access to the linkage.

Several commenters supported limiting access to the linkage.[62] One commenter stated simply that access must be limited to the orders of retail customers.[63] Two commenters believed, however, that the proposed restrictions on proprietary access are not consistent with an open, accessible, and efficient marketplace and would perpetuate the current two-tiered market. These commenters noted that non-market maker broker-dealers would not have an efficient mechanism to execute orders for their proprietary accounts,[64] resulting in the use of slower, manual execution methods, which ultimately would decrease liquidity and pricing efficiency.[65] Finally, one commenter stated that the proposed distinction between broker-dealer and non-broker-dealer customers is unfair and unsupportable.[66]

Instead of implementing a new system for the linkage, one commenter proposed using existing routing systems to allow members of one exchange to access other exchanges, and permitting the exchange being accessed to charge a small fee to eliminate the concern that the linkage would allow unlimited free access to other exchanges. The same commenter argued that unlimited and unrestricted access should be available to anyone for publicly displayed bids and offers.[67] Finally, one commenter proposed that the exchanges grant access to each other's order routing systems either through private vendors or through direct linkages between markets, pursuant to accessibility standards established by the Commission.[68]

At this time, while the Commission would support broader access between options markets, the Commission does not believe it is essential that an options linkage plan provide broader access for proprietary traders. The Amex/CBOE/ISE plan eliminates barriers to routing customer orders between markets, helping to ensure that customer orders have an opportunity to access the best price available in the options market. To achieve this goal, the plan provides for routing customer orders to other markets through the linkage. The plan's approach of permitting eligible market makers, acting as agents for customer orders, to access the linkage provides customer orders with access to other markets.

The Amex/CBOE/ISE plan also allows eligible market makers to use the linkage to hit quotes on an away market, thus helping to protect the priority of the better displayed price. As discussed below, the Commission also recognizes the validity of concerns with respect to unlimited principal access.

Finally, the Commission finds that, at this time, the proposed exclusion of non-market maker broker-dealers from the linkage is not unreasonable. The Amex/CBOE/ISE plan limits access to the linkage to eligible market makers due to their affirmative obligations to the markets. The Commission believes that, by limiting who has access to the linkage, the Amex/CBOE/ISE plan reasonably attempts to address the concern that allowing broader access to the linkage could dilute the value of exchange memberships.

2. Limitation on Principal Access

As previously noted, the Amex/CBOE/ISE plan proposed to limit eligible market maker access to the linkage for sending principal orders to less than 20 percent of each market makers total volume (the 80/20 Test). A market maker effecting more than 20 percent of its volume in a calendar quarter through the linkage would be prohibited from sending principal orders through the linkage in the subsequent quarter. The PCX plan proposed to prohibit the transmission of principal orders, except to unlock or uncross markets or to satisfy trade-through liability. Under the Phlx plan, eligible market makers would be permitted to send principal orders through the linkage without limitation.

Commenters generally maintained that limited principal access should be permitted to the extent it facilitates the operation of the linkage, but that it should not become a surrogate for exchange membership.[69] Several

[53] Susquehanna Letter and Botta Letter.

[54] Susquehanna Letter.

[55] Spear, Leeds Letter. The Commission notes that, at this time, only the ISE displays customer limit orders with size.

[56] CBOE Letter; Susquehanna Letter; and Botta Letter; *see also* Charles Schwab Letter.

[57] CBOE Letter; Susquehanna Letter; and Charles Schwab Letter; *see also* SIA Letter and Amex Letter.

[58] Pershing Letter; ISE Letter; and Amex Letter; *see also* SIA Letter and CBOE Letter.

[59] SIA Letter and ISE Letter.

[60] CBOE Letter; Amex Letter; and ISE Letter.

[61] Access would include, up to a specified size, automatic execution and firm quote treatment.

[62] Amex Letter; Susquehanna Letter; Botta Letter; and CBOE Letter.

[63] Knight Letter.

[64] Interactive Letter and Lek Letter.

[65] Spear, Leeds Letter. This commenter also opposed the limitation on market makers routing orders more frequently than every 15 seconds and routing orders for automatic execution more frequently than every minute. The commenter believed this would put competing market makers at a significant disadvantage when attempting to provide price equilibrium between markets.

[66] SIA Letter.

[67] Lek Letter.

[68] Charles Schwab Letter.

[69] Amex Letter; Susquehanna Letter; Botta Letter; and CBOE Letter.

commenters supported the Amex/CBOE/ISE plan's proposed 80/20 Test for volume restriction.[70] Another commenter argued, however, that each exchange should be permitted to independently adopt its own limitation, if any, on principal access.[71]

One commenter believed the 80/20 Test would put smaller market participants at a competitive disadvantage. This commenter preferred the PCX plan to the Amex/CBOE/ISE plan because it would allow for essentially unlimited principal trading to unlock or uncross a market.[72] Another commenter noted that the Commission and the exchanges should be mindful of the potential, practical difficulties associated with requiring a participant to unlock or uncross a market it has locked or crossed.[73]

The plan's limitation on principal access is designed to prevent the linkage from becoming a means of wide scale proprietary trading by broker-dealers on markets in which they are not members. The Commission finds that the 80/20 Test is a reasonable means to ensure that market makers use the linkage to prevent trade-throughs and honor other markets' quotes, as the plan intends, and not as a substitute for exchange membership. Otherwise, a trader on one exchange could gain virtually free access to another exchange through use of the linkage, without having to satisfy the exchange's membership requirements. The plan is not intended to displace membership in exchanges, or replace direct broker-dealer order routing connections to the exchanges. Thus, the plan does not preclude a market maker from obtaining direct access to a particular exchange by sending orders to such exchange through a member of that exchange or by becoming an exchange member itself.

The Commission recognizes that the 20 percent limitation on a market maker's principal activity in the Amex/CBOE/ISE plan is based on judgment, rather than practical experience with a linkage. The Commission believes that the 20 percent limitation is reasonable. If experience indicates that a different limit would be preferable, the percentages can be altered at a future date.

E. Trade-Through Provisions

As discussed above, the Amex/CBOE/ISE plan proposes that members in their markets should, absent reasonable justification and during normal market conditions, avoid initiating trade-throughs, subject to certain exceptions. Generally, commenters supported the trade-through protections provided for in the proposed plans.[74] One commenter noted that a linkage would enhance execution quality of customer orders by providing trade-through protection.[75] Another commenter specifically supported the Amex/CBOE/ISE plan's treatment of trade-throughs, which would limit satisfaction of a trade-through up to the verifiable number of customer contracts in the markets that were traded through, subject to the size of the transaction that caused the trade-through.[76] That commenter specifically opposed the Phlx's proposal, which would allow the total number of verifiable contracts to be satisfied to exceed the size of the transactions that caused the trade-through.[77]

One commenter believed that the trade-through provisions of the plans needed to be clarified.[78] First, this commenter noted that the proposed plans do not specify what time (*i.e.,* receipt or execution) would be used when evaluating whether a trade-through had occurred. Second, this commenter questioned whether a specialist would have to step up or send an order to a better market if the specialist had already sent that order and it had been rejected by a market that was previously at the NBBO.

One commenter noted that the plans do not provide any deterrent for initiating trade-throughs or ignoring linkage orders, other than the risk of a complaint by another market. The commenter believed that because the plans require the aggrieved party to complain about a trade-through within three minutes of the trade-through being reported by the Options Price Reporting Authority (''OPRA'') and because damages are limited to making the aggrieved party whole, violators initiating trade-throughs will reap the benefits of doing so, while only occasionally having to return any gains. The commenter encouraged the Commission to include a penalty, in addition to making aggrieved parties whole, extend the time during which complaints could be lodged to thirty minutes, and require the exchanges to bear the responsibility for detecting trade-throughs. The commenter also recommended exchange surveillance to deter participants from ignoring orders routed through the linkage.[79]

The Commission notes that trade-throughs currently can occur in the options market because there is no efficient means for accessing quotes across those markets. The Commission believes that approval of the Amex/CBOE/ISE plan will improve execution of orders and promote best execution opportunities by providing not only a linkage to send customer orders to markets if they have a better quote, but also remedies in the event that a better bid or offer is traded through. Generally, under the Amex/CBOE/ISE plan, a trade-through would be determined at the time the order is executed to avoid having an exchange become liable for a quote that did not exist in its market at the time of execution.

The rule proposed in the Amex/CBOE/ISE plan does not flatly prohibit trade-throughs and does not provide a remedy to the quotes or orders traded through unless the aggrieved party complains.[80] Because the trade-through provision depends upon the aggrieved party complaining of the trade-through within an allotted period of time, the Commission concurs with one commenter's opinion that the Amex/CBOE/ISE plan may not eliminate trade-throughs in all instances. The plan is beneficial nevertheless because it provides an efficient means, and some incentive, to avoid trade-throughs. The exchanges also have competitive incentives to avoid trade-throughs to attract broker-dealers seeking to satisfy their obligation to assess the various markets in determining how to achieve best execution of their customers' orders.[81] Moreover, the Trade-Through Disclosure Rule, proposed today in a separate release, would also give broker-dealers and exchanges a substantial

70 Amex Letter; Susquehanna Letter; CBOE Letter; Ianni Letter; and SIA Letter.

71 Knight Letter.

72 Interactive Letter.

73 SIA Letter.

74 SIA Letter; ISE Letter; Ianni Letter; and Botta Letter.

75 Knight Letter.

76 SIA Letter.

77 *Id.*

78 Botta Letter.

79 Interactive Letter.

80 The Commission notes that its approval of the trade-through provision in the Amex/CBOE/ISE plan should not be interpreted to mean that unless a party initiating a trade-through is required to satisfy, cancel or adjust a trade, a trade-through has not occurred. Generally, if an order is executed in one market center at a price inferior to that available in another market center, a trade-through has occurred, regardless of whether the aggrieved party complains of the trade-through. By approving the Amex/CBOE/ISE trade-through provision, the Commission is merely approving a means to limit potential trade-throughs.

81 In accepting orders and routing them to a market center for execution, brokers act as agents for their customers and owe them a duty of best execution. This duty requires a broker to seek the most favorable terms reasonably available under the circumstances for a customer's transaction. As a result, broker-dealers must periodically assess the quality of competing markets. *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

incentive to avoid trade-throughs involving customer orders, because the proposed rule would require such trade-throughs to be disclosed to customers.[82] The proposed Trade-Through Disclosure Rule would except broker-dealers from the requirement to disclose trade-throughs to customers if such customers' orders are executed on markets that are participants in an effective national market system options linkage plan that includes provisions reasonably designed to limit the execution of customer orders at prices inferior to any published price, including prices published by exchanges that are not linkage plan participants. Finally, if the Commission were to apply to the options markets the execution quality disclosure rules proposed today for the equity markets,[83] the exchanges would have additional incentives to avoid trade-throughs that would impair the quality of the executions the markets would be required to disclose.

The Commission does not believe that it is appropriate to require an exchange trading through the quote or quotes on another market to satisfy such quote or quotes for a greater number of contracts than the trade causing the trade-through. The Commission believes that such a requirement may impose an excessive penalty on a market maker that may have inadvertently traded through more than one market, and could be an unjustified windfall to a market that would not have received the order because another market had priority and could have executed the order in full.

F. Governance and Voting Requirements

An Operating Committee, composed of one representative of each participating exchange, is proposed to administer the Amex/CBOE/ISE plan. The majority of commenters expressing views about the Operating Committee supported the Operating Committee's discretion to develop and implement the linkage, and to advise participants regarding deficiencies, problems, or recommendations.[84] Further, commenters agreed that this authority should include defining plan terms, such as whether a "complex trade" should be excepted from trade-through liability at least during the initial stages of the linkage implementation.[85] One commenter stated that the representatives of the participants would have the most familiarity with the linkage and should be able to address issues regarding the functionality and specifications of the linkage.[86] Two commenters suggested that the Operating Committee should include representatives from member firms in addition to the participating exchanges.[87]

The commenters disagreed as to whether a unanimous vote was appropriate to amend the plan. Two commenters believed that plan amendments should require a unanimous vote, while a simple-majority would be appropriate for other actions, such as plan administration.[88] The commenters opposing the unanimous vote proposal feared that improvements and innovations could be blocked by the interests of a single entity,[89] reminiscent of problems with the ITS Plan.[90] Two commenters stated their belief that only a super-majority should be required to amend the plan.[91]

The Commission finds that the governance and voting requirements proposed in the Amex/CBOE/ISE plan are consistent with the Act. The Commission concludes that the proposed discretion and authority that is granted to the Operating Committee to implement and operate the linkage is reasonable. In addition, the Commission finds that the plan provisions requiring that a Member Advisory Committee be established should enhance the operation of the linkage and the administration of the plan.

Further, the Commission finds that the unanimous voting requirement for plan amendments is consistent with the requirements of the Act. The Amex/CBOE/ISE plan differs significantly from the ITS plan because it limits the issues subject to a unanimous vote under the plan.[92] While the Commission recognizes that a unanimous voting requirement could potentially be used by one participant to block innovations that could enhance the linkage, such a provision also encourages participation in the plan by preventing the majority from forcing changes to the markets of dissenting participants.[93]

G. Dissemination of Quotations With Size

Currently, the options exchanges do not disseminate the number of contracts their quote represents. The Commission specifically requested comment on whether a linkage plan should require the options markets to disseminate quotes with size[94] and, if so, what a reasonable time frame would be for implementation. Further, the Commission asked how a quote size requirement should be balanced against concerns about options systems capacity constraints.

The majority of commenters favored the development of a system to provide the dissemination of quotes with size.[95] Some of those commenters, however, stated that quotations with size should not be required at this time or as part of the linkage plan.[96] Two of these commenters noted the desirability of disseminating quotes with size but questioned whether such modifications would ever be warranted because of the many variables associated with such an action, such as whether existing options quotation systems would be able to handle quotes with size in the near future.[97] Finally, one commenter suggested that the issue be addressed by an amendment to the OPRA plan, rather than as part of the linkage.[98]

The Commission agrees that the dissemination of quotes with size would increase transparency in the options market. The Commission notes that OPRA has already begun studying the feasibility of disseminating quotes with size. Implementing the systems changes

[82] *See supra* note 33.

[83] *See supra* note 45.

[84] Amex Letter; CBOE Letter; and SIA Letter.

[85] Amex Letter; Ianni Letter; and SIA Letter.

[86] CBOE Letter.

[87] Pershing Letter and Goldman/Morgan Letter. The Commission notes that exchange members will be represented on the Member Advisory Committee.

[88] Amex Letter and CBOE Letter.

[89] Pershing Letter; Goldman/Morgan; and SIA Letter.

[90] Interactive Letter and Charles Schwab Letter.

[91] SIA Letter; and Ianni Letter.

[91] SIA Letter, and Ianni Letter.

[92] The proposed Amex/CBOE/ISE plan has many provisions that distinguish it from the ITS plan. The Commission believes those differences should prevent the ITS plan's shortcomings from becoming a problem in the options linkage. In particular, the ITS plan requires the unanimous consent of all participants to amend the plan to permit exchanges to become new participants, while the Amex/CBOE/ISE plan allows exchanges to become participants without any action by the then-current participants. The ITS plan is also a highly detailed document that, in many ways, limits the manner in which participants can innovate. The Commission believes that the Amex/CBOE/ISE plan has been drafted in a less restrictive manner that should allow participants to independently innovate without violating plan terms.

[93] The Commission has the authority, pursuant to Rule 11Aa3–2, to initiate a national market system plan amendment. *See* 17 CFR 240.11Aa3–2(b)(2).

[94] Currently, the options exchanges generally do not disseminate quotes with size. Rather, options quotes that are disseminated by OPRA reflect only the best bid and offer from each options exchange. Each exchange has rules establishing minimum firm quote requirements. Quotes that are disseminated over OPRA, however, do not indicate the *actual* depth of a given market. Thus, if the best displayed quote is based on a customer limit order that has a size greater than an exchange's firm quote requirement, its size is not communicated to the public.

[95] Donahue Letter; Ianni Letter; Amex Letter; Susquehanna Letter; Pershing Letter; SIA Letter; CBOE Letter; and Charles Schwab Letter.

[96] Amex Letter; Susquehanna Letter; Pershing Letter; SIA Letter; and CBOE Letter.

[97] Susquehanna Letter and SIA Letter.

[98] CBOE Letter.

necessary to add size to disseminated quotes, however, is a substantial undertaking and a variety of factors, including systems capacity,[99] must be considered. Therefore, the Commission has determined that the dissemination of quotes with size should not be mandated as part of the linkage plan.[100]

H. Firm Quote Size Requirements

The Amex/CBOE/ISE plan has provisions for designating the size for which a participant will be firm for its quotes. For customer orders, the Firm Customer Quote Size will be the lesser of: (1) The number of contracts the exchange sending the P/A Order guarantees it will automatically execute for customer orders that are entered directly in that market; or (2) the number of contracts the receiving exchange guarantees it will automatically execute for customer orders that are directly entered into that market. However, in no event, would a P/A Order be guaranteed for fewer than 10 contracts. For principal orders, the Firm Principal Quote Size will be the size guaranteed by a participant for incoming principal orders, but in no event, fewer than 10 contracts.

Several commenters suggested that these criteria were appropriate because: (1) They assure customer orders receive minimum guarantee execution sizes similar to those that would be in effect had the order initially been routed through the automatic execution facilities of the market displaying the best bid/offer; and (2) principal orders receive a minimum firm quote.[101] One commenter specified that the 10 contract minimum proposed in the Amex/CBOE/ISE plan was acceptable for P/A Orders executed in automatic execution systems, but the 20 contract minimum proposed in the PCX plan was unacceptable. That commenter supported the Amex/CBOE/ISE proposal to allow an exchange to elect whether to route all or part of an order through the linkage when the size of the order is larger than automatic execution eligible size.[102]

Other commenters stated that all quotes displayed by an exchange should be firm and subject to automatic execution of public orders up to the size displayed.[103] The commenters further stated that electronic access should not be halted unless a bona fide reason exists to halt all electronic trading.[104] One commenter asserted that an order that exceeds the minimum guarantee size should be filled based on the number of contracts available on the receiving exchange at receipt of the order. This commenter also stated that quotes should be firm to all market participants.[105] Finally, one commenter stated that exchanges do not currently comply with the firm quote rule and that by enforcing current firm quote obligations and eliminating rules permitting this noncompliance, the existing system would suffice to guarantee firm quote obligations.[106]

Another commenter proposed that the linkage be limited to small orders of 20 contracts or less because 20 contracts is the prevailing minimum size guarantee for automatic execution of orders. The commenter noted that this amount could be reasonably and uniformly increased.[107] Another commenter agreed with the notion of firm quote size for 20 contracts for each exchange.[108] Finally, one commenter recommended that the linkage initially be available for orders of ten contracts or fewer, but that it should over time be increased to fifty contracts or more.[109]

The Commission believes that it is important to have a firm customer quote requirement as an element of the plan to facilitate and ensure the efficient execution of customer orders.[110] The Amex/CBOE/ISE plan should ensure that a P/A Order would be treated comparably to customer orders received directly by the exchange showing the NBBO.[111] Moreover, the Commission believes that the Amex/CBOE/ISE plan allows the exchanges to continue to compete based on automatic execution size guarantees because the plan does not limit a participant's ability to increase its guarantee size.

The Commission notes that several commenters believed that quotes should be firm for greater size. The Commission believes that the plan adequately addresses this concern because there is sufficient flexibility in the Amex/CBOE/ISE plan to allow exchanges to execute orders that are greater than the firm quote customer size. For example, the Amex/CBOE/ISE plan allows an originating exchange to route an order for greater than the firm customer quote size to another exchange and permits the other exchange to execute the order in full.

I. Trade-or-Fade Provisions

Currently, options' exchanges rules do not require members' quotes to be firm for all orders. Instead, the exchanges have what are commonly known as trade-or-fade rules.[112] Generally, under the trade-or-fade rules, an order must be executed at the currently disseminated bid or offer, either by satisfying the full size of the order or by updating the disseminated quote to reflect that the previously disseminated quote is no longer available.[113] The Amex/CBOE/ISE plan continues to apply the exchanges' trade-or-fade rules in limited circumstances to both P/A Orders and principal orders.

Several commenters expressed concern that the plan did not expressly provide for the repeal of trade-or-fade rules by the options exchanges.[114] Commenters also asserted that the exchanges should provide firm quotes.[115] One commenter noted that without firm quotes, it would be difficult to determine the depth of trading interest, or the best execution price, or the best venue.[116]

The Commission has determined at this time to approve the Amex/CBOE/ISE plan, including the proposed trade-or-fade provisions. Although no exchange should be permitted to "back away" from its displayed quote, the Commission recognizes that there should be a mechanism that requires a

[99] The Commission notes that the level of quote message traffic generated by the options exchanges has been straining OPRA's systems capacity recently. OPRA, along with its processor, Securities Industry Automation Corporation, and the exchanges have been working to address the capacity limitations so that the systems will be able to accept and disseminate the quotes generated by the options markets in real-time. The Commission believes that, due to systems capacity limitations, it would be inappropriate to mandate size at this time because burdening the current OPRA system with modifications to add size could result in a further deterioration of options quote integrity.

[100] The amendments to the Quote Rule for options proposed today include two alternative provisions allowing markets to specify, rather than individually publish, options quote size. *See supra* note 33.

[101] Amex Letter; Susquehanna Letter; SIA Letter; and CBOE Letter.

[102] SIA Letter.

[103] Fenwick Letter and Interactive Letter.

[104] Donahue Letter and Interactive Letter.

[105] Charles Schwab Letter.

[106] Lek Letter.

[107] DOJ Letter.

[108] Ianni Letter.

[109] Goldman/Morgan Letter.

[110] In a separate release, the Commission today proposed applying the firm quote requirements of Exchange Act Rule 11Ac1–1 to the options markets. *See supra* note 33.

[111] Customer orders routed to another exchange may not receive the same guaranteed size as customer orders originating on the exchange showing the NBBO.

[112] *See generally* Amex Rule 958A, Commentary .01; CBOE Rule 8.51(b); PCX Rule 6.37(d); and Phlx Rule 1015(b).

[113] Generally, if a market maker changes its quote instead of executing an order, and then immediately re-displays its previously disseminated quote when there is no change in market conditions warranting such an action, the market maker is considered to be engaging in conduct inconsistent with just and equitable principles of trade.

[114] Ianni Letter and Interactive Letter.

[115] Donahue Letter; ISE Letter; Interactive Letter; PCX Letter; Fenwick Letter; Lek Letter; and Charles Schwab Letter.

[116] Charles Schwab Letter.

market to change its quote if it refuses to trade at its published (or implied) quote with an order for a size that exceeds its firm quote requirement. Consequently, the Commission supports the retention of trade-or-fade rules to the extent that such rules prevent markets from refusing to trade at their disseminated prices and then continuing to disseminate the same quotes.

V. Conclusion

It is hereby ordered, pursuant to Section 11A(a)(3)(B) of the Act,[117] and Rule 11Aa3–2,[118] that the intermarket linkage plan submitted by Amex, CBOE, and ISE is approved and the Amex, CBOE, and ISE are authorized to act jointly in planning, developing, operating, or regulating the intermarket linkage plan as a means of facilitating a national market system.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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[117] 15 U.S.C. 78k–1(a)(3)(B).

[118] 17 CFR 240.11Aa3–2.

SECURITIES AND EXCHANGE COMMISSION

[Release 34–43089; File No. 600–23]

Self-Regulatory Organizations; Government Securities Clearing Corporation; Notice of Filing and Order Approving a Request for Extension of Temporary Registration as a Clearing Agency

July 28, 2000.

Notice is hereby given that on June 2, 2000, the government Securities Clearing Corporation (''GSCC'') filed with the Securities and Exchange Commission (''Commission'') a request that the Commission grant GSCC registration as a clearing agency on a permanent basis.[1] The commission is publishing this notice and order to solicit comments from interested persons and to extend GSCC's temporary registration as a clearing agency through January 31, 2001.

On May 24, 1988, pursuant to Sections 17A(b) and 19(a) of the Securities Exchange Act of 1934 (''Act'')[2] and Rule 17Ab2–1 promulgated thereunder,[3] the Commission granted GSCC's application for registration as a clearing agency on a temporary basis for a period of three years.[4] The Commission subsequently has extended GSCC's registration through July 31, 2000.[5]

In the most recent extension of GSCC's temporary registration, the Commission stated that it planned in the near future to seek comment on granting GSCC permanent registration as a clearing agency. This extension of GSCC's temporary registration will enable the Commission to do so.

Interested persons are invited to submit written data, views, and arguments concerning the foregoing application. Such written data, views, and arguments will be considered by the Commission in granting registration or instituting proceedings to determine whether registration should be denied in accordance with Section 19(a)(1) of the Act.[6] Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Copies of the amended application for registration and all written comments will be available for inspection at the Commission's Pubic Reference Room, 450 Fifth Street, NW, Washington, DC 20549. All submissions should refer to File No. 600–23 and should be submitted by August 25, 2000.

It Is Therefore Ordered that GSCC's registration as a clearing agency (File No. 600–23) be and hereby is temporarily approved through January 31, 2001.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[7]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 00–19734 Filed 8–3–00; 8:45 am]

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[1] Letter from Sal Ricca, President and Chief Operating Officer, GSCC (May 30, 2000).

[2] 15 U.S.C. 78q–1(b) and 78s(a).

[3] 17 CFR 240.17Ab2–1.

[4] Securities Exchange Act Release No. 25740 (May 24, 1988), 53 FR 19639.

[5] Securities Exchange Act Release Nos. 29067 (April 11, 1991), 56 FR 15652; 32385 (June 3, 1993), 58 FR 32405; 35787 (May 31, 1995), 60 FR 30324; 36508 (November 27, 1995), 60 FR 61719; 37983 (November 25, 1996), 61 FR 64183; 38698 (May 30, 1997), 62 FR 30911; 39696 (February 24, 1998), 63 FR 10253; 41104 (February 24, 1999), 64 FR 10510; 41805 (August 27, 1999), 64 FR 48682; and 42335 (January 12, 2000), 65 FR 3509.

[6] 15 U.S.C. 78s(a)(1).

[7] 17 CFR 200.30–3(a)(16).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–43090; File No. SR–Amex–00–04]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the American Stock Exchange LLC Adopting a Peer Review Requirement for Auditors of Listed Companies

July 28, 2000.

I. Introduction

On February 14, 2000, the American Stock Exchange LLC (''Exchange'' or ''Amex''), submitted to the Securities and exchange Commission (''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change amending the *Amex Company Guide* to adopt a peer review requirement for auditors of listed companies. The proposed rule change was published for comment in the **Federal Register** on May 26, 2000.[3] The Commission received one comment letter in favor of the proposal.[4] This order approves the proposal.

II. Description of the Proposal

The Exchange proposes to amend the *Amex Company Guide* to require all independent public accountants auditing Exchange listed companies to have received an internal quality control review by an independent public accountant (''peer review''), or be enrolled in a peer review program that meets acceptable guidelines.[5] According to the Exchange, acceptable guidelines would include comparability to AICPA standards included in the Standards for Performing on Peer Reviews, as codified in the AICPA's SEC Practice Section Reference Manual, and oversight of the peer review program by an independent body comparable to the organizational structure of the Public Oversight Board, as codified in the AICPA's SEC Practice Section Reference Manual. Further, the proposal would require copies of peer review reports, accompanied by any letters of comment and letters of

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Securities Exchange Act Release No. 42803 (May 22, 2000), 65 FR 34236.

[4] Letter from Ronald Walton, Chair, American Institute of Certified Public Accountants (''AICPA'') SEC Practice Section Peer Review Committee, to Jonathan G. Katz, Office of the Secretary, Commission, dated June 16, 2000. This commenter supported the proposed rule change.

[5] The Exchange has noted that the Nasdaq Stock Market and certain banking agencies, such as the Federal Deposit Insurance Corporation, have implemented a peer review requirement.