

For the Nuclear Regulatory Commission.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44972; File No. SR-Amex-2001-19]

### Self-Regulatory Organizations; Notice of Filing of a Proposed Rule Change and Amendment Nos. 1, 2 and 3 by the American Stock Exchange LLC Relating to Its Performance Evaluation and Allocations Procedures

October 23, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 19, 2001, the American Stock Exchange LLC ("Amex" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On May 31, 2001, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On August 13, 2001, the Exchange submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> On August 27, 2001, the Exchange submitted Amendment No. 3 to the proposed rule change.<sup>5</sup> The Commission is publishing this notice to solicit

comments on the proposed rule change, as amended, from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to adopt Amex Rules 26 and 27 to codify the Exchange's performance evaluation and allocations procedures. The text of the proposed rule change is available at the Office of the Secretary, the Amex and the Commission.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

The Board of Governors of the Exchange is generally responsible for the supervision of its members. With regards to (1) evaluating the performance of specialists, registered traders, and brokers, and (2) allocating securities to specialists, the Board has delegated its responsibilities to the Committee on Floor Member Performance (the "Performance Committee" or "Committee") and the Allocations Committee, respectively.<sup>6</sup>

Performance evaluation is the non-disciplinary process<sup>7</sup> by which the

Exchange reviews Floor member conduct and takes remedial action where necessary to improve performance. The registration of specialists ("allocations") is the process by which the Exchange matches appropriate specialists to particular securities.

The Exchange proposes to codify its performance evaluation and allocation procedures as Amex Rules 26 and 27 in order to make them readily available to members since these procedures currently are not available in one easily accessed location.

##### Performance Evaluation (Rule 26)

Paragraph (a) of proposed Rule 26 describes the composition of the Performance Committee. The proposed rule states that the Performance Committee consists of 16 persons drawn from a larger pool divided as equally as possible among specialists, registered traders, brokers and upstairs member firm representatives. Specialists, registered traders, and brokers are the three classes of market participants on the Exchange Floor. Upstairs member firm representatives, while not on the Floor, make extensive use of the Exchange's services and have another perspective on the operation of the market. A Floor Governor chairs meetings of the Performance Committee and only may vote to break a tie. A

performance evaluation processes fulfill a combination of business and regulatory interests at exchanges and are not disciplinary in nature. The Commission states in the *Post X-17* case:

We believe that the reallocation of a market maker's (or a specialist's) security due to poor performance is neither an action responding to a violation of an exchange rule nor an action where a sanction is sought or intended. Instead, we believe that performance-based security reallocations are instituted by exchanges to improve market maker performance and to ensure quality of markets. Accordingly, in approving rules for performance-based reallocations, we historically have taken the position that the reallocation of a specialist's or a market maker's security due to inadequate performance does not constitute a disciplinary sanction.

We believe that an SRO's need to evaluate market maker and specialist performance arises from both business and regulatory interests in ensuring adequate market making performance by its market makers and specialists that are distinct from the SRO's enforcement interests in disciplining members who violate SRO or Commission Rules. An exchange has an obligation to ensure that its market makers or specialists are contributing to the maintenance of fair and orderly markets in its securities. In addition, an exchange has an interest in ensuring that the services provided by its members attract buyers and sellers to the exchange. To effectuate both purposes, an SRO needs to be able to evaluate the performance of its market makers or specialists and transfer securities from poor performing units to the better performing units. This type of action is very different from a disciplinary proceeding where a sanction is meted out to remedy a specific rule violation. (Footnotes omitted.)

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Letter from Bill Floyd-Jones, Jr., Assistant General Counsel, Legal and Regulatory, Amex, to Katherine A. England, Assistant Director, Division Market Regulation ("Division"), Commission (May 31, 2001). Amendment No. 1 adds discussion to the purpose section of the proposal regarding the ability of the Performance Committee to take appropriate action should a member or member organization fail without a reasonable excuse to meet with the committee after receiving notice. In addition, Amendment No. 1 corrects structural and typographical errors that appeared in the proposed rule language.

<sup>4</sup> See Letter from Bill Floyd-Jones, Jr., Assistant General Counsel, Legal and Regulatory, Amex, to Katherine A. England, Assistant Director, Division, Commission (August 10, 2001). Amendment No. 2 adds a reference to the Special Allocations Committee in the proposal and proposed rule text; adds allocations procedures for structured products and Exchange Traded Funds; and makes technical changes to the proposed rule text.

<sup>5</sup> See Letter from Bill Floyd-Jones, Jr., Assistant General Counsel, Legal and Regulatory, Amex, to Katherine A. England, Assistant Director, Division, Commission (August 24, 2001). Amendment No. 3 clarifies the Performance and Allocations Committee review procedures.

<sup>6</sup> See Amex Rules 170 and 958, which establish standards for specialists and Registered Options Traders. See also Article II, Section 3 of the Exchange Constitution, which provides in relevant part:

The Board shall establish standards and requirements for the registration of specialists or odd-lot dealers in securities dealt in on the Exchange, and may grant to a committee or committees, the authority to (i) approve the registration of specialists or odd-lot dealers, (ii) revoke or suspend any such registration at any time, (iii) allocate to a registered specialist or odd-lot dealer any security dealt in on the Exchange, and (iv) revoke any such allocation, temporarily or permanently, at any time.

<sup>7</sup> See *In the Matter of the Application of Pacific Stock Exchange's Options Floor Post X-17*, Admin. Proc. File No. 3-7285, Securities Exchange Act Release No. 31666 (December 29, 1992), 51 SEC DOC 261. The Commission determined that

Senior Floor Official may chair the Committee in the event that a Floor Governor is unavailable.

Paragraph (a) of the proposed Rule 26 also allows the Performance Committee to delegate some or all its responsibilities to one or more subcommittees consisting of six persons. Due to the large size of the Performance Committee, the Exchange believes that it is impractical to convene the full Committee for all matters that might come before it. As a result, it is the practice of the Performance Committee to use subcommittees to (1) screen matters to determine if they warrant the attention of the full Committee, and (2) resolve routine matters (e.g., adherence to zone performance standards). A Performance subcommittee would have less substantial remedial tools available to it than are available to the Performance Committee due to its limited size. The remedial actions available to Performance subcommittees are enumerated in paragraph (a) of proposed Rule 26.

Paragraphs (b) through (d) of proposed Rule 26 describe the responsibilities of the Performance Committee with respect to specialist, registered traders, and brokers. These paragraphs also enumerate the remedial actions available to the Committee with respect to each group of Floor members.

With respect to specialists, paragraph (b) of proposed Rule 26 would provide that the Performance Committee reviews proposed transfers to specialist registrations and specified transactions involving specialists. Paragraph (b) provides that the Performance Committee will approve a proposed transaction unless a "countervailing institutional interest" indicates that the transaction should be disapproved or conditionally approved. In determining the presence of a countervailing institutional interest, the Performance Committee would consider whether the proposed transaction would maintain or enhance the quality of the Exchange's markets. The Performance Committee also would consider whether the transaction would create a level of concentration among specialists that should be mitigated. Commentary .03 to proposed rule 26 describes the Exchange's "concentration" policy.

The Exchange proposes that the Performance Committee disapprove or conditionally approve a transaction if it appears to the Committee that the proposed transaction (1) would not maintain, or (2) would not enhance the quality of markets on the Exchange. The Committee also may disapprove or conditionally approve a transaction if it

appears to the Committee that it would raise concentration issues. This review authority gives the Performance Committee an important means for ensuring that specialists maintain quality markets on the Exchange and thus benefits investors.

In addition to reviewing transactions of specialists, the Performance Committee would review specialist performance relative to the quality of markets, competition with other markets, observance of ethical standards, and administrative factors. The Exchange believes that the Performance Committee of the Amex and its analogues at other principal equity and options exchanges traditionally have used these factors to review specialists performance to ensure the maintenance of quality markets. If the Performance Committee determines that a specialist has failed to properly perform as a specialist, the Exchange proposes that the Committee may take one or more of the 10 remedial actions enumerated in Paragraph (b) of proposed Rule 26. These range from relatively mild actions such as counseling the specialists on how to improve its performance or issuing an admonitory letter, to more intermediate actions such as assigning a performance rating<sup>8</sup> or requiring the adoption of a Performance Improvement Plan,<sup>9</sup> to stronger actions such as directing the reallocation of one or more securities.

The four types of securities that currently trade on the Amex are (1) stock and other equities, (2) structured products, (3) standardized options, and (4) Exchange Traded Funds ("ETFs").<sup>10</sup> Specializing or market making in these securities requires different resources, and firms or units that specialize in more than one security class customarily are staffed and managed along product line. As a result, poor performance by a specialist unit in listed equities might not be mirrored by poor performance by the same unit in listed options. Therefore, the Performance Committee would have the

<sup>8</sup> See Securities Exchange Act Release No. 27455 (Nov. 22, 1989), 54 FR 49152 (Nov. 29, 1989) (approving File No. SR-Amex-83-27, regarding the Exchange's "rating" system).

<sup>9</sup> Commentary .02 to proposed Rule 26 describes Performance Improvement Plans and the procedure for implementing them. In general, the Performance Improvement Plan procedure permits the Performance Committee to require specialists and registered traders to implement business plans to improve their performance.

<sup>10</sup> ETFs include, but are not limited to, Portfolio Depositary Receipts (e.g., SPDRs, DIAMONDS and Nasdaq-100 Index Tracking Stock), Index Fund Shares (e.g., Select Sector SPDRs and iShares) and Trust Issued Receipts (e.g., "HOLDRS"). The Exchange also lists corporate and government bonds.

authority to target remedial action to a particular class of security traded by a specialist or registered trader.

Paragraph (c) of proposed Rule 26 describes the responsibilities and authority of the Performance Committee with respect to registered traders. It is quite similar to paragraph (b) of proposed Rule 26 (which concerns specialists) in recognition of the fact that the Registered Options Traders ("ROTs") are "quasi-specialists."<sup>11</sup> Since the Exchange does not "allocate" securities to registered traders, however, there is no provision for reallocations or allocation preclusions with respect to registered traders.

Commentary .01 to proposed Rule 26 provides that an Auto-Ex<sup>12</sup> performance standard applicable to ROTs is monitored by the Performance Committee. The standard provides that any ROT that trades an option during a break-out situation and has signed-on to Auto-Ex for a period of two or more days over the ten previous business days must sign on to Auto-Ex for the break-out option. LEAPS are excluded from this standard. The proposed standard further provides that all ROTs that sign on to Auto-Ex for the break-out must remain on Auto-Ex for the duration of the break-out. ROTs that have signed-on to Auto-Ex during a break-out only are permitted to sign-off with the permission of a Floor Governor. The purpose of the standard is to ensure that there is sufficient liquidity for an option during times of market stress. The Performance Committee may prohibit a ROT, or his or her firm, from participating on Auto-Ex for up to six months for deviations from this standard.

Paragraph (d) of proposed Rule 26 describes the responsibilities and authority of the Performance Committee with respect to Floor Brokers. Since brokers do not act as dealers, they are not evaluated in terms of quality or markets and competition with other markets. Instead, they are evaluated with respect to order handling, observance of ethical standards, and administrative factors. In addition, the remedial actions that the Performance Committee may take with respect to brokers are more limited than those that may be taken with respect to registered

<sup>11</sup> See Commentary .01 to Amex rule 958. Unlike a specialist, however, a ROT may not handle agency orders. See also Amex Rules 111(c) and 950(c).

<sup>12</sup> Auto-Ex is the Exchange system that provides an automatic execution to incoming customer orders up to a specific size. Specialists and ROTs that sign on to the system take the opposite side of incoming customer orders at the displayed bid or offer except when a limit order on the book establishes the best bid or offer on the Amex.

traders and specialists because many of the Committee's remedial measures involve restrictions on acting as a dealer, which is not a broker's function.

Paragraph (e) of proposed rule 26 describes Performance Committee procedures. Paragraph (e) of proposed rule 26 provides that persons (*i.e.*, specialists, specialist units, registered traders or brokers) that are asked to address the Performance Committee because they may have failed to meet minimum performance standards are notified in writing of the matter(s) to be considered by the Committee and are provided with copies of any written materials that are given to the Committee prior to the meeting. Such persons may be questioned by the Performance Committee members and Exchange staff present at the meeting, and they have an opportunity to present information and documents to rebut any concerns about their performance. Anyone appearing before the Committee (not just persons that may have failed to meet appropriate performance standards) may be represented by counsel. Formal rules of evidence do not apply at meetings of the Performance Committee. If the Performance Committee determines that a member or member organization has failed to meet minimum performance standards, the affected person or persons would be notified in writing of the Committee's findings, conclusions, and the remedial action to be taken.

Paragraph (f) of proposed Rule 26 provides that the Performance Committee may take action against a member or member organization if the person or firm fails without reasonable excuse to meet with the Committee after receiving notice of the meeting.

Paragraphs (g) and (h) of proposed Rule 26 describe procedures for appealing decisions of the Performance Committee. Members and member organizations aggrieved by determinations of the Performance Committee or a Performance subcommittee must submit an application to review the decisions to the Secretary of the Exchange within five business days of receipt of the Committee's or subcommittee's written decision. Filing a timely application for review stays the decisions of the Performance Committee or subcommittee. Appeals from decisions of a Performance subcommittee are reviewed "de-novo" by the Performance Committee. Appeals from decisions of the Performance Committee are reviewed by the Amex Adjudicatory Council ("Adjudicatory Council"). The Exchange represents that the Adjudicatory Council may (1) Limit its

review to the record created by the Performance Committee, (2) consider additional matters that were not included in the record, or (3) hear the matter "de novo," as the Adjudicatory Council determines is appropriate to render a fair decision on the appeal. A verbatim record of the proceeding before the Adjudicatory Council is maintained and the Adjudicatory Council's decision is in writing. The decision of the Adjudicatory Council constitutes final action by the Exchange.

#### *Allocations Procedures (Rule 27)*

Paragraph (a) of proposed Rule 27 describes the composition and responsibilities of the Options and Equities Allocations Committees. The Options Allocations Committee is responsible for allocating standardized equity options. This Committee consists of 11 persons as follows: Six Floor brokers, two Registered Options Traders, and three representatives of upstairs member firms. The Equities Allocations Committee allocates the equity securities of operating companies. It consists of ten persons as follows: Six Floor brokers, one specialist, and three representatives of upstairs member firms. A Floor Governor, who only may vote to break a tie, chairs both Committees. A Senior Floor Official may chair a meeting in the event that a Floor Governor is unavailable.

The Special Allocations Committee allocates securities that are not allocated by the Options or Equities Allocations Committees and securities with special characteristics as may be determined by the Chief Executive Officer of the Exchange or his or her designee. It consists of six persons as follows: The Chief Executive Officer (or his or her designee), two brokers, two Registered Options Traders, and a representative of an upstairs member firm. The Special Allocations Committee is chaired by the Chief Executive Officer who does not vote except to make or break a tie. In the Chief Executive Officer's absence, a Floor Governor or Senior Floor Official may chair the Committee. The Options, Equities and Special Allocations Committees are collectively referred to herein as the "Allocations Committee."

Floor brokers have the greatest number of representatives on the Allocations Committee since they tend to have personal familiarity with all units on the Floor as a result of their representation of orders at different posts. Specialists have the fewest representatives on the Allocations Committee since they typically have limited personal familiarity with other units. In addition, specialists and the

units that they are associated with are ineligible to be allocated any security that is allocated at a meeting where they participate on the Committee. As a result, specialists frequently decline to participate at Allocations Committee meetings. Representatives of upstairs member firms have an intermediate number of representatives on the Committee (as do ROTs with respect to the Options Allocations Committee). Upstairs member firms, like brokers, are users of the services provided by specialists and have valuable insights as to their relative competencies. ROTs, as market makers, also have insights into the qualifications of different specialists. The Chief Executive Officer is a member of the Special Allocations Committee as a result of the role played by the Exchange's staff in securing listings of the securities that are allocated by the Special Allocations Committee (*e.g.*, ETFs).

Paragraph (b) of proposed Rule 27 provides that the Allocations Committee shall select the specialist or unit for a security that appears best able in the professional judgment of the Committee members to perform the functions of a specialist in the security to be allocated. The proposed rule also provides a non-exclusive list of the criteria that the Allocations Committee uses to decide which unit should be allocated a particular security. The Exchange, the New York Stock Exchange, Inc., and Chicago Board Options Exchange, Inc. customarily use these criteria to ensure that securities are allocated consistent with the interests of investors and the Exchange. Issuers of equity securities may elect to use the Exchange's "Issuer Choice" procedures to allocate a security<sup>13</sup> if they so desire, pursuant to paragraph (e) of proposed Rule 27 and Commentary .05 of proposed Rule 27.

Paragraph (b) of proposed Rule 27 also provides that specialists subject to a preclusion on new allocations in one or more classes of a security as a result of Performance Committee or a disciplinary action only are eligible for allocations of "related securities" as described in proposed Commentary .05 to Rule 27.

With respect to equity securities, proposed Commentary .05 to Rule 27 provides that newly listed convertible securities and securities issued in connection with a name change or reverse stock split are automatically allocated (*i.e.*, allocated without any involvement of the Allocations

<sup>13</sup> See Securities Exchange Act Release No. 23593 (Sept. 5, 1986), 51 FR 32985 (Sept. 17, 1986) (order approving File No. SR-Amex-86-10, regarding the Issuer Choice program).

Committee) to the specialist that already trades the issuer's securities regardless of an allocation preclusion. In other situations involving the allocation for equity securities that are related securities, proposed Commentary .05 provides that the Allocations Committee would determine whether the trading characteristics of the newly listed related security are closely related to the existing security given the Exchange staff's recommendations as to whether the newly listed related securities should be allocated to the current specialist. If the Allocations Committee determines that the trading characteristics of the newly listed related security are closely related to the existing listed security, it would allocate the newly listed security to the existing regardless of an allocation preclusion. If the Allocations Committee determines that the trading characteristics of the newly listed related security are not closely related to the existing security, the related security is allocated either by the Allocations Committee (paragraph (b) of proposed Rule 27) or according to the Issuer Choice procedure (paragraph (e) of proposed Rule 27). The existing specialist, if subject to an allocation preclusion, is eligible for the newly listed related security only if the issuer requests its current specialist under the Issuer Choice procedure.

With respect to the standardized options, proposed Commentary .05 provides that options on related securities are automatically allocated to the existing option specialist unless the existing options specialist is subject to an allocation preclusion. If the existing option specialist is subject to a preclusion on new option allocations, the specialist only will be allocated the new option if the Allocations Committee determines that the trading characteristics of the newly listed option are closely related to the existing option, given the Exchange's recommendation as to whether the newly listed related securities should be allocated to the current specialist. Unless the Allocations Committee makes the required determination, the existing specialist that is subject to an allocation preclusion is ineligible for the newly listed option on the related security.

Commentary .05 states that the term "related security" does not include ETF's. Thus, an ETF specialist that is subject to a preclusion on the allocation of ETCs is not eligible for any new ETF allocations for the duration of the preclusion.

Paragraph (e) of proposed Rule 27 describes the Exchange's "Issuer Choice" program, and should be read in

conjunction with Commentary .02 and .03 to proposed Rule 27, "Contacts with Unlisted Companies," and "Specialist and other Member Contacts with Issuers and Sponsors of Exchange Traded Funds and Structured Products for the Purpose of Securing New Listings." Commentary .02 to proposed Rule 27 provides that specialists or other members are required to submit a Notice of Marketing Interest ("NOMI") to the Exchange (1) prior to initiating any contact with an unlisted company regarding listing, or (2) within five business days of an unanticipated contact with a company where discussions regarding listing occurred or are anticipated in the future. There is an automatic 12-month sunset on the authorization of a specialist unit or other member to effect the listing of prospect company on the Exchange. This sunset period may be extended for one additional six-month period by Amex staff if the specialist or other member submits a written request to Amex staff detailing the activities that the specialist or other member has undertaken which it believes will result in a favorable listing decision. Once a company decides to list on the Exchange, specialists and other members can have no further communications with the company for the purpose of influencing the choice of specialist except for the interview described below.

Commentary .03 to Rule 27 provides that the Exchange must approved proposed contacts between specialists and potential issuers and sponsors of ETFs and Structured Products regarding potential new listings. The Exchange would approve the contact where it appears that the contact would benefit the Exchange's listing effort. The Exchange would disapprove the contact where it might hinder the listing effort or would be inappropriate. The approval would last for six months and could be extended for one or more six-month period where it appears that the specialist is making progress in securing the listing. The Exchange also could withdraw the approval prior to scheduled termination if it appears that the specialist contacts are hindering the Exchange's listing efforts.

Paragraph (e) of proposed Rule 27 provides that the Allocations Committee prepares a list of six qualified units based upon the criteria used by the Allocations Committee in selecting a specialist under its regular allocations process. The issuer or sponsor (in the case of an ETF) may request that a unit or units be placed on the list of eligible specialist. The Allocations Committee, however, is not obligated to honor such

requests. In the case of an equity security, the Allocations Committee only is advised of a company's preference for a particular specialist where the specialist's efforts actually have been instrumental in securing the listing as evidenced by the company filing a preference with the Exchange for the specialist within two weeks of the Exchange initiating a listing qualification review.

Pursuant to proposed Rule 27, issuers may interview specialists on the list of eligible units prepared by the Allocations Committee. Exchange staff would arrange these interviews, and in the case of an equity security, the Chief Executive Officer of the Exchange or his or her designee may require a member of the Exchange staff to attend such interviews to answer questions about the Exchange's allocation policies and to ensure that any statements by specialists and their representatives are consistent with the Exchange's policies on communications with unlisted companies. Inappropriate statements to issuers and ETF sponsors include, but are not limited to, apparent misrepresentations as to market making capabilities or promises unrelated to the specialist's role in making a market in the issuer's stock. Specialists and their representatives also may not supply information concerning another specialist unit or units either orally or in writing, except they may refer to overall floor-wide statistics.

Under proposed Rule 27, the issuer selects its specialist from the list of eligible units provided to it. In addition, if an issuer becomes dissatisfied with its specialist, it has a one-time right to request the reallocation of its securities. This right may be exercised at any time between 120 days and one year of listing. In the event that the issuer requests a reallocation under this provision, its securities may be reallocated either under the Exchange's Issuer Choice or regular allocations procedures.

Paragraph (c) of proposed Rule 27 provides miscellaneous procedures that apply to both the regular and Issuer Choice allocation process. Paragraph (c) of proposed Rule 27 also provides that all eligible specialists are automatically deemed to apply for all new listings. In contrast, options specialists must submit an application to be considered for a new allocation of options. In addition, the Exchange proposes to require that specialists disclose any business transactions (e.g., agreements) or other relationships (e.g., ownership of stock or other securities) that a specialist, its affiliates, and the employees of both the specialist and its

affiliates have with a newly listed company, its affiliates and the employees of the company and its affiliates. Specialists also would be required to confirm to the Exchange in writing the absence of any disclosable business transactions or relationships if there are none.

Paragraph (c) of proposed Rule 27 provides that specialists may present relevant information to the Allocations Committee for its consideration in connection with specific allocation decisions. The Allocations Committee would have discretion to permit members of a trading crowd to present relevant information to the Allocations Committee in appropriate circumstances. Information presented to the Allocations Committee could include, for example, undertakings as to the size of the markets and quote spreads that the Specialist and crowd would maintain, and other information relevant to the factors that the Allocations Committee may consider in making its decisions. The Allocations Committee may require that all submissions be in writing.

Paragraph (d) of proposed Rule 27 describes the "Pre-Allocation" or "Piggy-Back" allocation process. This procedure is used in situations where the Exchange decides to "piggy-back" a listing announced by another exchange (*i.e.*, the Amex determines to list an option following its designation by another exchange). Due to the delay attendant to the regular allocation process and the short time prior to the commencement of trading in "piggy-back" situations, pre-selected units identified by the Allocations Committee as the Exchange's premier units are allocated "piggy-back" options on a rotating basis.

Twice a year, the entire Allocations Committee pool meets to interview and review applications from all specialists that wish to be placed on the pre-allocation list. Following this review process, the Allocations Committee prepares a list of the selected units in such order of priority as the Allocations Committee designates based on the criteria enumerated in paragraph (b) of proposed Rule 27.

When the Exchange determines to list an option in response to its listing by another exchange, the Exchange proposes that the Exchange staff may contact available Floor Governors to confirm that no material performance situation or other relevant matter has developed that would cause the next unit on the list to be inappropriate to receive the allocation. If such a situation has developed, the Exchange proposes that specialists or specialist units would

be by-passed and the Allocations Committee would be convened as soon as possible to determine if the specialist or specialist unit should be removed from the pre-allocation list.

Paragraphs (f), (g), and (h) of proposed Rule 27 address the role of the Allocations Committee in the reallocation of securities. Paragraph (f) of proposed Rule 27 provides that the Allocations Committee follows its regular allocation procedures (not Issuer Choice) in the event that the Exchange reallocates securities because of, among other things, (1) A Performance Committee remedial action, (2) a specialist request to be relieved of a security for good cause, or (3) the registration of a specialist which is cancelled as a result of a disciplinary action. Paragraph (f) of proposed Rule 27 also provides that the procedures specified in paragraphs (g) and (h) of proposed Rule 27 shall apply to reallocations made in connection with the emergency reallocations due to financial or operating conditions or to reallocations because of business transactions that result in a transfer of one or more specialist registration.

As previously noted by the Exchange, the Performance Committee is responsible for reviewing proposed transfers of specialist registrations and specified transactions involving specialists including the dissolution of specialist units. Since the Performance Committee is primarily responsible for reviewing such matters, paragraph (g) of proposed Rule 26 provides that the Allocations Committee shall follow directions received from the Performance Committee with respect to the reallocation of securities in these matters. If the Performance Committee directs that there should be some other disposition of the securities than provided for by the parties, but does not give the Allocations Committee specific instructions as to how the securities should be allocated, the Allocations Committee would follow its customary (*i.e.*, no Issuer Choice) procedures in reallocating these securities. Paragraph (g) of proposed Rule 27 further provides that the Exchange will defer to the decision of the arbitrators in the event of an arbitration between specialists unless the Performance Committee determines that a countervailing institutional interest dictates that the Exchange either should not wait for and/or abide by the decision of the arbitrators. In such cases, the Performance Committee may direct the Allocations Committee to reallocate the disputed securities in a specified manner. In the absence of specific instructions from the Performance

Committee, the Allocations Committee reallocates the securities in accordance with its customary (no Issuer Choice) procedures.

Paragraph (h) of proposed Rule 27 addresses emergency reallocations for reasons of financial or operating condition. It provides that the Chief Executive Officer of the Exchange or the Senior Supervisory Officer on the Trading Floor, in consultation with the available Floor Governors, may request the Allocations Committee to convene to reallocate securities on an emergency basis where it appears that a unit cannot be permitted to continue to specialize in one or more of its securities with safety to investors, its creditors, or other members due to financial or operational conditions. The affected specialist would be notified of the meeting (the notice does not have to be in writing) and, if time and circumstances permit, the specialist will be given an opportunity to appear before the Allocations Committee. If a prior hearing is not feasible, however, the Exchange proposes that the Allocations Committee may proceed with the reallocation, and the specialist unit shall be afforded an opportunity to address the Committee as soon as reasonably possible after the reallocation. If the conditions which led to the reallocation no longer exist or are corrected, the Chief Executive Officer in consultation with the available Floor Governors, or the specialist unit may request the Allocations Committee to reconvene to consider whether the securities should be restored to the unit.

Paragraph (i) of proposed Rule 27 provides for the appeal of decisions of the Allocations Committee to the Amex Adjudicatory Council. A written application to appeal a decision must be filed with the Office of the Secretary within five business days of the decision of the Committee. An application to review the Allocations Committee's decision, however, does not stay the decision. Unless the Adjudicatory Council decides otherwise, the review of Allocations Committee decisions is limited to matters raised before the Committee. A verbatim record of the proceeding before the Adjudicatory Council is maintained and the Council's decision is in writing. The decision of the Adjudicatory Council is final and may not be appealed.

## 2. Statutory Basis

Proposed Rules 26 and 27 are consistent with section 6(b) of the Act<sup>14</sup> in general, and further the objectives of

<sup>14</sup> 15 U.S.C. 78f(b).

section 6(b)(5) of the Act<sup>15</sup> in particular, in that the Exchange's procedures are designed to promote just and equitable principles of trade and protect investors and the public interest by encouraging good performance and competition among specialists and other Floor members.

#### *B. Self-Regulatory Organization's Statement on Burden on Competition*

The Exchange believes that proposed Rules 26 and 27 will impose no burden on competition; rather, the proposed rules will enhance and encourage competition both within the Exchange, and, more significantly, between and among the Exchange and other exchanges and markets by establishing incentives for superior performance and thereby ensuring the maintenance of quality markets at the Exchange. In this respect, the Exchange believes that it is critical to recognize that the most important level of competition occurs not among specialists of the same exchange to obtain a particular listing (although this, too, is important), rather among specialists of different exchanges trading in the same security and actively competing for the business of the investing public.<sup>16</sup>

Moreover, the Exchange believes that the Commission has expressly recognized the types of procedures as are set forth in Rules 26 and 27 for allocating securities to the most suitable specialists, reviewing the performance of specialists and other Floor members, and, if applicable, reallocating securities, are necessary to ensure quality markets and thereby attract buyers and sellers to the Exchange.<sup>17</sup>

The Exchange did not solicit comments on this proposal and, therefore, did not receive written comments directly on proposed Rules 26 and 27. However, criticism was expressed to the Exchange during internal meetings to review these rules regarding the practice of payment for order flow in options and its alleged impact upon a specialist's market share, combined with the concomitant use of market share as a criterion for measuring performance by options specialists. The criticism expressed was that payment for order flow skews a specialist's market share in ways having

little or nothing to do with the quality of the market provided by the specialist.

Because the Exchange believes that the Commission has previously considered the practice of payment for order flow, it will not address the advantages or disadvantages of payment for order flow at this time.<sup>18</sup> Nevertheless, the Exchange acknowledges that payment for order flow can in some circumstances be one of many factors capable of affecting a specialist's market share in an option. The Exchange believes that payment for order flow, however, is never the sole determining factor of market share. Furthermore, the Exchange believes that, as in any free and competitive market, a loss of market share is a warning signal that the customer, in this case the investor, views the market as inferior in some respect to a competitor's market. According to the Exchange, to ignore the diminishment of market share would be tantamount to a declaration of non-competition (*i.e.*, it would ignore the fact that the investing public views another market or exchange as superior or more competitive). In such circumstances, the Exchange believes that the only responsible course is to investigate and weigh the reasons for the loss of market share to competitive markets and exchanges.

The Exchange notes that the Performance Committee may in its evaluation determine that the loss of market share occurred through no fault of the specialist involved, and the security would not be reassigned. In any event, the Exchange believes that market share is one of a number of appropriate factors for the Performance Committee to weigh in evaluating performance by specialists, including options specialists, and that inclusion of this criterion promotes competition among market makers and among markets. The Exchange believes that the failure to include loss of market share as one possible indicator of poor performance could leave the Exchange unable to prevent the erosion of a viable market in a security, which would reduce or eliminate competition with respect to that security.

<sup>18</sup> The Exchange notes that on July 20, 2000, the Exchange filed a proposed rule change establishing a marketing fee for equity option transactions of specialists and registered options traders used to attract order flow, which became effective upon filing with the Commission. The Exchange further notes that, after soliciting comments, the Commission allowed the rule to remain in effect. See Securities Exchange Act Release No. 43228 (Aug. 30, 2000), 65 FR 54330 (Sept. 7, 2000).

#### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others*

As set forth above in Item II(B), there were no written comments received by the Exchange directly in response to proposed Rules 26 and 27.

#### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

#### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. 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 submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-Amex-2001-19 and should be submitted by November 21, 2001.

For the Commission, by the Division of Market Regulation, pursuant to the delegated authority.<sup>19</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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<sup>19</sup> 17 CFR 200.30-2(a)(12).

<sup>15</sup> 15 U.S.C. 78f(b)(5).

<sup>16</sup> The Exchange represents that much of the new proposed rules are merely codifications of existing practices and procedures, and thus do not reflect any fundamental changes with respect to the allocation of securities to specialists or the evaluation of the performance of specialists and other Floor members.

<sup>17</sup> See note 5, *supra*.