that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

Under Rule 19b–4(f)(6)(iii) of the Act,[10] the proposal does not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest and the Exchange is required to give the Commission written notice of its intention to file the proposed rule change at least five business days prior to filing. The Exchange has requested that the Commission waive the 30-day operative date and the five-day pre-filing notice requirement in order for it to implement the proposed rule change as quickly as possible. The CBOE contends that the proposed rule is substantially similar to comparable rules of the Amex, ISE, and Phlx. The Commission, consistent with the protection of investors and the public interest, has determined to waive the 30-day operative period as well as the five-day pre-filing notice requirement,[11] and, therefore, the proposal is effective and operative upon filing with the Commission.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change 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–CBOE–2002–54 and should be submitted by October 16, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[12]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–24294 Filed 9–24–02; 8:45 am]

BILLING CODE 8010–01–P

[10] 17 CFR 240.19b–4(f)(6)(iii).

[11] For purposes only of waiving the five-day pre-filing notice requirement and the 30-day operative period for this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[12] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–46514; File No. SR–ISE–2001–19]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change by the International Securities Exchange LLC Relating to Facilitation of Customer Orders

September 18, 2002.

I. Introduction

On May 30, 2001, the International Securities Exchange LLC (''ISE'' or ''Exchange'') filed with 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 to reduce the exposure time required for the facilitation of customer orders through the Exchange's Facilitation Mechanism from 30 seconds to five seconds. Notice of the proposed rule change was published for comment in the **Federal Register** on August 6, 2001.[3] The Commission received thirteen comment letters regarding the proposal [4] and two letters from the ISE responding to the assertions of commenters who opposed its proposal.[5] On January 3, 2002, the ISE filed Amendment No. 1 to the proposed rule change, amending the proposal to provide for an exposure period of 10 seconds.[6] This order approves the proposed rule change, as amended, grants accelerated approval of Amendment No. 1, and solicits comments from interested persons on that amendment.

II. Description of the Proposal

ISE rules provide that an Electronic Access Member (''EAM'') generally may not trade as principal against an order of a customer that it is representing as an agent unless the EAM: (1) Enters the customer order into the market and waits at least 30 seconds before entering its counter proprietary order; (2) has been bidding or offering on the Exchange on behalf of its proprietary account at least 30 seconds prior to receiving the customer order; or (3) makes use of the Exchange's ''Facilitation Mechanism.'' [7]

When an EAM enters a customer order into this Facilitation Mechanism, a broadcast message alerts members of the Exchange's electronic ''crowd''—market makers and other members with proprietary orders in the relevant series at the inside bid or offer on the ISE trading system—to the size and price of the proposed facilitation. Crowd participants may indicate within a given time period (currently 30 seconds) whether they want to participate in the facilitation of the customer order at the proposed facilitation price. Crowd participants may also indicate that they are willing to participate in the facilitation of the customer order at a price better than the proposed facilitation price. If, however, this better

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 44612 (July 27, 2001), 66 FR 41074 (''Notice'').

[4] *See* letters to Jonathan G. Katz, Secretary, Commission, from: Joel Greenberg, Managing Director, Susquehanna International Group, LLP, dated August 16, 2001 (''Susquehanna Letter I''); Arthur Duquette, Senior Managing Director, Bear, Stearns & Co. Inc., dated August 24, 2001 (Bear Stearns Letter); Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, Incorporated (''CBOE''), dated August 27, 2001 (''CBOE Letter I''); Thomas N. McManus, Executive Director and Counsel, Morgan Stanley & Co. Incorporated, dated August 27, 2001 (''Morgan Stanley Letter''); Juan Carlos Pinilla, Managing Director, Equity Derivatives Group, J.P. Morgan Securities Inc., dated August 27, 2001 (''J.P. Morgan Letter''); Arthur S. Margulis, Jr., Managing Principal, Hull Trading Company, LLC, dated August 30, 2001 (''Hull Letter''); Michael J. Ryan, Executive Vice President and General Counsel, American Stock Exchange LLC (''Amex''), dated August 29, 2001 (''Amex Letter I''); Matthew D. Wayne, Chief Legal Officer, Knight Financial Products, LLC, dated September 14, 2001 (''Knight Letter''); Thomas A. Bond, Chief Operating Officer, Lee E. Tenzer Trading Company, dated November 9, 2001 (''Letco Letter''); Edward J. Joyce, President and Chief Operating Officer, CBOE, dated November 14, 2001 (''CBOE Letter II''); Edward J. Joyce, President and Chief Operating Officer, CBOE, dated February 25, 2002 (''CBOE Letter III''); Gerald D. O'Connell, Associate Director, Susquehanna International Group, LLP, dated March 6, 2002 (''Susquehanna Letter II''); and Michael J. Ryan, Executive Vice President and General Counsel, Amex, dated April 17, 2002 (''Amex Letter II'').

[5] *See* letters from Michael Simon, Senior Vice President and Secretary, ISE, to Jonathan G. Katz, Secretary, Commission, dated September 25, 2001, and October 5, 2001 (''ISE Letter I'' and ''ISE Letter II,'' respectively).

[6] *See* letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Commission, dated January 2, 2002.

[7] ISE Rule 717(d). To use the Facilitation Mechanism, an EAM must be willing to facilitate the entire size of the customer order. *See* ISE Rule 716(d).

price is equal to or better than the ISE best bid or offer, the crowd participant must indicate its willingness to participate in the facilitation of the customer order by entering an order or changing its quote on the Exchange's trading system, not through the Facilitation Mechanism.

Public customer orders that have been entered on the Exchange's trading system that are priced equal to or better than the facilitation price have priority, and are given the right to trade against the customer order being facilitated at the facilitation price. After any such public customer orders have been satisfied, the EAM is entitled to trade against 40% of the original size of the customer order being facilitated. Any responses at the facilitation price entered by crowd participants through the Facilitation Mechanism, or other orders and quotes at the facilitation price entered on the Exchange's trading system by crowd participants or other ISE members, share in the remainder of the order being facilitated proportionally according to the size they have indicated.

If, however, any crowd participants have indicated a willingness to participate at a price that improves upon the facilitation price—through the Facilitation Mechanism where appropriate, or by entering orders or changing their quotes on the Exchange—they take priority over the EAM. In addition, any other ISE members that have entered orders on the Exchange that are superior to the facilitation price similarly take priority over the EAM.[8]

Under the ISE's current rules, the electronic crowd is given 30 seconds to respond. Moreover, to indicate a willingness to facilitate an order at an improved price that is equal to or better than the best bid or offer on the Exchange, a crowd participant must change its quote or order at least 10 seconds before the end of this exposure period. The ISE now proposes to amend its rules to reduce the exposure period from 30 seconds to 10 seconds. The proposed rule change would also eliminate as unnecessary the requirement that, to improve the facilitation price at a price equal to or better than the ISE best bid or offer, a member must change its quotation or enter an order at least 10 seconds prior to the expiration of the exposure period.

In explaining the purpose of its proposal, the ISE states that the Facilitation Mechanism has failed to capture significant facilitation order flow. The ISE further states that its members explain that the current 30-second exposure requirement is a primary reason why they do not use this mechanism. The Exchange maintains that the rules of other, floor-based options exchanges permit a member to facilitate a customer order by taking it to the floor, exposing it for an instant by announcing it to the trading crowd, and then immediately trading against a guaranteed percentage of the order.[9] Thus, the ISE argues, a reduction of the exposure period on its own Facilitation Mechanism is necessary to allow it to compete on an equal footing with other exchanges to attract facilitation order flow.

The ISE believes that this shortened exposure period would be fully consistent with the electronic nature of its trading system. According to the Exchange, ISE members have implemented, or have the ability to implement, systems that monitor the Facilitation Mechanism broadcast messages and can automatically respond based upon pre-set parameters. In this electronic environment, the Exchange states, it is not necessary to provide an exposure time sufficiently long to permit a person, in all cases, to manually respond to a facilitation broadcast in order to provide the opportunity for crowd interaction. Thus, the Exchange believes that an exposure period of ten seconds would permit exposure of orders on the ISE in a manner consistent with its electronic market while addressing the Exchange's competitive concerns.

III. Summary of Comments

In the Notice, the Commission solicited views generally from interested persons on any aspect of the proposed rule change. In addition, the Commission requested that commenters express their views on: (1) Whether electronic programs or systems are available that would enable ISE members to monitor the Facilitation Mechanism broadcast messages and automatically respond based upon pre-set parameters, such that a five-second exposure period[10] would provide adequate time for crowd members to interact with an order before it is executed by the EAM; and (2) whether the manner in which orders are exposed and executed through the Facilitation Mechanism under the proposed rule change would be comparable to the manner in which orders subject to facilitation are exposed and executed on floor-based exchanges.

The Commission received thirteen comment letters concerning the ISE proposal, expressing the views of five commenters opposed to,[11] and four commenters supportive of,[12] the proposed rule change. Many of the commenters addressed specifically the questions noted above. In addition, the ISE submitted two letters responding to the arguments of those who opposed the proposal.[13]

A. Comments Opposing the Proposal

In general, five commenters believed that a shortened response period would not allow enough time for members of the electronic trading crowd to respond to a facilitation broadcast and thus would defeat the notion of an auction market.[14]

These commenters argued that specialists and market makers could not possibly respond with informed and careful judgment within such a shortened exposure period. They noted that crowd participants need time to assess their positions, market conditions, pricing analytics, and risk to be able to react to an order appropriately.[15] Some further noted that the EAM that submitted the facilitation broadcast, with whom these crowd participants must compete, likely has had knowledge of the order for a considerable amount of time—particularly in the case of an institutional customer order.[16]

Because these commenters contend that the trading crowd would be unable to respond to facilitation broadcasts within the proposed time frame, they conclude that EAMs would be able to trade with a significant share of their customers' orders. In the words of one commenter, the ISE would become a

[8] When orders and quotes improve upon the proposed facilitation price but cannot fill the entire order being facilitated, customers participate at the facilitation price, while non-customers trade at the improved price to which they committed.

[9] *See* Commentary .02 to Rule 950(d) of the American Stock Exchange (''Amex''), Rule 6.74(d) of the CBOE, and Rule 6.47(b)(4) of the Pacific Exchange (''PCX''), which, under certain conditions, guarantee a firm sending a customer's order to the exchange floor a participation right of 20% in that order (25% on the PCX) when the firm matches the best price given by the crowd in response to the floor broker's initial request for a market, and 40% when it improves upon the crowd's price. As detailed below, commenters opposed to the ISE proposal dispute the ISE's description of the exposure period and facilitation process on these exchanges. *See infra* notes 30–33 and accompanying text.

[10] The question in the Notice referred to the five-second exposure period proposed in the original version of the proposed rule change.

[11] *See* Amex Letters I and II; CBOE Letters I, II, and III; Knight Letter; Letco Letter; and Susquehanna Letters I and II.

[12] *See* Bear Stearns Letter; Hull Letter; J.P. Morgan Letter; Morgan Stanley Letter.

[13] *See supra* note .

[14] *See supra* note .

[15] *See, e.g.*, Susquehanna Letters I and II; CBOE Letter II.

[16] Knight Letter; Letco Letter.

''crossing exchange'' providing EAMs with ''unfettered rights for internalization,'' enabling them to trade against up to 100% of a customer order.[17] Customers would be harmed, because their orders would not receive opportunity for price improvement.[18] Liquidity providers—specialists and market makers—would also be highly disadvantaged.[19]

Moreover, one commenter argued that the marketplace as a whole would be impaired because the proposed rule change would result in EAMs taking an increasingly large share of orders, particularly the large institutional orders that represent a substantial percentage of the market.[20] This commenter believed that, as a result, no purpose would remain for market participants to act as liquidity providers, and ''the order flow providers [would] become the market and the pricing process [would be] determined in a non-competitive manner by the order flow providers.''[21]

Some commenters also took issue with the ISE's argument that, in its electronic environment, members have implemented, or have the ability to implement, systems that monitor the Facilitation Mechanism and can automatically respond to broadcasts based upon pre-set parameters.[22] One commenter drew the conclusion that most ISE members in fact do not currently have automatic response systems in place,[23] and stated that its own ''informal discussions with market participants confirm that developing such systems is a complex, expensive undertaking that many ISE members have not begun and indeed may not begin for quite some time.''[24]

Several commenters contended that reducing the exposure period as proposed would exclude persons who do not have this kind of response capacity or whose systems prove to be inadequate.[25] One commenter declared that the proposal would ''unfairly discriminate against the many market participants who are unable to automatically reply to ISE broadcast messages.''[26]

Some opponents of the proposal added that pre-set parameter systems are ''unlikely to offer price improvement, as they would inevitably be conservative due to the large amount of risk associated with block size orders and the fact that market and hedging conditions are different for each trade.''[27] Computer-generated responses, they believe, ''are far less likely to offer price improvement than if sufficient time is allowed for the human beings who did the programming to be able to take a ''fresh look'' and have a chance to revise their opinions about the options and/or underlying stock.''[28] Moreover, one commenter maintained, even those ISE members who confirm that they can implement their systems to respond within a reduced exposure period cannot confirm that they will.[29]

Commenters also challenged as ''erroneous and overly simplistic'' the ISE's contention that the rules of floor-based exchanges permit a member to facilitate a customer order by taking it to the floor, exposing it for an instant, and then immediately trading against a guaranteed portion of the order.[30] These commenters maintain that the rules of floor-based exchanges, which require that crowd members be given adequate opportunity to react to an order that a floor broker hopes to facilitate—and the assessment, analysis, and human interactive process that is necessary for them to exercise that opportunity—often demand that a facilitation transaction take at least 30 seconds [31] and can sometimes take as long as a minute [32] or more [33] to conclude.

One commenter further contended that the rules of the ISE should not always mirror the rules of floor-based exchanges, in any case.[34] An electronic market, it argued, does not include the physical proximity that enables all members of a trading crowd to see each other, communicate through open outcry, and participate in the market instantaneously, and thus holds greater risks that any particular order will not be exposed to a large enough group of other market participants to realize price improvement.

Some commenters added that a shortened exposure period would exacerbate the effect of another provision in ISE's rules, which restricts the composition of the electronic crowd that receives Facilitation Mechanism broadcasts to market makers and EAMs with proprietary quotations at the ISE's inside bid or offer.[35] In their view, this provision also limits price competition and encourages internalization.

One commenter argued that the proposed rule change would undermine the goal of greater linkage among options markets because traders on other exchanges would not even learn of pending trades at the ISE, much less have the chance to offer price improvement, before the exposure period would elapse.[36]

Three commenters provided additional comments after the filing of Amendment No. 1 to the proposal to provide for an exposure period of 10 seconds rather than five seconds.[37] Two of these commenters maintained that the amendment did not in any way alleviate the concerns they voiced with respect to the initial proposal.[38] The third commenter viewed the amendment as an admission that five seconds was too short an exposure period, and continued to maintain that a reduction from 30 seconds was unwarranted.[39] All three commenters reiterated the contention that the proposal would allow the ISE to become a vehicle for internalization. Two of these commenters elaborated on the argument that neither five nor 10 seconds would suffice for crowd members to respond to a facilitation broadcast in view of the assessment of conditions and risk they must make to be able to do so.[40] These commenters

[17] Knight Letter.

[18] Amex Letters I and II; CBOE Letters I, II, and III; Knight Letter; Susquehanna Letters I and II.

[19] Knight Letter. Some commenters add that even existing ISE rules governing the Facilitation Mechanism are ''not sufficient to provide facilitated orders with meaningful opportunities for order interaction and price improvement,'' *see* CBOE Letter II, and ''facilitate the transformation of the ISE to an internalization and crossing exchange.'' Susquehanna Letter I.

[20] Knight Letter. According to the Knight Letter, ''Although it is difficult to state with certainty what percentage of national options order flow is represented by institutions, [Knight Financial Products] estimates that the figure may very well be approximately 50%.'' *Id.*

[21] *Id.*

[22] CBOE Letters I and II; Susquehanna Letter I.

[23] CBOE Letter I.

[24] CBOE Letter II.

[25] CBOE Letters I and II; Letco Letter; Susquehanna Letter I.

[26] CBOE Letter I.

[27] Susquehanna Letter I, also quoted in CBOE Letter II.

[28] CBOE Letter II.

[29] *Id.*

[30] Susquehanna Letter I. *See also* CBOE Letters I and II; Amex Letters I and II; Knight Letter; Letco Letter.

[31] Knight Letter.

[32] CBOE Letter II. *See also* Amex Letter II, stating that the facilitation process ''typically, will take a minute or more to complete.''

[33] *See* Amex Letter I, stating that more complex facilitation orders in some cases can take several minutes.

[34] CBOE Letter I.

[35] *See, e.g.,* Susquehanna Letter I. Susquehanna Letter I also included a request that the Commission reconsider its approval of the ISE provision governing composition of the trading crowd.

[36] CBOE Letter I. *See also* Amex Letter II.

[37] Amex Letter II; CBOE Letter III; and Susquehanna Letter II.

[38] CBOE Letter III and Susquehanna Letter II.

[39] Amex Letter II.

[40] For instance, one commenter maintained that when the ISE adopted, in 2001, its rule that bars anticipatory hedging by a firm before it discloses a facilitation order to the crowd, the Exchange ''stated that crowd participants be able (sic) to participate in the execution of orders at equally favorable terms

Continued

further argued that, because the Commission has not approved proposals by other, floor-based exchanges to permit participation rights in more than 40% of an order to any market participant, Commission approval of the ISE proposal would result in disparate treatment of the ISE and the floor-based exchanges, and, in the words of one commenter, ''unequal regulation.''[41]

One of these commenters further expanded on the reasons why, in its view, a 10-second exposure period is inadequate to allow for price improvement of orders that a firm proposes to facilitate.[42] This commenter identified a ''probe phase'' that is part of the process of crossing an order on a floor-based exchange, during which time, in the commenter's description, the broker ''works'' the order for a considerable period before the cross order is bid and offered and can obtain significant price improvement for the customer.[43] Absent the equivalent of this probe phase to ''work'' the order prior to the 10-second bid-offer process, this commenter argues, the ISE proposal would allow an increased number of facilitation crosses to be transacted on the Exchange at biased prices, to the detriment of customers.

One commenter raised the issue of best execution, stating that, absent a step-up requirement of the options linkage plan, if a significant portion of options order flow is internalized, firms would need to address how they would comply with their best execution duties.[44]

B. Comments Supporting the Proposal

The four commenters supporting the proposal, all member firms of the ISE,[45] believe that, contrary to the opinion of opponents, the shortened exposure period would still leave ample time for electronic crowd participants on the ISE to respond to facilitation broadcasts.

These commenters responded affirmatively to the question of whether electronic systems are available that would enable ISE members to monitor facilitation broadcasts and automatically respond based upon pre-set parameters.[46] One commenter stated that, although it does not currently have a system that responds automatically, five seconds is more than adequate for its traders to react to facilitation broadcasts, which are highlighted by its custom software.[47] This commenter added that automation is possible in the near future, and remarked that while it would likely develop a response functionality on its own, it is certain that such functionality could also be made available by software providers. Another commenter stated that it already employs an electronic system in its market making capacity that responds to facilitation broadcasts based on pre-set parameters, in an average of less than one second.[48] It added that it understands anecdotally that other ISE market makers utilize similar systems. A third commenter stated that it understands that ISE members have, or are capable of building, electronic vehicles to respond with pre-programmed instructions.[49] The fourth commenter stated that its systems can easily be adapted to monitor broadcasts and respond within five seconds, and that it believes that other ISE members have similar capabilities.[50]

Supporters of the proposal further expressed the view that an electronic market should not be limited by the kinds of time considerations that may apply on floor-based exchanges. ''In the Internet age,'' wrote one commenter, ''time is no longer measured in seconds. Our proprietary systems are programmed to perform critical functions within a fraction of a second. Ability to respond manually is not the relevant benchmark in an all-electronic marketplace, where five seconds does give the crowd a meaningful opportunity to interact and price improve.''[51]

Three of the supporters of the proposal wrote that use of the Facilitation Mechanism on the ISE, with its current 30-second response period, is not a viable alternative for them on this electronic exchange, because its duration—in the words of one, an ''eternity'' in today's marketplace[52]—exposes them to significant risk that the market will have significantly moved by the time the facilitation transaction is executed.[53] These commenters maintained—in contrast to the assertion of some opponents of the proposal—that because there is by rule no minimum exposure time on floor-based exchanges, facilitation on those exchanges often takes substantially less than 30 seconds,[54] and, in the words of one, is typically a ''nearly instantaneous'' process.[55] This is a primary reason, these firms indicated, that ISE members take their facilitation trades to other options exchanges. All three commenters believe that the proposed rule change would enable the ISE to compete on a more equal footing with the floor-based exchanges to attract order flow.

Some commenters indicated that the proposed rule change would increase the opportunities for market making firms to respond to proposed facilitations and interact with customer orders, thus benefiting investors. As one explained, it does not currently reply to proposed facilitation crosses on floor-based exchanges because it is not physically present at every trading post where it makes markets electronically.[56] In general, supportive commenters wrote, the proposed rule change would benefit customers by allowing for more

as the member representing the order,'' and thereby acknowledged that members of the electronic crowd need time to assess the availability of hedging stock before they can act on a facilitation broadcast. *See* Susquehanna Letter II. *See also* Securities Act Exchange Release No. 44208 (April 20, 2001), 66 FR 21423 (April 30, 2001) (Order approving Supplementary Material .02 to ISE Rule 400 (Just and Equitable Principals of Trade)).

[41] Susquehanna Letter II.

[42] *Id.*

[43] According to this commenter, a broker who proposes a ''biased cross''—that is, a cross at a price that is away from the midpoint of the bid-ask spread or attempted during a volatile market—will usually encounter significant trading interest from the crowd and a high potential for price improvement for the customer's order, and will invariably need to grant additional time to the crowd to assess conditions and give improved prices. Therefore, this commenter argues, ''a broker will generally not even attempt to execute biased crosses without first probing the market by asking for a size market before attempting to bid and offer the cross,'' so that all sources of liquidity in the crowd are aware that liquidity is being sought, and ''everyone will have an opportunity to make a competitive quote at the onset.''

[44] *See* Amex Letter II.

[45] *See supra* note 12.

[46] Bear Stearns Letter; Hull Letter; J.P. Morgan Letter; Morgan Stanley Letter.

[47] Bear Stearns Letter.

[48] Morgan Stanley Letter.

[49] J.P. Morgan Letter.

[50] Hull Letter.

[51] Hull Letter. *See also* J.P. Morgan Letter, arguing that the proposal would limit risk, and that ISE members have or can build electronic systems to read and respond to facilitation broadcasts with pre-programmed instructions. In sum, the J.P. Morgan Letter declares: ''This is the essence of an electronic market[.]''

[52] J.P. Morgan Letter.

[53] Hull Letter; J.P. Morgan Letter; Morgan Stanley Letter. The Morgan Stanley Letter also cited risk to the client. *See*, on the other hand, CBOE Letter II, which questioned the risk to the EAM, ''particularly in light of the fact that, as several of the comment letters confirmed, floor-based exchanges typically take 30 seconds or more to complete a facilitation order,'' and maintained that any market risk to the client is more than offset by the potential price improvement that may occur in a 30-second period.

[54] Hull Letter.

[55] *See* Morgan Stanley Letter, which expressly factors in the time it takes for crowd members to respond to the announcement of the facilitation. *See also* J.P. Morgan Letter, describing the execution of the order as ''instantaneous'' after the announcement of the proposed facilitation at the floor post.

[56] Bear Stearns Letter. *See also* Morgan Stanley Letter.

flexibility and efficiency in the handling of customer orders, and acting as an incentive for crowd participants to compete based on price and to commit additional liquidity.[57]

C. ISE's Responses

The ISE submitted two letters responding to various arguments and factual assertions of commenters opposing the proposal.[58] In its first letter, the ISE insisted that any comparison of the exposure period for facilitated orders on floor-based exchanges and on electronic markets should focus solely on the time that it takes to execute an order once it is exposed to the crowd, not the time it takes to bring it to the floor.[59] On a floor-based exchange, the ISE maintained again, the execution can be instantaneous, while on its own electronic market, the mandatory exposure period is currently 30 seconds, putting the Exchange at a competitive disadvantage.

The purpose of the exposure period, the ISE argued, is to allow customer orders the opportunity to receive price improvement, as well as to give liquidity providers the opportunity to participate in facilitation trades. The Exchange maintained that the comments of ISE market makers in support of the proposed rule change demonstrate that crowd participants will, in fact, be able to respond within a shortened period and that the proposal will enhance competition for customer orders.

The ISE further responded to the objection that not all ISE members are included in the trading crowd that receives facilitation broadcasts, and that, hence, competition is already hampered. The ISE argued that it should not be obligated to provide competing market makers from other exchanges unrestricted opportunity to participate in its trading crowds. It further maintained that, in fact, the Exchange's members have more opportunity to participate in a crowd than at a floor-based exchange, where a member must be physically at the post to participate.[60]

In its second letter, the ISE responded to the contention of a commenter that the discussions generated in a floor-based auction forum generally require a longer time period to complete the price discovery process than the ISE's proposed exposure period, and do not allow for instant facilitation as the ISE claims.[61] The ISE countered that because its own exchange is an electronic marketplace, it includes no such discussions, and because participants instead rely on sophisticated technology, they can respond within a shortened period to interact with order flow.[62]

IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the provisions of the Act applicable to a national securities exchange, particularly those of Section 6(b)(5) [63] and Section 6(b)(8) [64] of the Act, and the rules and regulations thereunder.[65] Specifically, the Commission believes that, in the ISE's fully automated market, a 10-second response period will afford electronic crowds sufficient time to compete for customer orders submitted by an EAM into the Exchange's Facilitation Mechanism, thereby promoting just and equitable principles of trade, protecting investors and the public interest, and not imposing any burden on competition.

In assessing the ISE proposal, the Commission concurs with the view of one commenter, who stated that the Commission ''should apply the same standard to the ISE's Facilitation Mechanism (including the length of the exposure period) as it applies to the floor-based exchanges' rules—specifically, does the trading crowd have a meaningful opportunity to interact with the facilitation order and to provide price improvement.'' [66]

Although several commenters emphasized that on floor-based exchanges, trading crowds are given at least 30 seconds, if they so require—and sometimes longer—to respond to a customer order subject to facilitation, the Commission believes that this comparison is irrelevant in considering the ISE proposal. Instead, the critical issue in determining whether to approve the ISE's proposed rule change is this: Does an exposure period of ten seconds, within the ISE's own model, give an electronic crowd sufficient time to respond to a facilitation broadcast to compete with the EAM and provide price improvement for customer orders?

In responding to this inquiry, the Commission believes that the timeframes necessary for exposure and execution of orders be adjudged in light of that marketplace's model. For this reason, the Commission does not believe that a fully automated market such as the ISE should be tied to timeframes relevant to the procedures of a floor-based exchange, notwithstanding that the procedures and the nature of the human interactive process on a floor-based exchange may have advantages of their own. Unlike floor-based exchanges, where there is significant human interaction in each trading crowd with respect to the handling of orders, the ISE is a wholly automated marketplace where crowd members interact by electronic means. Thus, the Commission must consider whether electronic systems are readily available to ISE members that would allow them to respond to facilitation broadcasts in a meaningful way within the proposed timeframe.

The comment letters from four ISE member firms, as well as the Commission's own inquiry into available technology, indicating that such systems are indeed available, if not already in place—and that they can be obtained from vendors, if not developed by a firm on its own—persuade the Commission that a ten-second exposure period will provide adequate opportunity for crowd participants in an electronic environment to compete with an EAM for its customer orders. Because all ISE members will have the opportunity to develop or avail themselves of such systems, the Commission does not agree that the proposal would constitute unfair discrimination against market participants who are presently unable to

[57] Hull Letter; J.P. Morgan Letter.

[58] *See supra* note 5.

[59] ISE Letter I. The ISE was taking issue with the point made by one opposing commenter, who argued that even just the preliminary processing of a facilitation cross on a floor-based exchange—in which a customer order is first related by telephone to a floor brokerage booth together with a contra-side facilitation order, the order tickets are next prepared, and then the orders are walked over to the trading crowd—may often take more than 30 seconds.

[60] In this regard, the ISE noted that it provides access to EAMs in its order routing and execution systems and includes them in an electronic crowd when they are quoting for their proprietary accounts at the Exchange's best bid or offer.

[61] ISE Letter II.

[62] The ISE also noted the statement by this same commenter that in the discussions in floor-based auction forums, many order flow provider firms place undue pressure on trading crowds to permit them to effect facilitation crosses, notwithstanding rules that prohibit intimidation in the marketplace. This statement, the ISE maintained, confirms that it is at a competitive disadvantage, because its own electronic system assures compliance with the participation rules.

[63] 15 U.S.C. 78f(b)(5). Section 6(b)(5) requires that the rules of a national securities exchange be designed to, among other things, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest. It also requires that those rules not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

[64] 15 U.S.C. 78f(b)(8). Section 6(b)(8) requires that the rules of the exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

[65] In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[66] Hull Letter.

reply to ISE broadcast messages automatically.[67]

In addition, some commenters have argued that even if electronic monitoring and response systems are available, market makers would not necessarily use them. Some commenters further believe that automatic, pre-programmed competition, even when used, would result in more conservative responses than the competition of trading crowd participants reacting live on a floor-based exchange. The Commission believes that, given the competitive capabilities and built-in efficiencies that an automatic system could afford, and, in general, considering the nature of pricing in a derivative marketplace, such predictions are at best speculative. Many of the factors that govern options pricing are objective, keyed off of and limited by the price of the underlying security. In the areas where parameters can be adjusted to anticipate or create pricing differentials, areas that require human input, estimation, and anticipation, a firm may be tempted to be conservative. However, as in any market, a firm that is conservative in its pre-programmed responses runs the risk of being shut out completely from the trading by the quotes of more aggressive competitors.

Moreover, in considering the various proposals by the options exchanges to permit greater internalization of orders, the Commission believes the relevant inquiry is whether market makers have a fair opportunity and incentive to compete on an equal basis to trade with orders brought to the exchange, not whether—given that opportunity—they choose to avail themselves of it.[68]

Several commenters correctly noted that the Commission is keenly concerned about the issues raised by internalization in the options markets, and has been particularly vigilant with respect to proposed rule changes that would permit broker-dealers to internalize their customers' orders in a manner that could interfere with order interaction and discourage the display of aggressively-priced quotations. Indeed, the Commission is disinclined to approve not only those proposals by options exchanges that would guarantee broker-dealers the ability to internalize a significant portion of their own customers' orders, but also those proposed rule changes that would guarantee a large percentage of each customer order to any market participant. The Commission's concern with such proposals is that they may lock away so much of each order that crowd members will no longer have an incentive to compete.

The Commission believes, however, that the ability of market makers on the ISE to electronically monitor for facilitation broadcasts, and to program competitive responses based on pre-set parameters, undermines the assertion by these commenters that the proposed rule change would enable EAMs on the ISE to internalize up to 100% of their orders. Accordingly, the Commission does not agree that the ISE's proposed rule change is analogous to other proposals that would guarantee to certain market participants large percentages of each order.[69] Moreover, the Commission believes that one important difference between the ISE's market and, in particular, its Facilitation Mechanism, and floor-based markets is that the ISE's trading crowd does not know the identity of the EAM seeking to facilitate its customer's order. Accordingly, the automated, non-personal nature of ISE's market provides no opportunity for agreements between the facilitating firm and the trading crowd whereby, for example, the trading crowd agrees not to break up a firm's proposed facilitations in exchange for that firm's agreement to bring order flow to the exchange.

When an EAM on the ISE broadcasts its intention to facilitate a customer order and crowd members respond at a price that matches the EAM's price, an EAM is guaranteed only 40% of the order, a participation percentage the Commission found to be consistent with the Act in its initial approval of the ISE as a national securities exchange.[70] Moreover, if crowd members improve upon the facilitation price for the entire size of the order, the EAM will receive nothing. Thus, approval of the ISE proposal will in no way signify "disparate treatment" or "unequal regulation" of exchanges.

Further, the Commission notes that, although it agrees with the assertion of commenters that market makers must compete with an EAM who may have had knowledge of the order for a considerable amount of time before submitting the facilitation broadcast,[71] this potential advantage to the facilitating firm exists in all facilitation transactions, including those executed on floor-based exchanges.[72]

[67] As discussed at *supra* note 35 and accompanying text, some commenters have argued that the ISE unnecessarily restricts the universe of crowd participants who can respond to a facilitation broadcast to ISE market makers and EAMs at the inside bid or offer. The Commission has previously found that the composition of trading crowds as defined in the ISE's rules is consistent with the Act, and believes it unnecessary to revisit this issue at this time. *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000).

[68] One commenter argued that the ISE's proposal would undermine linkage among the options markets because traders on *other* exchanges would not be able to participate in trades by offering price improvement within the 10-second exposure period. *See supra* note and accompanying text. The Commission notes, however, that the goal of linkage is to preclude the execution of a customer order on one exchange at price inferior to the best price currently disseminated by another exchange. Linkage will not allow non-members of an exchange to participate in the auction process of the exchange where the customer order is brought for execution.

[69] Further, the Commission does not accept the contention of some commenters that even under existing rules, the ISE's Facilitation Mechanism does not allow meaningful opportunities for order interaction and price improvement and facilitates the transformation of the ISE to an internalization and crossing exchange. *See supra* note 19. The Commission has examined data provided by the ISE that, in its view, substantially refute this contention. One set of these data indicates that, over the six-month period from April through September 2001, facilitation trades represented only 3.12% of the volume on the Exchange. Another set of these data, compiled for the period from August through November 2001, indicates that market makers on the ISE are participating in trades submitted by EAMs through the Facilitation Mechanism. These data show that market makers traded with 33.4%, 43.4%, 24.0%, and 37.2% of the facilitation volume on the ISE, respectively, in each of the four months in this period.

[70] *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000).

[71] *See supra* note and accompanying text.

[72] *See supra* note . The Commission notes that the ISE rule against anticipatory hedging, *see supra* note 40, is similar to longstanding rules of this kind on all the other options exchanges, and was adopted by the Exchange at the Commission staff's urging after a market participant raised the concern that the ISE's rules, too, should contain such a provision. *See generally* Amex Rule 950(d), Commentary .04; CBOE Rule 6.9(e); Philadelphia Stock Exchange Rule 1064(d); and PCX Rule 6.49(b). These rules against anticipatory hedging generally state that it may be considered conduct inconsistent with just and equitable principles of trade for any member or associated person who has knowledge of all material terms and conditions of orders being crossed, an order being facilitated, or an order and a solicited order—the execution of which are imminent—to enter an order to buy or sell an option for the same underlying security or a related instrument until the terms of the order of which the member or associated person has knowledge have been disclosed to the trading crowd or the trade can no longer be considered imminent. These provisions were originally developed in the context of similar rules designed to prevent frontrunning of block transactions, and were conceived to preclude a member or associated person from using undisclosed information about an imminent cross, facilitation, or solicitation transactions in one option from trading a relevant option or other related instrument in advance of persons represented in the relevant option crowd. *See* Securities Exchange Release Act No. 34959 (November 9, 1994), 59 FR 59446 (November 17, 1994) (concerning the CBOE rule), also cited in Securities Exchange Release Act Nos. 42894 (June 2, 2000), 65 FR 36850 (June 12, 2000) (concerning approval of the Amex rule), and 44150 (April 4, 2001), 66 FR 19271 (April 13, 2001) (concerning the PCX rule). While the rule against anticipatory hedging may also result in giving crowd members time to assess the availability of hedging stock, as understood by the commenter cited at *supra* note 37 to be the ISE's intent, the Commission does not believe that this was the primary purpose of the

The sole issue, then, is whether in the instant proposal the crowd members in fact have a reasonable time and opportunity to respond to the broadcast message and compete for the order. As discussed above, the Commission believes that an exposure period of ten seconds on an electronic exchange such as the ISE affords an adequate opportunity for crowd members to respond in such a venue. Therefore, the Commission does not agree with the view of some commenters that an electronic exchange must accommodate manual responses by market makers.

With regard to the comment that floor-based exchanges allow for a ''probe phase'' before a facilitation cross is bid and offered, which may serve to decrease the possibility of ''biased crosses'' on those exchanges, the Commission believes that the need for this process on exchange floors may reflect a weakness of incentives on these floors to maintain or respond with quality quotes in the first place.

Accordingly, the Commission believes that it is appropriate for the Exchange to reduce the length of the Facilitation Mechanism's exposure period to 10 seconds. The Commission, however, intends to monitor closely the impact of this reduced exposure period. Therefore, the Commission has requested from the ISE, and the ISE has agreed to provide, statistics reflecting, for each month, the contract and trade volume of transactions executed through the Facilitation Mechanism as compared to total contract and trade volume executed on the Exchange; the extent to which crowd participants traded with orders submitted through the Facilitation Mechanism; and the extent to which EAMs submitting orders through the Facilitation Mechanism traded as principal with such orders.

The Commission also notes its agreement with the comment that an EAM that trades against part or all of a customer's order must satisfy its fiduciary duty to that customer of best execution. The Commission's approval of the proposed rule change in no way relieves a firm from best execution analysis of trades it executes through the ISE's Facilitation Mechanism. For example, if a firm believes it can obtain better terms for its customer by exposing that customer's order to the auction on the floor of another exchange, it may be obligated to do so, depending on the totality of facts and circumstances surrounding the facilitation and the customer's best interests. Moreover, if a firm cancels a customer order after it has been submitted into the Facilitation Mechanism, an investigation into the reason the order was canceled, and whether the customer received a better price elsewhere, may be warranted.

The Commission finds good cause for approving Amendment No. 1 to the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment No. 1 revised the proposed rule change to provide an exposure period of 10 seconds, affording more time for the ISE crowd to respond to facilitation broadcasts than under the original proposal. Thus, the amendment should alleviate somewhat concerns about shortening the Facilitation Mechanism's exposure time, and does not raise any other regulatory issues. Accordingly, the Commission finds good cause, consistent with Sections 6(b)(5) [73] and 19(b)(2) [74] of the Act to accelerate approval of Amendment No. 1 to the proposed rule change.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1, including whether the amendment 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 ISE. All submissions should refer to File No. SR–ISE–2001–19 and should be submitted by October 16, 2002.

VI. Conclusion

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR–ISE–2001–19), as amended, be and hereby is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[75]

Margaret H. McFarland,

Deputy Secretary.

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rule. The Commission further does not believe that this result is significant to market makers, except in the case of orders of unusual size. Moreover, a large institutional customer with an order of unusual size may turn to another venue for facilitation if it is concerned that it will not see price improvement because of this dynamic.

[73] 15 U.S.C. 78f(b)(5).

[74] 15 U.S.C. 78s(b)(2).

[75] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–46505; File No. SR–Phlx–2001–104]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Philadelphia Stock Exchange, Inc. Relating to Clerks on the Exchange's Options Floor

September 17, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on December 18, 2001, the Philadelphia Stock Exchange, Inc. (''Phlx'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Phlx. On June 27, 2002, the Phlx submitted Amendment No. 1 to the proposed rule change.[3] 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 Phlx proposes to adopt Exchange Rule 1090, Clerks, which would define and set forth permitted and prohibited activities of Clerks on the Exchange's Options Floor.

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

[2] 17 CFR 240.19b–4.

[3] *See* letter from Richard S. Rudolph, Director and Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated June 26, 2002 (''Amendment No. 1''). In Amendment No. 1, the Phlx: (1) Made technical and clarifying changes to the proposed rule text; (2) added proposed Commentaries .01 and .02 to proposed Phlx Rule 1090 to define and set forth additional requirements for Stock Execution Clerks and Specialist Clerks; and (3) provided additional clarifying explanations with respect to the proposed rule change.