

### *f. Restrictions on the Electronic Generation of Orders*

ISE Rule 717(f) prohibits members from entering, or permitting the entry of, orders created and communicated electronically without manual input unless such orders are non-marketable limit orders to buy (sell) that are priced higher (lower) than the best bid (offer) on the ISE (*i.e.*, limit orders that improve the best price available on the Exchange).<sup>141</sup> This provision is not designed, however, to prohibit EAMs from electronically communicating to the ISE orders manually entered by customer orders into front-end communications systems (*e.g.*, internet gateways, online networks).

Certain commenters criticize this provision by noting that the rule was likely created to prevent day traders with automated trading systems from sending orders to the ISE whenever they identify an arbitrage opportunity that could be capitalized by trading the option on the ISE and another related option on another exchange.<sup>142</sup> One commenter argues that because the Commission has rejected similar rule proposals in the past, the ISE should not be permitted to have such a rule.<sup>143</sup>

The Commission shares commenters' concerns that these provisions inhibit competition between automated customers and ISE market makers. In the equity markets, limit orders from active customers have been a valuable source of quote competition. Nonetheless, the Commission recognizes that the ISE's business model depends on market makers for competition and liquidity. Unlike flat open systems used elsewhere in the world, customer orders in ISE receive priority over market makers. Allowing electronic entry directly into a fully automated system could give automated customers a significant advantage over market makers. This could undercut the ISE business model. Moreover, the ISE's prohibition on electronically entered limit orders matching the best bid and offer still allows limit orders at improved prices. For these reasons, the Commission is unable to conclude that this limitation violates the statutory requirements. In the future, however, this limitation may need to be reviewed in light of experience with the ISE.

### *F. Listing Procedures*

The Commission notes that the ISE has filed its proposed listing procedures in Amendment No. 2. These procedures reflect those used by the existing exchanges trading standardized options and under which The Options Clearing Corporation ("OCC") operates. Although these procedures were not published in the **Federal Register** for notice and comment, the Commission notes that they have previously been approved for use by other exchanges after notice and comment.<sup>144</sup> Accordingly, the Commission believes that, in the interest of uniformity, it is appropriate to approve these procedures as part of the ISE's exchange registration.

### *G. Fees*

The ISE has not included its proposed fee schedule in its registration application. Generally, changes to exchange fees are filed pursuant to Section 19(b)(3)(A) of the Exchange Act and are effective upon filing.<sup>145</sup> The ISE, however, will submit a rule filing regarding its fees pursuant to Section 19(b)(1)<sup>146</sup> and Rule 19b-4<sup>147</sup> thereunder prior to beginning trading. This will enable the fees to be published in the **Federal Register** for notice and comment, prior to Commission action. The Commission must find that the ISE's proposed fees are consistent with Section 6(b) of the Act,<sup>148</sup> in general, and further the objectives of Section 6(b)(4)<sup>149</sup> in particular, in that they will provide for the equitable allocation of reasonable dues, fees, and other charges among the Exchange's members and other persons using its facilities.

### *H. Miscellaneous*

Recognizing that the ISE is a new, fully electronic options exchange, the Commission believes it would be unwise and impracticable, at the outset, to cast the Exchange into a preconceived mold. The Commission believes that the ISE's governance provisions and trading rules are sufficiently clear for the purposes of granting it exchange registration. Requiring the ISE to provide a high degree of specificity with respect to certain of its rules before registration as an exchange is likely unfeasible because it will be difficult for the ISE to determine exactly who or what decisions may need to be made

until the Exchange actually begins operating. As the ISE gains experience, the Commission expects that the Exchange will take appropriate steps to ensure, among other things, that its rules continue to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. However, as noted above, the ISE will be required to file certain rule changes with the Commission pursuant to Rule 19b-4 under the Exchange Act prior to beginning trading.<sup>150</sup>

The Commission also notes that the ISE will need to enter into several regulatory agreements and plans before it may begin trading. Specifically, the ISE must join the Plan for the Reporting of Consolidated Options Last Sale Reports and Quotation Information (known as the Options Price Reporting Authority), the OCC, the Intermarket Surveillance Group Agreement, the Joint-Exchange Options Plan, and the Options Sales Practice Agreement. In addition, as mentioned above the ISE intends to enter into a Rule 17d-2 agreement with NASD Regulation. This agreement must be filed with and approved by the Commission.

### **IV. Conclusion**

An appropriate order granting exchange registration will issue.

By the Commission (Chairman Levitt and Commissioners Johnson, Hunt, Carey and Unger).

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

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## **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-42455; File No. 10-127]

### **In the Matter of the Application of The International Securities Exchange LLC for Registration as a National Securities Exchange; Order Granting Registration as a National Securities Exchange**

February 24, 2000.

The International Securities Exchange LLC, having filed an application with the Commission for registration as a national securities exchange pursuant to Section 6 of the Securities Exchange Act of 1934 ("Exchange Act"); and

In reviewing the ISE's registration application, the Commission has weighed the particular rule provisions

<sup>150</sup> See 17 CFR 240.19b-4.

<sup>141</sup> See Amendment No. 2.

<sup>142</sup> See, *e.g.*, CBOE Letters 1 and 2.

<sup>143</sup> See CBOE Letters 1 and 2. The Commission notes that the proposals that the CBOE is referring to deal primarily with the definition of a "public customer." See File Nos. SR-CBOE-93-20, SR-CBOE-95-23, and SR-CBOE-96-07.

<sup>144</sup> See Exchange Act Release No. 29698 (September 17, 1991), 56 FR 48594 (September 25, 1991) (order approving the Joint-Exchange Options Plan).

<sup>145</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>146</sup> 15 U.S.C. 78s(b)(1).

<sup>147</sup> 17 CFR 240.19b-4.

<sup>148</sup> 15 U.S.C. 78f(b).

<sup>149</sup> 15 U.S.C. 78f(b)(4).

against the regulatory objectives of the Exchange Act. Among other things, those objectives embody the concept that exchanges will deal fairly with the public; that exchanges will be organized in such a fashion as to ensure their continued viability in asserting self-regulatory oversight over their members; and that exchanges may, so far as is consistent with other regulatory objectives of the Act, maintain competitive viability with other exchanges. Applying these criteria, the Commission finds it in the public interest to declare effective the registration of the ISE on the basis of its present rules; and

It appearing to the Commission that the rules of the exchange provide for the expulsion, suspension or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade and declare that the willful violation of any provisions of the Exchange Act, or of any rule or regulation thereunder, shall be considered conduct or proceeding inconsistent with just and equitable principles of trade; and It further appearing that the exchange is so organized as to be able to comply with the provisions of the Exchange Act and the rules and regulations thereunder, and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors; and

Finally, it appearing that the rules of the exchange do not impose any burden on competition that is not necessary or in furtherance of the purposes of the Exchange Act;

*It is ordered* that the application of the International Securities Exchange LLC for registration as a national securities exchange be, and hereby is, granted.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42456, File No. 4-429]

### Joint Industry Plan; Notice of Filing of Proposed Option Market Linkage Plans by the American Stock Exchange, Chicago Board Options Exchange, Pacific Exchange, and Philadelphia Stock Exchange

February 24, 2000.

#### I. Introduction

On January 19, 2000, pursuant to Rule 11Aa3-2 under the Securities Exchange

Act of 1934 ("Act")<sup>1</sup> and an order issued by the Securities and Exchange Commission ("SEC" or "Commission"),<sup>2</sup> the American Stock Exchange LLC ("Amex"), Chicago Board Options Exchange, Inc. ("CBOE"), Pacific Exchange, Inc. ("PCX"), and Philadelphia Stock Exchange, Inc. ("Phlx") filed with the Commission proposed plans for the purpose of creating and operating an inter-market option linkage ("plans").<sup>3</sup> As discussed below, Amex and CBOE filed identical plans (the "Amex/CBOE plan") and PCX and Phlx filed separate plans. Although the four exchanges achieved consensus on the majority of issues pertaining to a linkage, disagreement remains on several significant matters. Specifically, the exchanges failed to agree about whether the linkage should require routing of orders based on price/time priority,<sup>4</sup> who should have access to the linkage, and the appropriate remedy owed when one market trades at a price inferior to that displayed on another market (known as a "trade-through"). Pursuant to Rule 11Aa3-2(c)(1), the Commission is publishing this notice of, and soliciting comments on, the Amex/CBOE plan. The Commission is also publishing this notice of the PCX and Phlx plans, which differ from the Amex/CBOE plan with respect to certain elements which the Commission is considering including in a linkage plan<sup>5</sup> and as to which the

<sup>1</sup> 17 CFR 240.11Aa3-2.

<sup>2</sup> On October 19, 1999, the Commission issued an Order directing the exchanges to file a national market system plan for linking the options markets within 90 days. Securities Exchange Act Release No. 42029 (October 19, 1999), 64 FR 57674 (October 26, 1999) ("October 19, 1999 Order").

<sup>3</sup> The Commission's October 19, 1999 Order also requested the International Securities Exchange ("ISE") to participate with the options exchanges in the development of an inter-market linkage plan. The ISE has filed an application with the Commission to register as a national securities exchange. See Securities Exchange Act Release No. 41439 (May 24, 1999) 64 FR 29367 (June 1, 1999). The ISE submitted a plan identical to that filed by Amex and CBOE. Because the Commission has not approved the ISE's application for registration as a national securities exchange, however, the ISE may not be a signatory to a linkage plan at this time.

<sup>4</sup> Both PCX and Phlx propose price/time priority as an element of the linkage. Price/time priority generally requires that if an exchange receives an order but it is not the first exchange to display the best price, that exchange must route the order to the exchange that was first at the best price. PCX and Phlx propose a number of textual distinctions from the Amex/CBOE plan to incorporate price/time priority. In the Phlx plan, many of the proposed modifications to the Amex/CBOE plan relate to an expanded role for the facilities manager. Although the term "facilities manager" is not defined in the plans, it is presumed by the plans to be an outside vendor who may be selected to build and operate a system linking the options exchanges' existing systems.

<sup>5</sup> Rule 11Aa3-2 specifically provides that the Commission may approve a proposed national

Commission therefore also seeks comments.

#### II. Background

In 1975, Congress directed the Commission to oversee the development of a national market system.<sup>6</sup> At the time, the trading of standardized options was relatively new.<sup>7</sup> As a result, the Commission deferred applying to the options markets many of the national market system initiatives that applied to the equity markets to give options trading an opportunity to develop. Nevertheless, since the establishment of the options exchanges, the Commission has repeatedly called for market integration facilities for the options markets.<sup>8</sup> In 1991, in response

market system plan "with such changes or subject to such conditions as the Commission may deem necessary or appropriate."

<sup>6</sup> Pub. L. No. 94-29 Stat. 97 (1975).

<sup>7</sup> The trading of standardized options on securities exchanges began in 1973, with the organization of CBOE as a national securities exchange. See Securities Exchange Act Release No. 9985 (February 1, 1973) 1 S.E.C. Doc.11 (February 13, 1973). Subsequently, the Commission approved options pilot programs at Amex, Phlx, PCX, and the Midwest Stock Exchange ("MSE"). The New York Stock Exchange ("NYSE") began trading options in 1985. See Securities Exchange Act Release No. 11144 (December 19, 1974) 40 FR 3258 (January 20, 1975); Securities Exchange Act Release No. 11423 (May 15, 1975) 6 S.E.C. Doc. 894 (May 28, 1975); Securities Exchange Act Release No. 12283 (March 30, 1976) 41 FR 14454 (April 5, 1976); Securities Exchange Act Release No. 13045 (December 8, 1976) 41 FR 54783 (December 15, 1976); and Securities Exchange Act Release No. 21759 (February 14, 1985) 50 FR 7250 (February 21, 1985). The MSE's options program was merged into the CBOE's program in 1979. The NYSE sold its options business to CBOE in 1997. Currently, Amex, CBOE, PCX, and Phlx are the only national securities exchanges that trade standardized options.

<sup>8</sup> See Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. (Comm. Print No. 96-IFC3, December 22, 1978) (examining the major issues of market structure in standardized options markets, including multiple trading); Securities Exchange Act Release No. 16701 (March 26, 1980) 45 FR 21426 (April 1, 1980) (deferring expansion of multiple trading to afford the options exchanges an opportunity to consider the development of market integration facilities); Securities Exchange Act Release No. 22026 (May 8, 1985) 50 FR 20310 (May 15, 1985) (urging options market participants to consider the development of market integration facilities); Directorate of Economic and Policy Analysis, "The Effects of Multiple Trading on the Market for OTC Options" (November 1986); Office of the Chief Economist, "Potential Competition and Actual Competition in the Options Market" (November 1986); Securities Exchange Act Release No. 26871 (May 26, 1989) 54 FR 24058 (June 5, 1989) (requesting comment on three measures, including an inter-market linkage). In 1989, the Commission adopted Rule 19c-5, which generally prohibits any exchange from adopting rules limiting its ability to list any stock option class because that option class is listed on another exchange. See Securities Exchange Act Release No. 26870 (May 26, 1989) 54 FR 23963 (June 5, 1989). In proposing Rule 19c-5, the Commission acknowledged that market integration facilities were unlikely to be built voluntarily if they were a prerequisite to