

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

On May 17, 2001, the CHX received written comment regarding the proposed rule change from Susquehanna Partners, GP, a CHX market maker firm. In its comment letter, Susquehanna raised three principal bases for objecting to the marketing fee and made collateral reference to one possible adverse consequence of the marketing fee.<sup>9</sup>

Two of Susquehanna's objections focus on the issue of revenue and the financial impact of the marketing fee on market makers. Specifically, Susquehanna argues that imposition of the marketing fee is not appropriate because CHX specialists currently receive a portion of the tape revenue generated by transactions on the CHX, whereas market makers do not share in this revenue. As set forth above, the CHX believes that this issue would be resolved to the parties' mutual benefit by agreements between specialists and market makers that provide for a rebate of the marketing fee to market makers who contribute to market share growth.

Susquehanna also argues that because the marketing fee is structured on a per-share basis as opposed to a per-trade basis, providers of large liquidity like Susquehanna will pay a disproportionate amount of the marketing fee. In the CHX's view, this argument ignores that the marketing fee will not be assessed in instances where the order is not the result of payment for order flow. According to the CHX, market makers who participate in large share transactions that arrive at the CHX independently of payment for order flow will not be forced to pay a marketing fee with respect to such trades. The CHX believes that per-share assessment of the marketing fee is appropriate because payment for order flow generally is made on a per share basis, permitting a virtual "pass through" of the marketing fee to order-sending firms.

Finally, Susquehanna argues that the CHX would be harmed if Susquehanna departs from the floor, removing a source of liquidity for large-sized orders. The CHX believes that it has adequate sources of liquidity without

Susquehanna, should Susquehanna decline to bear its proportionate share of order flow costs by ceasing operations on the CHX floor in order to avoid assessment of the marketing fee.

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

The foregoing rule change proposal has become immediately effective pursuant to Section 19(b)(3)(A) of the Act<sup>10</sup> and Rule 19b-4(f)(2) thereunder<sup>11</sup> because the CHX has designate it as establishing or changing a due, fee, or other charge of the CHX. At any time within 60 days after the filing of the rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purpose of the Act.<sup>12</sup>

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the forgoing, 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, N.W., Washington D.C. 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 at 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-CHX-2001-10 and should be submitted by August 29, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

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

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44641; File No. SR-ISE-2001-17]

### Self-Regulatory Organizations; Order Granting Accelerated Approval of Proposed Rule Change by the International Securities Exchange LLC Relating to Permanent Approval of Its Allocation Algorithm Pilot

August 2, 2001.

#### I. Introduction

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 May 23, 2001, the International Securities Exchange LLC (the "Exchange" or the "ISE") filed with the Securities and Exchange Commission ("Commission"), a proposed rule change requesting permanent approval of its allocation algorithm pilot.

The proposed rule change was published for comment in the **Federal Register** on July 11, 2001.<sup>3</sup> No comments were received on the proposal. This order approves the proposal on an accelerated basis.

#### II. Description of the Proposal

The Exchange is proposing to amend Supplementary Material .01 to Rule 713 to adopt the Exchange's current allocation algorithm pilot program on a permanent basis. The Exchange's allocation algorithm pilot was approved by the Commission on May 22, 2000,<sup>4</sup> and recently was extended until August 1, 2001.<sup>5</sup>

ISE Rule 713 provides that customer orders have priority, based on the time priority of such orders. ISE Rule 713(e) provides that if there are two or more non-customer orders or market maker quotations at the Exchange's inside market, after filling all customers at that

<sup>13</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> Securities Exchange Act Release No. 44508 (July 3, 2001), 66 FR 36353.

<sup>4</sup> See Securities Exchange Act Release No. 42808 (May 22, 2000), 65 FR 34515 (May 30, 2000) ("Release No. 42808").

<sup>5</sup> See Securities Exchange Act Release No. 44340 (May 22, 2001), 66 FR 29373 (May 30, 2001) ("Release No. 44340").

<sup>9</sup> The CHX states that Susquehanna had raised the same objections at a meeting of the Strategic Planning Subcommittee on Payment for Order Flow on May 8, 2001. The CHX also notes that, following a lengthy exploration of the issue raised by all parties in interest, and notwithstanding market maker opposition to the marketing fee, this subcommittee voted, by clear majority, in favor of the proposed rule change.

<sup>10</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>11</sup> 17 CFR 240.19b-4(f)(2).

<sup>12</sup> For purposes of calculating the abrogation date, the Commission considers the 60-day period to have commenced on July 19, 2001, the date on which the CHX amended the filing.

price, executions will be allocated between the non-customer orders and market maker quotations "pursuant to an allocation procedure to be determined by the Exchange from time to time \* \* \* ." ISE Rule 713(e) also states that, if the primary market maker ("PMM") is quoting at the Exchange's inside market, it will have precedence over non-customer orders and competitive market maker ("CMM") quotes for execution of orders that are up to a specified number of contracts. Supplementary Material .01 to ISE Rule 713 specifies the ISE's allocation procedure for non-customer orders and market maker quotations and defines the size of orders for which the PMM has priority to be those of five contracts or fewer.

The allocation procedure is a trading algorithm programmed in the ISE's electronic auction market system (the "System") that determines how to split the execution of incoming orders among professional trading interests at the same price. All public customer orders at a given price are always executed fully before the trading algorithm is applied. Moreover, because the algorithm is applied automatically by the System upon the receipt of an executable order, only those non-customer orders and market maker quotes at the best price that are in the System participate in the algorithm. Thus, there is no opportunity for a market participant to receive an allocation unless it had an order or quote in the System at the execution price at the time the incoming order was received by the System.

Subject to the PMM's participation rights discussed below, allocation of executions to non-customer orders and market maker quotes is based on the size associated with the order or quote relative to the total size available at the execution price. According to the Exchange, because PMMs have unique obligations to the ISE market,<sup>6</sup> they are provided with certain participation rights. If the PMM is one of the participants with a quote at the best price,<sup>7</sup> it has participation rights equal

to the greater of (1) the proportion of the total size at the best price represented by the size of its quote, or (2) 60 percent of the contracts to be allocated if there is only one other non-customer order or market maker quotation at the best price, 40 percent if there are two other non-customer orders and/or market maker quotes at the best price, and 30 percent if there are more than two other non-customer orders and/or market maker quotes at the best price.<sup>8</sup> This allocation procedure has been approved by the Commission on a permanent basis, and the Exchange did not propose any changes to the procedure at this time.<sup>9</sup>

The allocation procedure further provides that the PMM has precedence to execute orders of five contracts or fewer. This means that such orders will be executed first by the primary market maker if it is quoting at the best price. This aspect of the allocation procedure was approved by the Commission on a one-year pilot basis.<sup>10</sup> In its temporary approval of this PMM preference for the pilot period, the Commission stated its intent to monitor the rule's impact on competition during the pilot period and the ISE agreed to provide four types of specific confidential data to the Commission on a quarterly basis. The ISE also committed to lowering the size of the orders to which the PMM is given a preference if the execution of orders for five contracts or fewer by PMMs exceeded 40 percent of total exchange

quoting at the best price at the time the executable order is received by the System. Moreover, the size associated with the PMM's quote must be sufficient to fill the portion of the order that would be allocated to it according to the participation rights. For example, if a PMM would be allocated 30 contracts according to its participation rights, but the size of its quote is only 20 contracts, the PMM would receive an allocation of only 20 contracts. If the size associated with a PMM's quote is only three contracts when an executable order for five contracts is received (assuming there are no public customer orders), the PMM would execute only three contracts.

<sup>6</sup> According to the participation rights, a PMM quoting at the inside market generally is allocated the plurality of an order. For example, if a both a PMM and CMM are quoting at the inside market for 50 contracts each, an incoming order for 10 contracts will be allocated between the two for six and four contracts respectively (a 60% allocation to the PMM). If the PMM is quoting for 50 contracts and there are two CMMs each quoting for 50 contracts, the PMM is allocated four contracts and the two CMMs are allocated three each (40 percent for the PMM, and the remaining 60 percent split equally between the CMMs because they are quoting an equal size.) At a minimum, a PMM will be allocated 30 percent of an order, regardless of the number of other quotes or orders at that price.

<sup>9</sup> See Release No. 42808, *supra* note 4.

<sup>10</sup> *Id.* The Commission extended the pilot to August 1, 2001 in order to consider this proposed rule change requesting permanent approval. See Release No. 44340, *supra* note 5.

volume (excluding volume from the execution of facilitation orders).

### III. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission has reviewed the ISE's proposed rule change and finds, for the reasons set forth below, that the proposal is consistent with the requirements of section 6 of the Act<sup>11</sup> and the rules and regulations thereunder applicable to a national securities exchange.<sup>12</sup> Specifically, the Commission believes that the proposal to provide PMMs with the preference for orders of five contracts or fewer is consistent with Section 6(b)(5) of the Act.<sup>13</sup> Section 6(b)(5) requires that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

In its original approval order for the ISE's allocation algorithm, the Commission, responding to various issues raised by commenters, stated that it intended to use the one-year pilot period to monitor the rule's impact on competition by reviewing the four types of specific data that ISE provided to the Commission on a quarterly basis.<sup>14</sup> During the pilot period and the pilot extension period, the Exchange has provided the statistics required under the terms of the pilot and has monitored the percentage of total ISE volume resulting from execution of orders of five contracts or fewer by the PMMs. The Commission notes that the 40% threshold was not reached during the pilot program and pilot extension period; indeed, the total percentage was substantially lower than 40%. In particular, the Commission notes that throughout the pilot program and pilot extension, a large percentage of orders of five contracts or fewer were executed by participants other than the PMM, and a large percentage of all the volume on

<sup>11</sup> 15 U.S.C. 78f.

<sup>12</sup> In approving this rule, the Commission notes that it has also considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> See Release No. 42808, *supra* note 4.

<sup>6</sup> For example, PMMs are responsible for: (1) Ensuring that all ISE disseminated quotations are for at least 10 contracts; (2) addressing customer orders that cannot be automatically executed when another market is disseminating a better quotation; and (3) opening the market. See ISE Rule 803(c).

<sup>7</sup> The participation rights are programmed into the trading algorithm, so that they are applied automatically by the System when splitting executions among non-customer orders and market maker quotes after public customer orders at the same price are fully executed, as described above. Consequently, like any other market participant, the PMM cannot receive any portion of an allocation, regardless of its participation rights, unless it is

the Exchange were executed by participants other than the PMM.

The Commission does not believe that the small order participation right for PMMs (*i.e.*, five contracts of fewer preference) will necessarily result in a significant portion of the Exchange's volume being executed by the PMM, especially in light of the fact that the PMM executes against such orders only if it is quoting at the best price, and only for the number of contracts associated with its quotation. In order to provide a safeguard against the potential for increased PMM executions in the future in excess of the proposed 40% threshold, however, the ISE agrees to continue to maintain the technological capability to compile the sort of data it provided to the Commission during the pilot period and pilot extension, and agrees to compile and provide such data to the Commission at its request.<sup>15</sup> The Commission further notes that the Exchange will continue to evaluate periodically the percentage of the volume executed on the Exchange that is comprised of orders for five contracts or fewer executed by primary market makers, and will reduce the size of the orders included in this provision if such percentage is over 40 percent. Given the existence of these continued safeguards, as well as the lack of anticompetitive statistical trends observed by the Commission during the pilot period and pilot extension, the Commission finds that the proposed rule change is consistent with Section 6(b)(5).

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The original filing proposing the ISE's pilot program for small order participation right for PMMs was subject to a full notice and comment period.<sup>16</sup> In addition, this proposal requesting permanent approval of the same provision will, as of the date of this order, have been subject to a full notice and comment period and no comment letters were received by the Commission. Moreover, the one-year pilot period and related reporting obligations by ISE were responsive to the issues raised by commenters to ISE's earlier filing regarding its allocation algorithm.<sup>17</sup> Accordingly, the Commission finds good cause for approving the proposed rule change

(SR-ISE-2001-17) prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**.

#### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>18</sup> that the proposed rule change (SR-ISE-2001-17) is approved on an accelerated basis.

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

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

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44637; File No. SR-PCX-2001-26]

#### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Exchange, Inc., Relating to Accepting Orders from Professional Customers

August 1, 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 July 6, 2001, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The PCX proposes to allow PCX Floor Brokers and qualified Floor Clerks of Floor Brokers to accept offers from "Professional Customers" (as defined) for execution on the Exchange's trading floor. The text of the proposed rule change is below. Additions are in *italics*.

\* \* \* \* \*

¶ 4963 Options Floor Broker Defined  
Rule 6.43(a)—No change.

#### (b) Conducting a Limited Public Business

(1) *Notwithstanding the provisions of subsection (a) of this Rule, qualified*

*Floor Brokers and Floor Clerks of qualified Floor Brokers may conduct a public business limited to accepting orders directly from Professional Customers, as defined below, for execution on the Floor of the Exchange. Any Floor Broker or Floor Clerk of a Floor Broker seeking to conduct such a limited public business must first:*

(A) *successfully complete the Series 7 Examination or the Series 7A Examination; and*

(B) *register and receive approval from the Exchange. The form of registration will be prescribed by the Exchange.*

(2) *For purposes of this rule, a "Professional Customer" includes a bank; trust company; insurance company; investment trust; a state or political subdivision thereof, charitable or nonprofit educational institution regulated under the laws of the United States, or any state, or pension or profit sharing plan subject to ERISA or of any agency of the United States as of a state or political subdivision thereof, or any person (other than a natural person) who has, or who has under management, net tangible assets of at least sixteen million dollars.*

(3) *Members who conduct a limited public business pursuant to the provisions of subsection (b) of this Rule 6.43 are strictly prohibited from holding customer funds and/or customer securities.*

\* \* \* \* \*

#### 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 Exchange proposes to adopt the requirement that qualified Floor Brokers and Floor Clerks located on the floor of the PCX who wish to accept orders directly from professional investors for execution on the trading floor must take and pass either the Series 7 or Series

<sup>15</sup> Telephone conversation between Katherine Simmons, Vice President and Associate General Counsel, ISE, Deborah Flynn, Assistant Director, Division of Market Regulation, Commission and Geoffrey, Pemble, Attorney, Division of Market Regulation, Commission, on July 25, 2001.

<sup>16</sup> See Release No. 42808, *Supra* note 4.

<sup>17</sup> *Id.*

<sup>18</sup> 15 U.S.C. 78s(b)(2).

<sup>19</sup> 17 CFR 200.30-3(a)(12).

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

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