(2) A broker or dealer shall make the report required by paragraph (b)(1) of this section publicly available within one month after the end of the quarter addressed in the report.

(c) *Customer requests for information on order routing.* (1) Every broker or dealer shall, on request of a customer, disclose to its customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders.

(2) A broker or dealer shall notify customers in writing at least annually of the availability on request of the information specified in paragraph (c)(1) of this section.

(d) *Exemptions.* The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

Dated: November 17, 2000.

By the Commission.

Jonathan G. Katz,

Secretary.

[FR Doc. 00–30131 Filed 11–30–00; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–43591; File No. S7–17–00]

RIN 3235–AH96

Firm Quote and Trade-Through Disclosure Rules for Options

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''SEC'' or ''Commission'') is adopting an amendment to Rule 11Ac1–1 under the Securities Exchange Act of 1934 (''Exchange Act'') to require options exchanges and options market makers to publish firm quotes. The Commission also is adopting new Rule 11Ac1–7 under the Exchange Act to require a broker-dealer to disclose to its customer when its customer's order for listed options is executed at a price inferior to a better published quote and what that better quote was, unless the transaction was effected on a market that is a participant in an intermarket options linkage plan approved by the Commission. These rules will facilitate the ability of market participants to obtain the best price for customer orders.

EFFECTIVE DATE: February 1, 2001.

FOR FURTHER INFORMATION CONTACT: Deborah Flynn, Senior Special Counsel, at (202) 942–0075, Kelly Riley, Special Counsel, at (202) 942–0752, John Roeser, Attorney, at (202) 942–0762, Terri Evans, Special Counsel, at (202) 942–4162, and Heather Traeger, Attorney, at (202) 942–0763, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION:

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I. Executive Summary

Recent increases in the multiple listing of options classes previously listed on a single exchange have intensified the competition among the option exchanges and heightened the need to further integrate the options markets into the national market system. The marked increase in multiple trading is indicative of the dynamic environment in which the options markets currently operate.[1] While the growth in multiple trading has increased the competition between markets, it also has dramatically altered the environment in which options market participants conduct their trading. In particular, multiple trading raises new best execution challenges for brokers.[2] When an option is listed on only one exchange, brokers do not have to decide where to route an order, and consequently, satisfying their best execution obligations is simpler than when they must consider the relative merits of routing an order to two or more market centers. With as many as five options exchanges currently trading

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[1] For example, in August 1999, only 32% of equity options classes were traded on more than one exchange. By the end of September 2000, the number of equity options classes that were multiply-traded had risen to 45%. In addition, aggregate options volume traded only on a single exchange fell from 61% to 15% over this same period.

[2] In accepting orders and routing them to an exchange for execution, brokers act as agents for their customers and owe them a duty of best execution. A broker's duty of best execution is derived from common law agency principles and fiduciary obligations. It is incorporated both in self-regulatory organizations' rules and in the antifraud provisions of the federal securities laws through judicial and Commission decisions. This duty requires a broker to seek the most favorable terms reasonably available under the circumstances for a customer's transaction. As a result, brokers must periodically assess the quality of competing markets. See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

certain options classes, brokers are required to regularly and rigorously evaluate the execution quality available at each options exchange.

Directly relevant to a broker's ability to obtain best execution for its customers is the ability to get the best price available. The considerable growth in the number of options classes traded on more than one exchange has significantly increased the likelihood that an order may be executed at a price that is inferior to a quoted price available on another exchange (''intermarket trade-through''). According to preliminary data analyzed by the Commission's Office of Economic Analysis, during the week of June 26, 2000, 5 percent of all trades in the 50 most active multiply-traded equity options were executed at prices inferior to the best price quoted on a competing market. Currently, it is difficult to ensure that a customer order sent to one exchange will receive the best available price because of the absence of fair access and an efficient mechanism allowing a market participant at one exchange to reach a better price published by another exchange. As a result, better prices quoted on another exchange do not always receive price priority, and customer orders may receive inferior executions.

Because of our concerns about the increasing likelihood of intermarket trade-throughs in the options markets, on October 19, 1999, the Commission issued an Order directing the options exchanges to act jointly to file a national market system plan for linking the options markets.[3] On July 28, 2000, the Commission approved an intermarket linkage plan proposed by three of the options exchanges (''Linkage Plan'') [4] and subsequently, the other two exchanges filed with the Commission amendments to permit their participation in the Linkage Plan. [5]

In conjunction with its approval of the Linkage Plan, the Commission proposed a new rule, Exchange Act Rule 11Ac1–7 (''Trade-Through Disclosure Rule''),[6] to require a broker-dealer to disclose to its customer when the customer's order for a listed option is executed at a price inferior to a better published quote and that better quote, unless the transaction was effected on a market that participates in an intermarket linkage plan approved by the Commission.[7] In addition, the Commission proposed to amend Exchange Act Rule 11Ac1–1 (''Quote Rule'') [8] to require options exchanges and options market makers to publish firm quotes. [9] These proposed rules were intended to facilitate the ability of market participants to obtain the best price for customer orders without mandating a specific linkage.

With the current expansion of multiple trading in options, the Commission is increasingly concerned about intermarket trade-throughs of customer orders. The Commission believes that adoption of the new rule and amendment to the Quote Rule are necessary at this time to encourage the removal of barriers to access to, and the use of efficient vehicles to reach, better prices on another market. Consequently, as discussed below, the Commission today is adopting the Trade-Through Disclosure Rule [10] and amending the Quote Rule,[11] substantially as proposed, with certain modifications recommended by commenters.

II. Background

Section 11A of the Exchange Act,[12] enacted as part of the Securities Acts Amendments of 1975,[13] sets forth Congress' findings concerning the establishment of a national market system. Congress found, among other things, that it was in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the availability to brokers, dealers, and investors of quote and transaction information.[14] Congress also found that linking all of the markets for qualified securities would ''foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.'' [15]

The national market system was intended by Congress to potentially encompass ''all segments of corporate securities including all types of common and preferred stocks, bonds, debentures, warrants, and options.'' [16] Congress included all types of securities because it believed that many of the goals of a national market system, such as the availability of information with respect to price, volume, and quotations, would be universally beneficial.[17]

Congress did, however, recognize the differences between the markets and granted the Commission broad powers to implement a national market system without forcing all securities markets into a single mold.[18] Accordingly, Congress granted the Commission the authority to implement the objectives of the 1975 Amendments,[19] while allowing the Commission to recognize and classify markets, firms, and securities in any manner appropriate or necessary in the public interest or for the protection of investors.[20]

Many of the national market system initiatives were implemented in the equities markets at a time when

[3] *See* Securities Exchange Act Release No. 42029, 64 FR 57674 (October 26, 1999) (''October 19, 1999 Order''). The October 19, 1999 Order directed the American Stock Exchange LLC (''Amex''), Chicago Board Options Exchange, Inc. (''CBOE''), Pacific Exchange, Inc. (''PCX''), and Philadelphia Stock Exchange, Inc. (''Phlx'') to act jointly in discussing, developing, and submitting for Commission approval an intermarket linkage plan. The Commission's Order also requested the International Securities Exchange LLC (''ISE'') to participate with the options exchanges in the development of an intermarket linkage plan. The ISE was subsequently registered as a national securities exchange for options trading on February 24, 2000. *See* Securities Exchange Act Release No. 42455, 65 FR 11387 (March 2, 2000).

[4] *See* Securities Exchange Act Release No. 43086, 65 FR 48023 (August 4, 2000). As originally approved, the Amex, CBOE, and ISE were the only participants in the Linkage Plan.

[5] *See* Securities Exchange Act Release Nos. 43573 (November 16, 2000); and 43574 (November 16, 2000). The Commission issued orders to permit Phlx and PCX to participate in the Linkage Plan.

[6] Exchange Act Rule 11Ac1–7, 17 CFR 240.11Ac1–7.

[7] *See* Securities Exchange Act Release No. 43085 (July 28, 2000), 65 FR 47918 (August 4, 2000) (''Proposing Release'').

[8] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

[9] *See* Proposing Release, supra note 7.

[10] Exchange Act Rule 11Ac1–7, 17 CFR 240.11Ac1–7.

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

[12] 15 U.S.C. 78k–1.;

[13] Pub. L. No. 94–29, 89 Stat. 97 (1975) (''1975 Amendments''). In the 1975 Amendments, Congress directed the Commission to oversee the development of a national market system. Congress granted the Commission broad, discretionary powers to oversee the development of a fully integrated national market system for the processing and settlement of securities transactions. See also infra note 16.

[14] Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C).

[15] Section 11A(a)(1)(D) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(D).

[16] Senate Committee on Banking, Housing, and Urban Affairs, Report to Accompany S. 249, S. Rep. 94–75, 94th Cong., 1st Sess. 7 (1975) (''Senate Report''). *See* also Committee of Conference, Report to Accompany S. 249, H.R. Rep. No. 94–229, 94th Cong., 1st Sess. 2 (1975) (''Conference Report'').

[17] Id.

[18] *See* Senate Report. See also Conference Report. In the Conference Report, the Committee stated that the unique characteristics of securities other than common stocks may require different treatment in a national market system.

[19] The two primary objectives of the 1975 Amendments were (1) ''the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements,'' and (2) ''the centralization of all buying and selling interest so that each investor will have the opportunity for the best execution of his order, regardless of where in the system it originates.'' See Senate Report.

[20] Section 11A(a)(2) of the Exchange Act authorizes the Commission to designate, by rule, securities qualified for trading in the national market system. 15 U.S.C. 78k–1(a)(2).

standardized options trading was relatively new.[21] Therefore, even though Congress had intended to include options in a national market system, the Commission deferred applying many of the national market system initiatives to options to give options trading an opportunity to develop.[22] Today, the options markets continue to operate with limited market integration facilities.[23]

A. Prior Attempts To Limit Intermarket Trade-Throughs

To address the limited market integration facilities in the options market, the Commission has repeatedly encouraged the exchanges to implement mechanisms to limit trade-throughs.[24] For example, in 1980, at the time the Commission ended the voluntary moratorium on expansion of standardized options trading, it asked for comment on several approaches to more fully integrate the options markets into the national market system, including a market linkage system similar to the Intermarket Trading System (''ITS''),[25] requiring brokerage firms to route retail orders on an order-by-order basis to the market center showing the best quotation, and an order exposure system for options public limit orders.[26]

Subsequently, the Commission's adoption of Exchange Act Rule 19c-5 in 1989 [27] created the need for some mechanism to ensure that customers' orders for multiply-traded options could be executed at the best available price. Accordingly, in 1990, the Amex, CBOE, New York Stock Exchange (''NYSE''),[28] and PCX filed with the Commission a proposed Joint Industry Plan providing for the creation and operation of an Options Intermarket Communications Linkage (''Proposed Plan'').[29] The Commission sought comment on the Proposed Plan,[30] but neither the Proposed Plan nor its Model Trade-Through Rule was adopted, in part, because the options exchanges could not reach a consensus on several critical elements.

During the comment period on the Proposed Plan, an alternative plan was considered that involved the gradual phase-in of multiple trading, along with the adoption of exchange rules and operational enhancements linking the markets non-electronically (''Phase-In Plan'').[31] Specifically, the Phase-In Plan would have provided for the re-routing of orders received through automated systems to other execution facilities, in conjunction with a trade-or-fade rule.[32] Again, however, the exchanges did not agree to the Phase-In Plan and it was not adopted.

In 1994, the markets adopted trade-or-fade rules, which require a market maker to revise its quote if it is unwilling to trade at its published quote with an order sent to it by a market maker from another exchange.[33] The trade-or-fade rules do not provide efficient means of access between the markets. They also provide little incentive to try to reach a better quote

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

[22] In October 1977, in response to allegations of widespread manipulation in the market for exchange-traded options, the Commission initiated an investigation and special study of the options markets. The result of the Commission's investigation was The Report of the Special Study of the Options Markets, issued on December 22, 1978 (''Options Study''). 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). In the Options Study, the Commission acknowledged that Congress had intended to include options in a national market system, and set forth a number of issues to be explored before the options markets could be fully integrated into the national market system. Options Study at 1029–1030. The Options Study delineated the following as among the issues to be explored in the options market: (1) A comprehensive quotation system for the dissemination of firm quotes; (2) market linkage and order routing systems to enable the best execution of orders; (3) nationwide limit order protection to ensure that agency orders receive auction-type trading protections; and (4) off-board trading restrictions. Subsequently, the Commission approved, pursuant to Section 11A of the Exchange Act and Rule 11Aa3–2 thereunder, a national market system plan that collects and disseminates consolidated quotes and trades for the options markets, the Options Price Reporting Authority (''OPRA'') Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information (''OPRA Plan''). See Securities Exchange Act Release No. 17638 (March 18, 1981).

[23] The Commission has repeatedly called for increased national market system initiatives in the options markets. See Securities Exchange Act Release No. 16701 (March 26, 1980), 45 FR 21426 (April 1, 1980) (deferring expansion of multiple trading to afford the options exchanges an opportunity to consider the development of market integration facilities); Securities Exchange Act Release No 22026 (May 8, 1985), 50 FR 20310 (May 15, 1985) (urging options market participants to consider the development of market integration facilities); Directorate of Economic and Policy Analysis, ''The Effects of Multiple Trading on the Market for OTC Options'' (November 1986); Office of the Chief Economist, ''Potential Competition and Actual Competition in the Options Market'' (November 1986); and Securities Exchange Act Release No. 26871 (May 26, 1989), 54 FR 24058 (June 5, 1989) (requesting comment on three measures, including an intermarket linkage). In 1989, the Commission adopted Exchange Act Rule 19c-5, which generally prohibits any exchange from adopting rules limiting its ability to list any stock options class because that options class is listed on another exchange. See Securities Exchange Act Release No. 26870 (May 26, 1989), 54 FR 23963 (June 5, 1989). In 1990, then Chairman Breeden requested that the options exchanges develop an intermarket linkage plan. See letter from Chairman Breeden to the Registered Options Exchanges dated January 9, 1990.

[24] Id.

[25] In the equity markets, the ITS Plan includes a trade-through rule protecting displayed bids and offers for ITS-eligible exchange-listed securities. *See* Securities Exchange Act Release No. 17703 (April 9, 1981), 22 S.E.C. Doc. 707. In conformance with the ITS Plan, each participating exchange and the National Association of Securities Dealers (''NASD'') has adopted rules that limit trade-throughs in exchange-listed securities. *See* Securities Exchange Act Release No. 17704 (April 9, 1981), 46 FR 22520 (April 17, 1981). The NASD submitted a proposed trade-through rule for exchange-listed stocks, which the Commission approved on May 6, 1982. *See* Securities Exchange Act Release No. 18714, 47 FR 20429 (May 12, 1982). On June 21, 1985, the Commission requested comment on, among other things, the extent to which securities listed on The Nasdaq Stock Market, Inc. (''Nasdaq'') should be subject to trade-through rules. *See* Securities Exchange Act Release No. 22127 (June 21, 1985), 50 FR 26584 (June 27, 1985). In addition, in recently adopting amendments to the ITS Plan to expand the linkage to all listed securities, the Commission concluded that the NASD should continue to consider modifications to its existing trade-through rule to cover non-ITS participants, but that such modifications were not a precondition to approval of the expanded linkage. *See* Securities Exchange Act Release No. 42212 (December 9, 1999), 64 FR 70297 (December 16, 1999).

[26] *See* Securities Exchange Act Release No. 16701 (March 26, 1980), 45 FR 21426 (April 1, 1980) (''Moratorium Termination Release'').

[27] Exchange Act Rule 19c–5, 17 CFR 240.19c–5. *See* Securities Exchange Act Release No. 26870, *supra* note 23.

[28] The NYSE has since sold its options business to the CBOE. *See* Securities Exchange Act Release No. 38542 (April 23, 1997), 62 FR 23521 (April 30, 1997).

[29] The filing was amended on April 29, 1991, when the signatories to the Proposed Plan submitted a Model Option Trade-Through Rule as Exhibit A to the Proposed Plan (''Model Trade-Through Rule''). The Model Trade-Through Rule would have been incorporated into each of the options exchanges' rules. The Model Trade-Through Rule provided that, absent reasonable justification or excuse, a member in a participant market should avoid initiating a trade-through when purchasing or selling an options contract permitted to be transmitted through the proposed linkage.

[30] *See* Securities Exchange Act Release No. 30187 (January 14, 1992), 57 FR 2612 (January 22, 1992).

[31] The Phase-In Plan was put forth by the Securities Industry Association (''SIA'') and endorsed by the Committee on Options Proposals (''COOP''). *See* letters to Jonathan G. Katz, Secretary, SEC, from Thomas P. Hart, Chairman, SIA Options and Derivative Products Committee, dated March 10, 1992; and Michael Schwartz, Chairman, COOP, dated March 11, 1992.

[32] *Id. See also* letter from Richard C. Breeden, Chairman, SEC, to Alger B. Chapman, Chairman & CEO, CBOE, dated June 30, 1992 (setting forth the Commission's understanding of the elements of the Phase-In Plan).

[33] *See* Securities Exchange Act Release Nos. 34431, 34432, 34444, 34434, and 34435 (July 22, 1994), 59 FR 38994 (August 1, 1994) (orders approving proposed rule changes filed by Amex, CBOE, NYSE, Phlx, and PCX, respectively). *See also* Amex Rule 958A, Commentary 01; CBOE Rule 8.51(b); PCX Rule 6.37(d); Phlx Rule 1015(b); and ISE Rule 804.

in another market, because that quote need not be firm when reached. Thus, the trade-or-fade rules have done little to promote price priority or discourage intermarket trade-throughs. As described below, the rules adopted by the Commission today respond to changes in the options markets and reflect a different approach to limiting intermarket trade-throughs and promoting price priority.

B. Application of the Quote Rule in the Options Market

As a testament to the importance of firm quotes in the securities markets, one of the first national market system initiatives implemented by the Commission in the equity markets was the Quote Rule.[34] The Quote Rule requires all national securities exchanges and associations to establish procedures for collecting from their members bids, offers, and quotation sizes with respect to reported securities, and for making such bids, offers, and sizes available to quotation vendors. It also requires that quotation information made available to vendors be ''firm,'' subject to certain exceptions.

By its terms, the Quote Rule currently does not apply to options. At the time the Quote Rule was adopted in 1978,[35] standardized options had been listed and traded on the options exchanges for only a few years, and the Commission had imposed a moratorium that restricted the expansion of options trading.[36] For example, in 1980, when the Commission lifted the moratorium on options listings, it also set forth its vision on the future of options multiple trading, including the feasibility of firm quotes.[37] Successful implementation of a linkage among the markets was thought to depend upon the quality and reliability of quotation information disseminated by each market center. At that time, however, the Commission believed that the imposition of a firm quote requirement on the options markets and market participants was unworkable.[38]

In conjunction with the Commission's adoption in 1989 of Rule 19c-5 [39] relating to multiple trading of options, the Commission published a staff concept release that discussed options market structure issues associated with multiple trading, and outlined suggestions for possible market structure enhancements.[40] The release emphasized that the availability and reliability of comprehensive quotation information for options are important elements in considering the concerns traditionally associated with multiple trading.

The release discussed whether the then-existing quote and trade reporting mechanism for options needed to be adapted for multiple trading by requiring that equity options quotes be firm. Market participants had, in the past, argued against a firm quote requirement in the options markets for a number of reasons.[41] These concerns, however, were recognized as largely moot due to the development of autoquote [42] and automatic execution [43] systems, which indicated that firm quotes were, at the very least, possible.[44]

Today, each options market requires its market makers to have firm quotes for some types of orders. [45]Therefore, the Commission believes that imposing a market-wide firm quote obligation on options market participants should not be unduly burdensome. While the exchanges' firm quote rules and automatic execution systems provide their public customers with firm quote guarantees, these rules currently do not extend to other market participants. As described below, the amendments to the Quote Rule adopted by the Commission today require that options quotes be firm for broker-dealer orders for at least one contract.

III. Description of Proposed Rulemaking [46]

A. Proposed Trade-Through Disclosure Rule

In the Proposing Release, the Commission proposed new Rule 11Ac1–7 under the Exchange Act [47] to require a broker-dealer to disclose to a customer when the customer's order to buy or sell a listed option is executed at a price inferior to the best quote published at the time of execution of the customer's order. The proposal identified seven circumstances in which a trade executed at a price inferior to a published price on another market would, nevertheless, not be considered a trade-through for purposes of the

[34] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1. The reliability and availability of quotation information are basic components of a national market system and are needed so that broker-dealers are able to make best execution decisions for their customers' orders, and customers are able to make order entry decisions. *See* Securities Exchange Act Release No. 12670 (July 29, 1976), 41 FR 32856 (August 5, 1976) (proposing Exchange Act Rule 11Ac1–1).

[35] *See* Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978), as amended in Securities Exchange Act Release Nos. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996); and 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998).

[36] *See supra* notes 21 and 22 and accompanying text.

[37] *See* Moratorium Termination Release, *supra* note 26.

[38] In 1980, quotes were updated manually; thus, the options exchanges argued that it would be virtually impossible for a market maker to update its quotes in a timely fashion each time the underlying stock price moved.

[39] *See* Securities Exchange Act Release No. 26870, *supra* note 23.

[40] *See* Securities Exchange Act Release No. 26871, *supra* note 23.

[41] One major concern of market participants was that due to the derivative nature of options, and the need to adjust quotes in numerous series in response to a single price change in the underlying security, it would be impossible, or at least impractical, to require options market makers to honor their disseminated quotes. Further, it was thought to be difficult for an exchange to identify which member of a trading crowd was responsible for a quote and to provide a mechanism for quotes to be modified or withdrawn.

[42] Autoquote systems enable options market professionals to update their quotes in numerous options series simultaneously.

[43] Automatic execution systems provide, in effect, firm quotes for public customer orders.

[44] *See* Securities Exchange Act Release No. 26871, *supra* note 23.

[45] *See generally* Amex Rule 958A (requiring a specialist to sell/buy at least 10 contracts at the offer/bid displayed when the order reaches the trading post); CBOE Rule 8.51 (generally requiring a trading crowd to sell/buy at least the RAES contract limit applicable to a particular options class at the offer/bid displayed when a customer order reaches the trading station); PCX Rule 6.86 (generally requiring a trading crowd to provide a depth of 20 contracts for all non-broker-dealer orders at the bid/offer disseminated at the time an order is announced at the trading post); Phlx Rule 1015 (requiring that public customer orders be filled at the best market for a minimum of 10 contracts); and ISE Rule 804 (requiring a market maker to enter the number of contracts it is willing to buy or sell at its quote and prohibiting a market maker from entering a bid or offer for less than 10 contracts).

[46] In response to the Proposing Release, the Commission received comment letters from fourteen commenters representing the views of four exchanges, seven firms, and four other interested parties. *See* letters to Jonathan G. Katz, Secretary, SEC, from Samuel F. Lek, Chief Executive Officer, Lek Securities Corporation, dated September 20, 2000 (''Lek Letter''); Michael J. Simon, Senior Vice President and Secretary, ISE, dated September 18, 2000 (''ISE Letter''); George Brunelle, Brunelle & Hadjikow, dated September 15, 2000 (''Brunelle Letter''); Juan Carlos Pinilla, Managing Director, J.P. Morgan Securities, Inc. (''JPMorgan Letter''); Thomas A. Bond, CBOE, dated October 9, 2000 (''CBOE Letter''); Phillip D. DeFeo, Chairman and Chief Executive Officer, PCX, dated October 10, 2000 (''PCX Letter''); Michael G. Vitek, President, Botta, dated September 29, 2000 (''Botta Letter''); Joel Greenberg, Managing Director, Susquehanna Investment Group, dated September 22, 2000 (''Susquehanna Letter''); Chris Delzio, Amex Member, dated August 15, 2000 (''Delzio Letter''); Lewis Singletary, Journeyman Holdings Corporation, dated September 30, 2000 (''Singletary Letter''); Meyer S. Frucher, Phlx, dated September 18, 2000 (''Phlx Letter''); Edward Provost, Executive Vice President, Business Development Division, CBOE, dated September 13, 2000 (asking for an extension of the comment period); Robert Bellick, Co-Managing Partner, Wolverine Trading, L.L.P., dated October 25, 2000 (''Wolverine Letter''); Robin Roger, Managing Director and Counsel, Morgan Stanley Dean Witter, dated October 25, 2000 (''Morgan Stanley Letter''); and William McGowen, Chairman, Options Committee, SIA, dated October 31, 2000 (''SIA Letter'').

[47] *See* Proposing Release, *supra* note.

rule.[48] In addition, as an incentive for markets to cooperate in developing effective means to access the quotes of other markets to avoid intermarket trade-throughs, the Commission's proposal excepted broker-dealers from the proposed disclosure requirements if they effected their customer orders on options markets that participated in an intermarket linkage plan approved by the Commission that had provisions reasonably designed to limit intermarket trade-throughs.

B. Proposed Amendments to the Quote Rule

The Commission also proposed to amend Exchange Act Rule 11Ac1–1 to require options exchanges and options market makers to publish firm quotes.[49] Because OPRA currently does not have the ability to collect from the exchanges and disseminate to quotation vendors size information, the Commission proposed to amend the Quote Rule so that broker-dealers would not be required to communicate, and options exchanges would not be required to collect and make available on a quote-by-quote basis, the size associated with each quotation in listed options. Instead, an options exchange would be required to establish by rule and periodically publish the size for which its best bid or offer in each options series that is listed on the exchange is firm. If, however, an exchange does collect quotations with size from its broker-dealers, it would have to make such information available as currently required under the rule.[50]

In addition, the Commission proposed two alternatives relating to the flexibility an exchange would have to establish the size for which its quotes were firm for different types of orders. Specifically, under proposed Alternative A, the size for which an exchange's best bid or offer is firm would have to be the same for orders received from customers as for orders received from broker-dealers. Under proposed Alternative B, however, an exchange could allow market makers to establish different firm quote sizes for broker-dealer orders and for customer orders.

Finally, the Commission proposed to require a responsible broker or dealer to respond to an order within 30 seconds by either executing the entire order or executing at least that portion of the order equal to its applicable firm quote size and revising its quote.

IV. Discussion

A.Trade-Through Disclosure Rule

After carefully reviewing the comment letters, the Commission has decided to adopt the Trade-Through Disclosure Rule, with several modifications from the proposal. Under this rule, a broker is required to disclose to its customer when the customer's order for listed options is executed at a price inferior to a better published quote, and to disclose the better published quote available at that time.[51] This disclosure must be made to the customer in writing at or before the completion of the transaction,[52] and may be provided in conjunction with the confirmation statement routinely sent to investors. Such disclosure must be displayed as prominently as the transaction price disclosed to the customer.

The Trade-Through Disclosure Rule provides, however, that a broker-dealer is not required to disclose to its customer an intermarket trade-through if the broker-dealer effects the transaction on an exchange that participates in an approved linkage plan that includes provisions reasonably designed to limit customers' orders from being executed at prices that trade through a better published price.[53] In addition, broker-dealers will not be required to provide the disclosure required by the Trade-Through Disclosure Rule if the order is executed as part of a block trade.[54]

A number of commenters supported the Commission's proposal to require broker-dealers to disclose trade-throughs.[55] In particular, one commenter believed that intermarket trade-throughs virtually would be eliminated if a broker-dealer were required to disclose to a customer that an order was executed at a price that was inferior to the best-published quote.[56] Another commenter disagreed with this view, however, stating that the imposition of a disclosure requirement would not have a significant impact on the frequency of intermarket trade-throughs.[57]

In addition, several commenters noted that the disclosure required by the Trade-Through Disclosure Rule would never need to be made by broker-dealers if all exchanges join the Linkage Plan.[58] The Commission notes, however, that under the current terms of the Linkage Plan, any participant may withdraw from the plan with 30 days prior written notice to each of the other plan participants and the facilities manager, if any.[59] In addition, there may be new options exchanges entering the market in the future and those exchanges may decide not to participate in the Linkage Plan or any other intermarket linkage plan approved by

[48] The seven exceptions to the proposed definition of a trade-through included when: (1) The market publishing the better price was experiencing systems problems, which made the quote inaccessible; (2) OPRA was experiencing queuing; (3) the market publishing the better price was experiencing unusual market conditions; (4) the market showing the better price was in a trading rotation; (5) the customer order was executed as part of a trading rotation in that options class; (6) the customer order was executed as part of a complex trade; or (7) the market publishing the better quote fails to respond to an order routed to it within 30 seconds of receiving the order. *See* Proposing Release, *supra* note.

[49] *See* Proposing Release, *supra note*.

[50] As noted above, OPRA does not have the capability to collect size information from the options exchanges, but it anticipates implementing systems changes to accommodate quotes with size in January 2001.

[51] Exchange Act Rule 11Ac1–7(b)(1), 17 CFR 240.11Ac1–7(b)(1). The Commission believes that a broker-dealer should be allowed to rely on the market of execution to notify the broker-dealer when a trade-through has occurred and the best quote available at that time. One commenter suggested that the Trade-Through Disclosure Rule require that exchanges provide all relevant information to the broker-dealers, including a determination of whether a trade-through has occurred. See Morgan Stanley Letter. The Commission does not believe it is necessary at this time to impose such a requirement and expects that an exchange that does not participate in a linkage plan will have strong incentives to provide a broker-dealer executing orders on its market with any information the broker-dealer needs to comply with disclosure obligations.

[52] The term ''completion of the transaction'' in the Trade-Through Disclosure Rule shall have the meaning provided in Exchange Act Rule 15c1–1(b)(1), 17 CFR 240.15c1–1(b)(1). Exchange Act Rule 11Ac1–7(b), 17 CFR 11Ac1–7(b).

[53] Exchange Act Rule 11Ac1–7(b)(2)(i), 17 CFR 240.11Ac1–7(b)(2)(i). The Trade-Through Disclosure Rule also provides the Commission with the authority to exempt any broker or dealer from the requirements of the rule. Exchange Act Rule 11Ac1–7(c), 17 CFR 240.11Ac1–7(c).

[54] Exchange Act Rule 11Ac1–7(b)(2)(ii), 17 CFR 240.11Ac1–7(b)(2)(ii). The Commission sought comment on whether broker-dealers should be excepted from the trade-through disclosure requirement if they systematically route customer orders on an order-by-order basis to the exchange with the best price at the time the order is routed. Only one commenter addressed this issue, noting that simply routing orders to an exchange displaying the best price at the time the order is routed is not sufficient because of variances in the national best bid and offer (''NBBO''), the possibility that the receiving market does not offer trade-through protection, or the possibility of price improvement. At this time, the Commission has decided not to provide broker-dealers with an exemption from the disclosure requirements of the Trade-Through Disclosure Rule on this basis.

[55] *See* Lek Letter; PCX Letter; JPMorgan Letter; and ISE Letter.

[56] *See* Lek Letter.

[57] *See* CBOE Letter.

[58] See JPMorgan Letter; ISE Letter; CBOE Letter; Phlx Letter; and Wolverine Letter. Another commenter argued that the focus of the Commission and the options industry should be on preventing the occurrence of intermarket trade-throughs by moving ahead aggressively on implementing the Linkage Plan, rather than by disclosing intermarket trade-throughs to investors after the fact. See SIA Letter.

[59] See Linkage Plan, Section 12.

the Commission. Moreover, as discussed further below, the Linkage Plan approved by the Commission must still be amended before the Commission would consider it to be reasonably designed to limit intermarket trade-throughs and, therefore, satisfy the exception from trade-through disclosure. Therefore, the Commission continues to believe that the Trade-Through Disclosure Rule is needed to ensure that, if the exchange on which their orders are executed does not belong to an approved linkage plan designed to limit intermarket trade-throughs, investors receive disclosure when their orders are not executed at the best price.

It is an important feature of the Trade-Through Disclosure Rule adopted today that it does not prohibit intermarket trade-throughs. At times, investors may value speed, size, or liquidity over price. By not prohibiting intermarket trade-throughs, the rule permits investors to achieve their goals and provides them with information that will facilitate their ability to actively monitor whether the quality of executions they receive is satisfactory.[60] Therefore, the Commission believes that the rule will help to ensure that the decision not to pursue publicly-displayed, superior prices is rooted in the interests of customers, not that of intermediaries. In addition, the Commission believes that in the absence of direct linkages, the rule will encourage broker-dealers to develop effective means of accessing better quotes published by other markets and thereby, avoid intermarket trade-throughs.[61]

1. Minimum Requirements for Linkage Plans

The Trade-Through Disclosure Rule excepts from its requirements any broker-dealer that executes customer orders on exchanges that participate in an intermarket linkage plan that is reasonably designed to limit intermarket trade-throughs. The Commission believes that to be reasonably designed to limit intermarket trade-throughs, a plan should contain, at a minimum, provisions to: (1) Limit participants from trading through, not only the quotes of other linkage plan participants, but also, the quotes of exchanges that are not participants in an approved linkage plan; (2) require plan participants to actively surveil their markets for trades executed at prices inferior to those publicly quoted on other exchanges; and (3) make clear that the failure of a market with a better quote to complain within a specified period of time that its quote was traded-through may affect potential liability, but does not signify that a trade-through has not occurred. Accordingly, the Linkage Plan must be amended before broker-dealers effecting transactions on exchanges participating in the plan would be excepted from the disclosure requirements of the Trade-Through Disclosure Rule.[62] The Commission does not agree that these modifications to the Linkage Plan would add significant costs without adding significant additional deterrence to intermarket trade-throughs, as stated by one commenter,[63] and believes that the minimum requirements are important factors to consider in assessing whether a linkage plan is ''reasonably designed to limit trade-throughs'' and therefore, vitiate the need for broker-dealers to provide disclosure to their customers.

The Commission requested comment on what provisions a linkage plan should include and whether the minimum factors set forth above are sufficient. In particular, the Commission asked for comment on whether, instead of requiring that a linkage plan limit intermarket trade-throughs of the quotes disseminated by markets that do not participate in an approved linkage plan, a linkage should only be required to limit intermarket trade-throughs of markets that participate in an approved linkage plan. In this regard, one commenter asserted that the Commission should not require a linkage plan to protect against trading through those markets that are not participants of the same linkage plan because those markets would be difficult to access effectively. This commenter noted that a linkage plan provides an efficient and almost instantaneous means by which one exchange participating in the plan can access another exchange participating in the plan, as well as minimum size guarantees for orders routed through the linkage, and therefore, assures customers and dealers access to the best bid or offer. In contrast, for markets that do not participate in the linkage plan, the lack of effective access simply increases the time needed to execute a customer order without any corresponding guarantee of execution.[64]

Other commenters, however, supported the notion that a linkage plan must provide some form of protection against trading through any exchanges that do not participate in the linkage plan.[65] One of the commenters stated that options exchanges should adopt reasonable rules and procedures to address trade-throughs of markets that do not participate in an approved linkage plan because, to instill investor confidence in the options market, there must be the same basic protections against trade-throughs as are available in the equity market.[66] Another commenter argued that firms that do not execute transactions on an exchange that participates in a linkage plan should be required to disclose intermarket trade-throughs of both participant and non-participant markets, particularly in light of the possibility that a market could opt out of the plan.[67]

In proposing this rule, the Commission recognized that, by providing an incentive for markets to cooperate in developing effective means to access other markets, intermarket trade-throughs would be minimized. However, the value of the Trade-Through Disclosure Rule would be greatly diminished to the extent that: (1) One or more options exchanges decide not to participate in an approved linkage plan; (2) intermarket trade-throughs were not minimized by the implementation of a linkage plan because the plan fails to provide protection across all markets, including markets that do not participate in the linkage plan; (3) away markets fail to complain about intermarket trade-throughs; or (4) market makers or specialists were not subject to potential sanctions for intermarket trade-throughs. Accordingly, the Commission believes that to provide sufficient

[60] One commenter contended that the proposal would do nothing to improve the transparency of execution quality. *See* Wolverine Letter. The Commission disagrees with this assertion. Although the disclosures about execution quality adopted today for the equity markets provides much more information to investors than the Trade-Through Disclosure Rule does, the Commission believes that, before execution quality disclosures could be required for options trading, potentially difficult issues, such as the absence of a consolidated NBBO in the options market, would have to be resolved. *See* Securities Exchange Act Release No. 43590 (November 17, 2000).

[61] The Commission notes, however, that the Trade-Through Disclosure Rule does not replace the well-established duty that brokers provide best execution to their customers. To the contrary, brokers remain obligated to seek the most favorable terms possible under the circumstances for their customers. *See supra* note.

[62] In addition, to comply with these standards, an exchange participating in a linkage would have to adopt rules to allow the exchange to sanction specialists or market makers that trade through better prices of other exchanges, maintain policies and procedures that would limit the occurrence of intermarket trade-throughs, and maintain records that would identify intermarket trade-throughs and any review or remedial action taken by the exchange in response to such intermarket trade-throughs.

[63] *See* JPMorgan Letter.

[64] *See* CBOE Letter.

[65] *See* ISE Letter and Phlx Letter.

[66] *See* ISE Letter.

[67] *See* Phlx Letter.

incentives to markets to avoid intermarket trade-throughs under the Trade-Through Disclosure Rule, an intermarket linkage plan must contain the provisions described above provide broker-dealers executing orders on markets participating in the plan with an exception to the disclosure requirements of the rule. Specifically, the Commission believes that to maintain the integrity and value of a Trade-Through Disclosure Rule, a linkage plan must provide protection against orders trading through the quotes of all markets, regardless of whether that market participates in the plan. However, to allow the options exchanges to retain greater flexibility, the Commission is not mandating participation in a particular intermarket linkage plan.

2. Mandatory Participation in a Linkage Plan

The Commission also sought comment on whether it should order the options exchanges to become participants in the Linkage Plan or any other intermarket linkage plan. In response, several commenters expressed their view that the proposed Trade-Through Disclosure Rule was a vehicle to compel options exchanges to join an intermarket linkage plan,[68] and one argued that the Commission should directly require all options exchanges to become participants in a qualified linkage plan rather than ''creating a disclosure-based exception that accomplishes *de facto* the same result.'' [69] Another commenter, however, expressly stated that it did not believe that participation in a single linkage plan should be mandatory. This commenter concurred with the Commission's contention in the Proposing Release that a single linkage may fail to adapt over time and may impede the entry of new market participants.[70]

The Commission intends for the intermarket linkage plan exception to the Trade-Through Disclosure Rule to encourage options markets to participate in a Commission-approved intermarket linkage plan. In fact, all five options exchanges are now participants in the Linkage Plan.[71] However, at this time, the Commission continues to be reluctant to force, by government mandate, all options exchanges to participate in a single linkage system that may, for example, fail to maintain up-to-date technology. The Commission believes that, in the absence of barriers to access, the growth of electronic order-routing systems may enable the options exchanges to access one another's markets directly through agreed-upon methods, or indirectly through broker-dealers. As a result, the Commission continues to believe that, given effective access, there may well be a variety of equally effective, or more effective, ways in which technology may be employed by the markets to encourage price priority and decrease the likelihood of intermarket trade-throughs in the options markets. Consequently, rather than mandating exchange participation in any one linkage plan, the Commission is adopting the more flexible approach, as proposed, that provides incentives for the markets and their members to develop mechanisms to reduce the frequency of intermarket trade-throughs, while allowing market participants to choose the form of mechanism employed.

3. Exception From Disclosure Requirement for Block Trades

Finally, in response to comments, the Commission is adopting an exclusion from the trade-through disclosure requirement for block trades.[72] The Commission sought comment on whether to except block trades from the trade-through definition because of their size in relation to the quote, their special handling needs, and the greater resources of customers placing block orders to monitor the quality of executions they receive. Two commenters specifically supported such an exception.[73]

For ease of administration, the Commission has adopted, in part, the definition of ''block trade'' used in the Linkage Plan,[74] which was developed by the options exchanges. Because a block trade would involve 500 contracts or more and a premium value of at least $150,000, the Commission anticipates that only highly sophisticated investors will place such trades. Moreover, as noted by commenters, because of the size of these block orders, market participants placing such orders do not necessarily expect execution of the full order at the best-quoted price.[75] As a result, the Commission believes that the value of a trade-through disclosure for market participants placing such orders likely would be minimal.

4. Definition of Trade-Through

The Commission is adopting the definition of a trade-through and the exceptions to the definition of a trade-through, substantially as proposed. Specifically, a trade-through occurs when a customer order is executed at a price inferior to a quote published by another market at the time of execution.[76] The rule also identifies four circumstances in which a trade executed at a price inferior to a published price on another market would, nevertheless, not be considered a trade-through for purposes of the rule.[77]

a. OPRA Delays. Because a broker-dealer should not be required to disclose to its customer that its order was executed at a price inferior to a ''stale'' quote, a trade will not be considered a trade-through if it occurs while OPRA is experiencing queuing.[78] In the past, the aggregate message traffic generated by the options exchanges has, at times, surpassed OPRA systems capacity, which could result in the dissemination of quotes that are no longer accurate or accessible.

b. Systems Malfunctions. Similarly, the Commission believes that it is appropriate to exclude from the definition of trade-through trades that are executed at a time when an exchange has verified that the market publishing the better price was experiencing systems malfunctions, thus resulting in inaccessible quotes.[79] For example, this may occur when a broker-dealer has attempted to access the superior published quote and has been unsuccessful because of systems

[68] *See* ISE Letter; Phlx Letter; and CBOE Letter.

[69] *See* CBOE Letter.

[70] *See* PCX Letter. On the other hand, another commenter expressed concern that a disclosure-based approach to creating incentives for markets to link will not be as effective in fostering quote and order competition and interaction as a direct Commission role in mandating a universal linkage. *See* Morgan Stanley Letter. The Commission is not, however, attempting to foster quote and order interaction by adopting the Trade-Through Disclosure Rule, but is, instead, trying to achieve the more limited goal of reducing the possibility for investors' orders to be executed at a price inferior to the best available price.

[71] *See supra* notes 4 and 5.

[72] Exchange Act Rule 11Ac1–7(b)(2)(ii), 17 CFR 240.11Ac1–7(b)(2)(ii). The term ''block trade'' is defined as a transaction in an options series that is for 500 or more contracts and has a premium value of at least $150,000. Exchange Act Rule 11Ac1–7(a)(1), 17 CFR 240.11Ac1–7(a)(1).

[73] *See* JPMorgan Letter and SIA Letter.

[74] *See* Linkage Plan, Section 2 (3).

[75] *See* JPMorgan Letter and SIA Letter. One of these commenters noted that with respect to block-sized orders, the quote bears ''little relationship to the average price that the customer could get for the entire order.'' *See* JPMorgan Letter. The other of these commenters argued that ''because large orders are far more dependent on liquidity than smaller orders, the ability to get a block off on a timely, efficient basis may be severely impacted by strict adherence to a trade-through rule.'' *See* SIA Letter.

[76] Exchange Act Rule 11Ac1–7(b)(3), 17 CFR 240.11Ac1–7(b)(3).

[77] Exchange Act Rule 11Ac1–7(b)(4), 17 CFR 240.11Ac1–7(b)(4).

[78] Exchange Act Rule 11Ac1–7(b)(4)(ii), 17 CFR 240.11Ac1–7(b)(4)(ii).

[79] Exchange Act Rule 11Ac1–7(b)(4)(i), 17 CFR 240.11Ac1–7(b)(4)(i).

problems in the quoting market. The Commission believes that there is no value in requiring a broker-dealer to disclose an inability to access a market's quote that has been verified as inaccessible.

c. Relief from Firm Quote Obligation. The definition of trade-through also excludes a trade executed at a price inferior to a price published by another exchange if the other exchange or its members were relieved of their obligations under the Quote Rule because the exchange has determined, for example, that, as a result of unusual market conditions,[80] it is incapable of accurately collecting and disseminating quotes.[81]

One commenter recommended that the Commission provide brokers with discretion to interpret the exceptions broadly in light of their duty of best execution, instead of forcing a broker to incur the risk of subsequently providing an inferior price to a public customer against its better judgment. This commenter argued that a broker should have discretion to ''use the 'unusual market circumstances' exception to refuse to route a trade to an exchange that has a history of disseminating 'flickering' quotes, rather than being forced to disclose to the customer a trade-through of a phantom 'better' price that, in all likelihood, never existed.'' [82]

The Commission agrees that brokers must always consider their best execution obligations to their customers.[83] The Trade-Through Disclosure Rule does not prohibit intermarket trade-throughs; it merely requires a firm to provide information to its customer about the market at the time of execution. Therefore, the Commission does not agree that broker-dealers should be granted discretion to avoid disclosure if they trade through another market quote because of their discomfort with the quality of that market's quote. While the Commission appreciates the commenter's concerns regarding ''flickering quotes,'' the Quote Rule amendments adopted today are designed to address this issue by requiring that disseminated quotes be firm up to the applicable firm quote size.

d. Thirty-Second Delay. In addition, the Trade-Through Disclosure Rule excludes from the definition of trade-through a trade that occurs after an exchange member attempts to access a better-published quote for a customer order and the market publishing the better quote fails to respond to the order routed to it in a timely fashion.[84]

Although one commenter contended that the Commission should not adopt this exception to the definition of a trade-through because it condones the actions of a market maker who simply ignores an incoming customer order that is unfavorable or inconvenient,[85] the Commission believes that a broker-dealer should not be obligated to disclose a trade-through in the event that an exchange member attempted to access a better published quote for a customer order, but the market publishing the better quote failed to respond to the order routed to it within 30 seconds of receiving the order. In this instance, the exchange member has attempted to access the superior published quote and has been unsuccessful. The Commission believes that the originating broker-dealer should not be obligated to provide the disclosure when the member of another exchange has failed to satisfy its obligations under the Quote Rule. In addition, the Commission believes that there is no value in requiring an exchange member to repeatedly attempt to access an inaccessible quote, especially in a volatile market where substantial delays may result in far inferior executions for the investor. Further, the Commission believes that the amendments to the Quote Rule adopted today will ensure that responsible broker-dealers honor their quotes up to the size for which they are required to be firm, and expects exchanges to surveil their members to ensure compliance with the amended Quote Rule.

e. Trades Not Excluded from the Definition of Trade-Through. In the Proposing Release, the Commission sought comment on whether a trade-through disclosure requirement should apply to all trade-throughs, or only when an order is executed at a price that trades through a better price by a certain price increment or amount. The Commission noted that this question is particularly important in a decimals trading environment, where quotes may be for a smaller size and the trade-through price for smaller increments, and with respect to large orders, where the quote size may be small in relation to the order size.

Several commenters supported such a ''materiality'' standard.[86] For example, one commenter argued that all orders would benefit, regardless of size, from an exception to the disclosure requirement for trade-throughs of price increments immaterial in relation to the spread. This commenter believed that any trade-though disclosure should include the size of the traded-through quote, but that a materiality exception would be preferable to disclosure of the size of the quote, because such size disclosure would be more costly for market participants, including customers.[87] Another of these commenters believed the disclosure requirement should not apply if the price and size of the trade-through was *de minimus*. Although this commenter did not define *de minimus*, the commenter argued that given the imminent conversion to decimal pricing, the burdens of disclosing when an order trades through a quote that is better by a very small amount or is only for a small size would not be justified.[88] On the other hand, one commenter opposed adopting a *de minimus* exception to the trade-through definition due to the inherent difficulty in defining what constitutes *de minimus*, and the possibility that opportunities for the unbundling of orders to avoid trade-though liability would be created.[89]

The Commission believes that it is inappropriate at this time to attempt to establish a materiality standard. The Commission notes that, as of September 25, 2000, only 36 options are trading in decimals. As a result, the Commission does not believe that it, the options exchanges, or other market participants has had sufficient experience with a decimals environment. The Commission notes, however, that it will continue to evaluate this issue as decimal pricing is expanded to all options classes and the markets adapt to the decimals environment.

[80] Exchange Act Rule 11Ac1–1(b)(3), 17 CFR 240.11Ac1–1(b)(3). Currently, each options exchange has rules that allow the exchange to suspend its firm quote requirements if, for example, a systems malfunction or other circumstance impairs the exchange's ability to disseminate or update market quotes in a timely and accurate manner. *See* Amex Rule 958A; CBOE Rule 8.51(a); PCX Rule 6.86(d); Phlx Rule 1015(a)(ix); and ISE Rule 804(d). The options exchanges may have to amend these rules to conform to the Quote Rule's exception for unusual market conditions.

[81] Exchange Act Rule 11Ac1–7(b)(4)(iii), 17 CFR 240.11Ac1–7(b)(4)(iii).

[82] *See* JPMorgan Letter.

[83] *See supra* note 2. One commenter asserted that under the Commission's proposal, brokers would no longer have to make best execution evaluations. *See* Wolverine Letter. The Commission strongly disagrees with this view and expects brokers to continue to fulfill their obligations to seek the most favorable terms reasonably available under the circumstances for a customer's order.

[84] Exchange Act Rule 11Ac1–7(b)(4)(iv), 17 CFR 240.11Ac1–7(b)(4)(iv).

[85] *See* Brunelle Letter. Another commenter, however, supported this proposed exception. *See* ISE Letter.

[86] *See* JPMorgan Letter; CBOE Letter; and PCX Letter.

[87] *See* JPMorgan Letter.

[88] *See* PCX Letter.

[89] *See* CBOE Letter.

In addition, a few commenters recommended that the trade-through disclosure requirement not be applied to orders from upstairs broker-dealers and orders of customers who consent to the potential for an execution at an inferior price.[90]

Because upstairs broker-dealers' orders are not eligible to be transmitted through the linkage pursuant to the Linkage Plan, one commenter argued that broker-dealers should not be required to disclose an execution at a price inferior to the best price.[91] The Commission notes that the trade-through disclosure requirement would not require disclosure to upstairs broker-dealers because it only applies when a broker-dealer executes a non-broker-dealer order.

A commenter also recommended including an exception for trades of customers who request that their orders be executed on a particular market, regardless of whether a better price is available on another market. This commenter contended that a customer may give such consent because of its greater interest, for example, in the speed of execution.[92] Another commenter suggested an exception for when customers provide instructions to route, or avoid routing, their orders to a particular exchange, irrespective of price.[93]

The Commission does not believe that it is appropriate to except broker-dealers from the requirement to disclose a trade-through to its customer even when a customer requests that its order be executed on a particular market, regardless of price. While one commenter suggested that a trade-through disclosure to a customer that has explicitly requested an execution at an inferior price may be superfluous, the Commission is concerned that the adoption of such an exception may result in broker-dealers entering into blanket adhesion contracts with customers, solely to allow the broker-dealer to execute order flow on a particular options exchange even though that exchange does not provide the best price.[94] The Commission believes that such an exception would raise investor protection concerns, particularly with respect to unsophisticated investors who may not fully appreciate the impact of the agreement and may lack the ability to negotiate preferable terms. In addition, the Commission believes that in those instances where a customer has expressed a desire to have its order executed on a particular exchange regardless of a better published price available on another market, the customer will not perceive the disclosure of a trade-through as problematic.

Finally, the Commission's definition of a trade-through also includes transactions executed as part of a complex trade. Although the Commission proposed to exclude complex trades, which were defined as transactions in an option series that are executed in conjunction with related transactions occurring at or near the same time for the purpose of executing a particular investment strategy,[95] the Commission now believes that such an exclusion is not appropriate.[96] On further consideration, the Commission has determined that such disclosure is important, even to customers executing more complex trades. Because retail customers use these types of investment strategies, information about the execution price relative to other prices may be invaluable to their understanding and decision-making. Even the most sophisticated investors may find this information useful.

5. Compliance Date

The Trade-Through Disclosure Rule will become effective on February 1, 2001, and its compliance date is April 1, 2001. On April 1, 2000, broker-dealers will be required to make the required disclosures unless their transactions are effected on markets that are participants in an effective national market system options linkage plan that includes provisions reasonably designed to limit intermarket trade-throughs. The Commission believes that a linkage plan is not reasonably designed to limit intermarket trade-throughs unless it has been implemented and is operating. While one commenter expressed its view that the Commission should not require compliance with the Trade-Through Disclosure Rule until the Linkage Plan has been implemented,[97] the Commission is concerned that tying the compliance date to this event may provide a disincentive for the options markets to fully implement the Linkage Plan. Accordingly, the Commission does not, at this time, believe that it is necessary to delay the compliance date of this rule until the linkage is fully implemented and operating. The Commission will consider granting temporary exemptive relief to broker-dealers from the requirements of the rule if the markets continue to make substantial progress towards implementing the Linkage Plan.

B. Amendments to the Quote Rule

As discussed above, the Commission is adopting amendments to the Quote Rule to extend its application to options traded on national securities exchanges. Generally, the Quote Rule requires exchanges to collect quotations, and sizes associated with those quotations, from their members who are responsible broker-dealers and make those quotations and sizes available to quotation vendors for each subject security listed and admitted to unlisted trading privileges on the exchange.[98]

The Commission received several comment letters addressing the proposed Quote Rule amendments. A number of commenters voiced their support for amending the Quote Rule to include listed options,[99] stating, for example, that firm quotes will promote efficiency and increase customer confidence in the markets.[100] One commenter noted that the lack of such a rule in the options markets impeded firms' ability to execute customer orders in an efficient manner because they have to explore posted quotes to determine if a quote is firm for an entire order or only for an order of minimal size.[101]

Other commenters, however, opposed the proposed amendments to the Quote Rule.[102] Two of these commenters argued that the current exchange rules and exchange automatic execution systems sufficiently guarantee firm quotes to public customers. Thus, they contended that amending the Quote Rule would simply extend its application to broker-dealer orders, a result they opposed.[103] One commenter noted that current competition among market makers for public customer

[90] *See* PCX Letter and Brunelle Letter.

[91] *See* PCX Letter

[92] *See* PCX Letter.

[93] *See* Brunelle Letter.

[94] Payment for order flow and other similar arrangements increase the likelihood that such contracts could become commonplace.

[95] *See* Proposing Release, *supra* note 7.

[96] One commenter recommended narrowing the proposed definition of complex trades to exclude certain investment strategies that include stock trades, such as ''buy-writes,'' in which an investor buys stock and writes a call on that stock. *See* ISE Letter. The Commission believes, however, that other strategies, such as spreads (the simultaneous purchase or sale of options on the same underlying stock with different strike prices or expiration dates or both) and straddles (simultaneous purchase and sale of an equal number of calls and puts on the same underlying security with identical strike prices and expiration dates), are sufficiently similar to buy-writes to warrant similar treatment.

[97] *See* PCX Letter.

[98] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

[99] *See* JPMorgan Letter; ISE Letter; PCX Letter; Lek Letter; Wolverine Letter; and SIA Letter.

[100] *See* Lek Letter and PCX Letter.

[101] *See* JPMorgan Letter.

[102] *See* Botta Letter; Susquehanna Letter; Brunelle Letter; and Phlx Letter.

[103] *See* Botta Letter and Susquehanna Letter.

orders is intense, and believed that the proposed amendments would force allocation of capital into areas of unacceptable risk, such as trading against other broker-dealers, and away from the facilitation of public customer orders.[104]

The Commission has carefully considered the issues raised by commenters and believes it is appropriate to adopt amendments to the Quote Rule to extend its application to the options markets. The Commission, however, has made accommodations for the way in which the options markets operate. The Commission believes that the amendments will provide significant and immediate benefits to investors. In particular, market participants, including customers and broker-dealers, will be able to rely on quotes up to their published size in routing orders that are not eligible for execution in the automatic execution systems. The Commission believes that this result should lead to increased competition on the basis of size among the options exchanges, which should enable investors to receive better executions for their orders. It will also enable market makers and other broker-dealers to more easily trade with displayed quotes, increasing the accuracy and efficiency of displayed quotes.

As noted above, the availability of quotation information is one of the key components of a national market system. While options quotation information is provided to market participants today through OPRA, the Commission believes that this information will be substantially enhanced by the amendments to the Quote Rule. Quotes are not useful to market participants if they are not honored. Further, because market participants will be required to disclose trade-throughs of superior quotes (unless an exception applies), these superior quotes must be firm for all market participants, including broker-dealers. Otherwise, the Trade-through Disclosure Rule would be unworkable, and market makers would be forced to either route customers' orders to anomalous quotes, or unwillingly match that quote to avoid trade-through disclosure. The Commission believes that requiring options quotes to be firm furthers the national market system goals of Section 11A[105] and will benefit all options market participants.

Because of developments in technology and changes in the options markets, the Commission also believes that the current exchange rules and automatic execution systems alone are no longer sufficient to provide adequate investor protections. Currently, the options markets are permitted to fade from their quotes without consequence, pursuant to their trade-or-fade rules.[106] In addition, as noted by one commenter, options market makers frequently change the terms of trades or ''break'' trades subsequent to execution, without prior notice to the customer.[107] Thus, options investors and their brokers cannot fully rely on the disseminated quotation information on which they base their order routing decisions. The Commission believes that options investors deserve the same protections as equity investors and therefore, the Commission is adopting amendments to extend the coverage of the Quote Rule to the options market with modifications to accommodate certain unique aspects of the options market. The Commission also believes that a market maker that executes a trade at its disseminated quote and then changes the terms or ''breaks'' the trade may well, absent exceptional circumstances, be in violation of the firm quote obligation adopted today.

1. Collecting and Making Available Quotation Sizes

Because the options markets currently do not disseminate to quotation vendors the size associated with their bids and offers[108] and due to the existing limitations on OPRA system capacity, the Commission is adopting amendments to the Quote Rule so that options exchanges may decide not to collect from their members and make available to vendors the size associated with each quotation in listed options. Instead, exchanges may choose to establish by rule and periodically publish the size for which their best bid and offer in each options series[109] that is listed on the exchange is firm.[110] If the rules of an exchange do not require its members to communicate to it quotation sizes for listed options, then responsible brokers or dealers that are members of that exchange will be relieved of their obligations under the Quote Rule to communicate to such exchange their quotation sizes. Instead, each such responsible broker or dealer may satisfy its firm quote obligation by executing any order to buy or sell a listed option that is a subject security, in an amount up to the size established by the exchange's rules.[111] An options exchange may, of course, choose to establish procedures for collecting from its members, and making available to vendors, the sizes of such members' quotes.

The Commission is not adopting the recommendation of a few commenters that exchanges be required to disseminate quotation sizes as soon as OPRA is capable of doing so.[112] One commenter raised the concern that the proposed amendments to the Quote Rule would result in each exchange using its portion of OPRA bandwidth differently, which could benefit exchanges that show relatively limited size information, and have a significant adverse effect on exchanges that collect and disseminate the ''real'' size of their trading interest.[113] This commenter suggested that the Commission use its exemptive authority under the Quote Rule to require all exchanges to disseminate size with their quotations, even if an exchange determines to establish by rule and periodically publish its firm quote size.

Another commenter, while also acknowledging OPRA capacity constraints, argued that the concept of the periodic publication of firm quote sizes is contrary to OPRA's plan to require the dissemination of size with every options quote by January 2001.[114] Thus, this commenter believed that the

[104] *See* Susquehanna Letter.

[105] 15 U.S.C. 78k–1.

[106] *See supra* note and accompanying text. The Commission expects the options exchanges will seek approval from the Commission to amend their existing rules to conform to the Quote Rule.

[107] *See* Brunelle Letter. This commenter believes that because options trades are broken so frequently, public investors, who are required to honor all of their commitments, are held to a much higher standard than exchange market makers. This commenter recommends that in addition to the rules proposed, the Commission require market makers to disclose their failures to honor quotes and completed transactions.

[108] Currently, OPRA does not have the systems capability to collect and disseminate quotes with size. OPRA is, however, scheduled to have this capability by January 2001. Some options markets may, however, choose to continue not to disseminate quote size.

[109] The Commission is including the definition of the term ''option series'' in the Quote Rule. Under Exchange Act Rule 11Ac1–1(a)(29), the term ''option series'' means contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions. 17 CFR 240.11Ac1–1(a)(29).

[110] Exchange Act Rule 11Ac1–1(d)(2), 17 CFR 11Ac1–1(d)(2).

[111] Exchange Act Rule 11Ac1–1(d)(2), 17 CFR 11Ac1–1(d)(2).

[112] In this regard, several commenters suggested that the Commission wait until OPRA is able to disseminate size before proceeding with the amendments. *See* Susquehanna Letter; Botta Letter; PCX Letter; Phlx Letter; and JPMorgan Letter. One commenter suggested that the Commission adopt this approach to quote size only temporarily. *See* Morgan Stanley Letter. Another commenter characterized the Commission's approach as an ''appropriate solution,'' arguing that the Commission should refrain from mandating that size be disseminated with each quotation until the existing limitations on OPRA systems capacity have been remedied. *See* SIA Letter.

[113] *See* ISE Letter.

[114] *See* Phlx Letter.

proposed amendments to the Quote Rule appeared to be unnecessary. Finally, one commenter recommended that any amendment to the Quote Rule require on-floor specialists and market makers, as well as the options exchanges, to publish on a quote-by-quote basis the size associated with each quote. [115]

The Commission has decided, at this time, not to require the options exchanges to disseminate quotes with size. Currently, OPRA does not have the capability to accept size with options quotes, although it does anticipate disseminating quotes with size in January 2001. The Commission notes that the options exchanges generate significantly more quotes than the equity exchanges. Adding size to quote messages will increase the bandwidth necessary to disseminate options market data, and possibly, increase the number of messages if a new quote is required every time its associated size is modified. As discussed above, over the past year, OPRA has suffered serious capacity constraints due to the tremendous amount of quote message traffic generated by the exchanges. Due to the limitations on OPRA systems capacity, the Commission, while supporting OPRA's efforts to modify its systems to accommodate size, does not believe that it is appropriate to mandate further burdens on OPRA systems capacity at this time.

Pursuant to the amendments to the Quote Rule adopted by the Commission today, the options exchanges will be required to publicize the size for which its quotes will be firm either on a quote-by-quote basis or by publicizing its rule establishing its firm quote sizes. The Commission believes that periodic publication will be sufficient to inform options market participants of the relevant size information they need to make informed order routing decisions. Although the Commission recognizes one commenter's concerns that disseminating quotes with size may require more OPRA systems capacity, the Commission believes that this is a competitive issue and consequently, so long as investors have access to the size information that they require, it is not necessary for the Commission to require the dissemination of quotes with size at this time.

2. Firm Quote Sizes for Customer and Broker-Dealer Orders

The Commission proposed two alternatives regarding the size for which responsible broker-dealers' quotes for listed options would be required to be firm. Under proposed Alternative A, the size for which a responsible broker-dealer's best bid or offer is firm would be required to be the same for orders received from customers and for orders received from broker-dealers. Proposed Alternative B would permit an exchange to establish different firm quote sizes for broker-dealer orders than for customer orders. The Commission requested commenters' views on these two alternatives.

Several commenters supported Alternative A under which the Commission proposed that the firm quote size be the same for both customer and broker-dealer proprietary orders. [116] One of these commenters argued that providing the same firm quote size to all market participants emboldens investor confidence in fair pricing because if the price of a security is too low, then another professional will be ready and able to bring the price in line by entering buy orders, and vice versa for sell orders. This commenter opposed a different firm quote sizes because it believed that this would permit a two-tiered market — one consisting of displayed quotes for non-professionals only, and another, ''shadow'' market for professionals. Further, the commenter argued that the supposition that market makers would widen their spreads if their quotes were exposed to other market professionals is unjustified and unsupported by empirical data, and in any case, the public is more harmed by non-competitive, un-real quotes than by wider spreads. [117] Another of these commenters, however, believed that applying the Quote Rule equally to all market participants would prove unworkable at this time because of the structure of the options market. [118]

On the other hand, several commenters preferred allowing responsible broker-dealers to be firm for different sizes for customers and broker-dealers, as proposed in Alternative B.[119] Some commenters argued that if market makers were required to establish a single quotation size for all market participants, they would likely decrease the disseminated size of their quotes and their execution guarantees, limiting liquidity available to customers.[120] They argued that the ability to establish differing quote sizes for broker-dealer and customer orders would allow market makers to provide customers with greater liquidity, while limiting their exposure to non-customers.[121] Other commenters argued that market makers, not the Commission, should determine how much liquidity they want to guarantee to professionals.[122]

One commenter explained that market makers provide different liquidity guarantees to professional orders to protect against being ''picked off,'' and noted that if market makers quote less aggressively, public customers whose orders are generally automatically executed at the NBBO could be adversely affected.[123] This commenter noted that market makers compete against each other by guaranteeing different sizes, which would be eliminated if only one quote size applied to all types of orders. Another commenter argued that options market makers are at far greater risk than stock specialists of being picked off by professionals and that it would be exponentially more difficult for an options market maker than for a stock specialist to provide continuously updated quotes that would be firm against professional interest.[124] However, another commenter noted that the equity market does not exempt traders and market makers from the Quote Rule when dealing with other broker-dealers.[125]

After careful review of the commenters' observations and suggestions, the Commission is adopting amendments to the Quote Rule that allow the options exchanges to establish different firm quote sizes for broker-dealer orders than for customer orders.[126] An exchange that chooses not to collect from their members and make available to vendors the size associated with each quotation in listed options may establish by rule and periodically publish the size at which its best bid or offer in each options series listed on the exchange is firm for orders from customers and orders from broker-dealers.[127] An exchange would also have the flexibility to collect from its members and make available to quotation vendors the quotation sizes at which such members are firm for customer orders and, at the same time, to establish by rule and periodically

[115] *See* Brunelle Letter.

[116] *See* JPMorgan Letter; ISE Letter; Lek Letter; Wolverine Letter; and Morgan Stanley Letter.

[117] *See* Lek Letter.

[118] *See* ISE Letter.

[119] *See* Botta Letter; CBOE Letter; PCX Letter; Susquehanna Letter; and SIA Letter.

[120] *See* Botta Letter; CBOE Letter; PCX Letter; ISE Letter; Susquehanna Letter; and SIA Letter.

[121] *See* PCX Letter; CBOE Letter; and ISE Letter.

[122] *See* Susquehanna Letter and Botta Letter.

[123] *See* Botta Letter.

[124] *See* Susquehanna Letter.

[125] *See* Lek Letter.

[126] Exchange Act Rule 11Ac1–1(d)(1), 17 CFR 240.11Ac1–1(d)(1). Exchange rules must require responsible broker-dealers to be firm for orders for the accounts of broker-dealers for at least one contract.

[127] Exchange Act Rule 11Ac1–1(d)(1)(ii), 17 CFR 240.11Ac1–1(d)(1)(ii).

publish a different size for which their members' quotes must be firm for broker-dealer orders.[128]

The Commission believes that the unique structure of the options markets, specifically, the tremendous number of products that must be continuously quoted by options market makers or specialists, warrants this specific accommodation. Currently, there are approximately 178,000 options series for which options market makers and specialists continuously provide two-sided quotations. Consequently, the Commission believes that permitting different quote size guarantees is the best course of action at this time to help ensure the continued availability of liquidity, which facilitates the maintenance of fair and orderly markets. The Commission will, however, continue to evaluate the markets to determine if, in fact, this provision is warranted.

3. Minimum Quote Size

In the Proposing Release, the Commission requested commenters' views on whether the Commission should establish a minimum number of contracts for which quotes should be firm. The Commission received no comments in support of mandating a minimum firm quote size.[129]

Two commenters did suggest that in absence of a mandated minimum firm quote size, quotes should be firm for at least one contract, which has the economic equivalent of 100 shares of stock, the minimum quote size in the equities markets.[130] One of these commenters believed that the minimum firm quote size should be viewed as a competitive, rather than a regulatory, issue.[131] Other commenters argued against a minimum firm quote size because any such minimum would facilitate and encourage wide-scale proprietary trading by broker-dealers on markets in which they are not members.[132] One of these commenters believed that non-members of an exchange should not be allowed to gain free access to the exchange, because such access could dilute the value of exchange memberships.[133]

The Commission agrees that quote size is a competitive issue and should not be dictated by regulation. Under the Quote Rule adopted today, each options exchange will be required to publicize the size at which their market makers or specialists are firm. The Commission believes that competitive market forces will dictate appropriate firm quote sizes for customer and broker-dealer orders in the options markets.

Nevertheless, the Commission believes that each disseminated quote must represent at least one contract — any less would mean that a quote was not actually firm. For this reason, the Commission is adopting a requirement that if an exchange allows quotes to be firm in different sizes for broker-dealer orders than for customer orders, its rules must require its market makers to be firm for a minimum of one contract. As noted by one of the commenters, one contract is the economic equivalent of 100 shares of stock and therefore, this requirement establishes in the options market a standard equivalent to that applied in the equities market.

On a related note, the Commission believes that in those instances in which a quote is disseminated by an exchange that collects and aggregates quotation sizes from several responsible broker-dealers, each responsible broker-dealer would be required to be firm for at least one contract for broker-dealer orders.[134] Therefore, for example, if an exchange collects and disseminates a quote, the size of which reflects the aggregate size of three competing responsible broker-dealers, the exchange quote must be firm to orders from broker-dealers for at least three contracts, one for each responsible broker-dealer.[135]

4. Automatic Execution Systems

The amendments to the Quote Rule adopted today do not affect the ability of the options exchanges to provide execution guarantees through their automatic execution systems. The exchanges' automatic execution systems are generally used for small, public customer market and marketable limit orders. Options exchanges will continue to have the flexibility to publish a different firm quote size for a particular options class than its automatic execution guarantee size. The Commission, however, may reevaluate this approach if it results in a decrease in liquidity available for customer orders.

5. Exception During Trading Rotations

Under the Quote Rule, responsible brokers or dealers are relieved of their obligations if, for example, the responsible broker or dealer is in the process of effecting a transaction and immediately thereafter, communicates a revised quotation. The amendments to the Quote Rule being adopted today also relieve responsible brokers or dealers from their firm quote obligations when an order for listed options is presented during a trading rotation in that listed option.[136] During trading rotations, market makers may be unable to generate quotes in a timely fashion. The Commission is adopting as part of the Quote Rule the definition of "trading rotation" proposed in the Trade-Through Disclosure Rule, with a slight modification.[137] Specifically, the definition of trading rotation has been modified to include references to reopening and closing rotations, as well as to opening rotations as proposed, because the same difficulties in providing firm quotes during opening rotations apply during those other types of trading rotations.[138]

6. Thirty-Second Response

As discussed above, if a responsible broker or dealer fails to respond to an incoming order within the 30 seconds, the Trade-Through Disclosure Rule permits the routing broker or dealer to execute its customer's order at an inferior quote without being required to disclose the better, but unresponsive, quote to its customer.[139] The Commission is adopting an amendment to the Quote Rule[140] to require a responsible broker or dealer to respond to an order to buy or sell a listed option in an amount greater than the firm quote size within 30 seconds by either: (i) executing the entire order; or (ii) executing at least that portion of the order equal to the applicable firm quote size and revising its bid or offer.[141] The

[128] Exchange Act Rule 11Ac1–1(d)(1)(iii), 17 CFR 240.11Ac1–1(d)(1)(iii).

[129] *See* PCX Letter; Phlx Letter; JPMorgan Letter; ISE Letter; CBOE Letter; and Susquehanna Letter.

[130] *See* PCX Letter and SIA Letter.

[131] *See* PCX Letter.

[132] *See* Phlx Letter and Morgan Stanley Letter.

[133] *See* Phlx Letter.

[134] For customer orders, each responsible broker-dealer will be firm for its published size.

[135] In comparison, exchanges that disseminate one quote for a trading crowd, based on a single, automatically generated quote would be required to be firm only for a minimum of one contract.

[136] Exchange Act Rule 11Ac1–1(d)(4)(ii), 17 CFR 240.11Ac1–1(d)(4)(ii).

[137] The Commission did not propose in the Proposing Release to include a definition of the term "trading rotation" in the Quote Rule.

[138] Exchange Act Rule 11Ac1–1(a)(30), 17 CFR 240.11Ac1–1(a)(30).

[139] Exchange Act Rule 11Ac1–7(b)(4)(iv), 17 CFR 240.11Ac1–7(b)(4)(iv).

[140] Exchange Act Rule 11Ac1–1(d)(3), 17 CFR 240.11Ac1–1(d)(3). A responsible broker's or dealer's applicable firm quote size would be its published quote size or, if a responsible broker or dealer has been relieved of the obligation to communicate its quotation sizes, the minimum firm quote size established by its exchange's rules. One commenter noted that the proposed amendments to the Quote Rule failed to incorporate the use of a defined term, "published quotation size," where applicable. *See* ISE Letter. In response to the comment, the Commission is adopting technical amendments to the Quote Rule to more uniformly apply the defined term, published quotation size.

[141] When a responsible broker-dealer chooses to respond to an order in an amount greater than the firm quote size by executing only that portion of the

Quote Rule requires responsible brokers and dealers to *immediately* execute an order to buy or sell listed options in an amount equal to or less than its firm quote size.[142]

The Commission requested comment on its proposal to require responsible broker-dealers, within 30-seconds, to either execute an entire order or execute that portion of an order that is equal to its firm quote size, and thereafter revise its bid or offer. One commenter stated that, ultimately, the Commission should require that quotes be subject to automatic or nearly automatic executions.[143] Similarly, several other commenters considered 30 seconds too long because it imposed unnecessary market risk on customers and could result in market makers abusing the time period by holding orders until the last second in an attempt to gain an advantage.[144] One commenter suggested that market makers be required to immediately respond to orders that are not larger than the disseminated quote size and respond within 15 seconds, which is the turnaround time in the Linkage Plan, to orders of greater size.[145] Another commenter suggested a 10-second response time would be more appropriate.[146]

Further, because different types of orders require different handling procedures, which means that execution times will be different, one commenter opposed any requirement that would institute an across-the-board 30-second reporting requirement for all orders.[147] This commenter suggested that the Commission defer any decision on this issue until the Linkage Plan has been implemented and the exchanges have gained some experience and data regarding turnaround times. In addition, this commenter suggested that if the Commission extends trade-through protection to markets that do not participate in any approved linkage plan, 30 seconds may be too long a time period for those instances in which an order is routed to a market that does not participate in any approved linkage plan, because there may not be a guarantee of an execution in the event that such market backs away from its quote or is not firm for the entire order.

Finally, another commenter believed that the 30-second response time would not delay trades but suggested that the Commission make an exception for fast market conditions, and remain open to changing the response time as technology improves.[148]

For orders greater than an exchange's firm quote size, the Commission is adopting the 30-second response requirement, as proposed. The Commission believes that the Quote Rule currently requires responsible broker-dealers to immediately execute orders in a size up to its firm quote size and is not amending that requirement as applied to options. Accordingly, orders equal to or smaller than a responsible broker-dealers' firm quote size must be immediately executed.

The Commission believes that it is appropriate to establish a time limit by which a recipient market maker must execute an order larger than its quote, or change its quote. The Commission believes that a time period must be set forth in the rule to prevent broker-dealers from waiting an inordinate amount of time before executing an order or changing their quote. In this regard, the Commission is concerned that in the absence of a set time frame, the execution of orders may be unduly delayed. Therefore, at this time, the Commission believes that the 30-second time limit appropriately balances the need for price priority against the need for efficient execution of orders. The Commission will, however, evaluate this time frame as the exchanges implement these amendments and as technology progresses to determine if another time frame is more appropriate.

7. One-Percent Exception

Under the Quote Rule exchanges are required to collect and make available the quotes communicated to them by responsible broker-dealers for subject securities. A subject security is any exchange-traded security except a security for which an exchange's executed volume during the most recent calendar quarter comprised one percent or less of the aggregate trading volume for such security as reported to OPRA, and any security actually quoted by an exchange.[149] One commenter believed that this exception was not necessary for listed options.[150] This commenter argued that the possibility of a chilling effect on the liquidity of inactively-traded securities would not justify the monitoring burden that the exception would impose on brokers, who would be forced to keep track of which quotes were firm and which, due to the one percent exception, were not.

The Commission believes that the options markets and options market makers should be permitted to make use of the one percent exception. The Commission is not persuaded that this exception, applied for years in the equity markets, will impose significant compliance burdens on market participants. Any quote actually published by the exchange must be firm.

8. Amendments to Defined Terms

To effectuate the application of the Quote Rule to listed options, the Commission is amending several defined terms used in that rule. In particular, the Commission is expanding application of the Quote Rule to include transactions in listed options[151] by amending the definition of the term ''reported security,''[152] to include any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan[153] or an effective national market system plan for reporting transactions in listed options.[154] Consequently, listed options are now also included within the definitions of ''covered security,''[155]

order equal to the firm quote size, and thereafter, revising its bid or offer to an inferior price, the Commission expects that, in the absence of a price movement in the underlying security, the responsible broker-dealer will not reinstate its original bid or offer for at least thirty seconds. A responsible broker-dealer may not reinstate its bid or offer for at least thirty seconds even if a competing market maker independently quotes at the original price during the thirty second period.

[142] Exchange Act Rule 11Ac1–1(c)(2), 17 CFR 240.11Ac1–1(c)(2).

[143] *See* Morgan Stanley Letter.

[144] *See* Phlx Letter; ISE Letter; and Brunelle Letter.

[145] *See* ISE Letter.

[146] *See* Brunelle Letter.

[147] *See* CBOE Letter.

[148] *See* JPMorgan Letter.

[149] *See* Exchange Act Rule 11Ac1–1(a)(25), 17 CFR 240.11Ac1–1(a)(25).

[150] *See* JPMorgan Letter.

[151] The Commission defines the term ''listed option'' in the Quote Rule as any option traded on a registered national securities exchange or automated facility of a registered national securities association. *See* Exchange Act Rule 11Ac1–1(a)(27), 17 CFR 240.11Ac1–1(a)(27).

[152] One commenter noted that by changing the definition of reported security in the Quote Rule, options would be subject to the Limit Order Display Rule, Exchange Act Rule 11Ac1–4, 17 CFR 240.11Ac1–4, which incorporates by reference the definition of reported security in the Quote Rule. *See* JPMorgan Letter. As the Commission did not intend to amend the Limit Order Display Rule in this manner, the Commission is adopting a conforming amendment to the definition of reported security in the Limit Order Display Rule, to retain the existing definition in that rule.

[153] All national securities exchanges and national securities associations must file with the Commission a transaction reporting plan regarding transactions in listed equity and Nasdaq securities. *See* Exchange Act Rule 11Aa3–1(b)(1), 17 CFR 240.11Aa3–1(b)(1).

[154] Currently, the OPRA Plan is the only effective national market system plan that collects, processes, and makes available transaction reports for listed options.

[155] The term ''covered security'' is defined as any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Exchange Act, 15 U.S.C. 78c(a)(51)(A)(ii). *See* Exchange Act Rule 11Ac1–1(a)(6), 17 CFR 240.11Ac1–1(a)(6).

''exchange-traded security,'' [156] and ''subject security.'' [157] Thus, options exchanges and market makers are obligated to publish their quotes and, as importantly, be firm for those quotes.

In addition, the Commission is amending the definition of ''consolidated system'' under Rule 11Ac1–1(a)(5) [158] to include a transaction reporting system operating pursuant to an effective national market system plan, as proposed. The effect of this amendment is to make clear that listed options would be ''subject securities'' with respect to an exchange or association only if, during the most recent calendar quarter, the exchange or association chooses to publish quotes or the aggregate trading volume on such exchange or association is more than one percent of the aggregate trading volume as reported by OPRA.

9. Compliance Date

The amendments to the Quote Rule become effective on February 1, 2001, and have a compliance date of April 1, 2001. Although several commenters recommended that market makers and exchanges not be required to comply with the amendments to the Quote Rule until OPRA is able to disseminate quotes with size,[159] the Commission believes that these amendments will provide significant benefits to options market participants and does not believe that they should be delayed while OPRA develops new systems changes. Further, because the options exchanges will not be required to disseminate size on a quote-by-quote basis, market makers and exchanges can comply with the amendments to the Quote Rule even if OPRA is unable to accept quotes with size by April 1, 2001.

V. Paperwork Reduction Act

Certain provisions of the new rules contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[160] Accordingly, the Commission submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Commission proposed, and OMB approved, amendments to the collection of information titled ''Rule 11Ac1–1, Dissemination of Quotations'' (OMB Control Number 3235–0461). The Commission also proposed to create a new information collection entitled ''Rule 11Ac1–7, Trade-Through Disclosure Rule.'' OMB has approved the new collection, and has assigned it OMB Control Number 3235–0543, with an expiration date of November 30, 2003. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless it displays a currently valid OMB control number.

The Proposing Release solicited comments on these collection of information requirements.[161] No comments were received that addressed the PRA portion of the Proposing Release. The Commission believes that its previously published estimates of the information collection burdens associated with the new rule and rule amendments are appropriate.

Any collection of information pursuant to the new rules would be mandatory. Market centers that are national securities exchanges or national securities associations would be required to retain the required collections of information for not less than five years, the first two years in an easily accessible place. Broker-dealers would be required to retain the collections of information for not less than three years, the first two years in an easily accessible place.

A. Use and Disclosure of the Information Collected

The information collected pursuant to the Trade-Through Disclosure Rule would be sent to customers and retained by broker-dealers. No information, however, will be collected or retained under this rule if all of the options exchanges participate in an effective national market system options linkage plan that is reasonably designed to limit intermarket trade-throughs. This information would be used by customers to evaluate the quality of the executions they receive. It would also be used by broker-dealers to evaluate and make determinations related to their best execution obligations. The Commission and the options markets would use the information collected pursuant to the rule for inspections, examinations, trading reconstructions, enforcement inquiries or investigations.

The information collected pursuant to the Quote Rule would be held by broker-dealers and markets. Customers of broker-dealers, as well as other market participants, would use this information to determine the sizes associated with the best prices available for listed options. The Commission and self-regulatory organizations (''SROs'') would use the information collected pursuant to the rule for inspections, examinations, trading reconstructions, enforcement inquiries or investigations.

The Commission and other securities regulatory authorities would obtain possession of the information only upon request. Any collection of information received by the Commission, SROs, and other securities regulatory authorities would not be disclosed under the terms of the proposal, subject to the provisions of the Freedom of Information Act, 5 U.S.C. 552.

B. Trade-Through Disclosure Rule

1. Capital Costs

As the Commission noted in the Proposing Release, if a broker-dealer effects trades on a market that participates in an approved linkage plan with provisions reasonably designed to limit intermarket trade-throughs, including trade-throughs of prices on markets not participating in a linkage plan, the broker-dealer will have no paperwork capital costs or paperwork burdens under the Trade-Through Disclosure Rule. The same will hold true if all options markets participate in such a linkage plan. As noted above, all five options exchanges are currently participants in the Linkage Plan approved by the Commission on July 28, 2000.[162] Only minor modifications to the Linkage Plan are necessary for it to be considered reasonably designed to limit intermarket trade-throughs.

The Trade-Through Disclosure Rule would require broker-dealers to make certain disclosures to customers if the broker-dealer effects trades on markets that do not participate in an approved linkage plan. Broker-dealers would incur paperwork costs to modify systems to permit them to: (1) Receive information about when a trade-through has occurred and the price that was traded through; (2) match information about trade-throughs with customer accounts; and (3) disclose to customers when trade-throughs occur. The Commission has estimated that it would take a computer programmer at an

[156] The term ''exchange-traded security'' is defined as any covered security or class of covered securities listed and registered, or admitted to unlisted trading privileges, on an exchange. *See* Exchange Act Rule 11Ac1–1(a)(10), 17 CFR 240.11Ac1–1(a)(10).

[157] The term ''subject security'' is defined to include any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system. *See* Exchange Act Rule 11Ac1–1(a)(25), 17 CFR 240.11Ac1–1(a)(25).

[158] Exchange Act Rule 11Ac1–1(a)(5), 17 CFR 240.11Ac1–1(a)(5).

[159] *See* Susquehanna Letter; Botta Letter; PCX Letter; Phlx Letter; and JPMorgan Letter.

[160] 44 U.S.C. 3501 *et seq.*

[161] *See* Proposing Release, *supra* note .

[162] *See* Linkage Plan, *supra* note 4.

hourly rate of approximately $50 [163] between 500 and 1,000 hours to modify the average broker-dealer's systems to receive trade-through information, at a cost of between $25,000 and $50,000 for each broker-dealer. Approximately 7,500 broker-dealers were registered with the Commission as of December 31, 1999. Of those, approximately 3,800 conduct business with the general public. Most introducing firms, however, rely on their clearing firms to generate confirmation statements for customers.[164] As a result, fewer than 330 broker-dealers would actually have to modify their systems, should any modifications be necessary. However, if all 330 registered broker-dealers that clear customer accounts pursuant to Exchange Act Rule 15c3–3 [165] were required to make these systems modifications, the one-time paperwork cost would be between $8,250,000 and $16,500,000.

2. Burden Hours

If a broker-dealer effects trades on markets that do not participate in an approved linkage plan with provisions reasonably designed to limit intermarket trade-throughs, including trade-throughs of prices on markets not participating in an approved linkage plan, the broker-dealer would be required to disclose trade-throughs to its customers. However, because broker-dealers' systems would have already been reprogrammed to receive information about trade-throughs and to appropriately disclose such trade-throughs to customers, the Commission has estimated that the paperwork burden of the disclosure for broker-dealers would be nominal, since it would merely require a small amount of additional information to be provided to customers at or before the completion of the transaction on confirmation statements, or in some equivalent fashion.[166]

C. Amendments to the Quote Rule

1. Capital Costs

In the Proposing Release, the Commission noted that options exchanges are obligated already, pursuant to their participation in the OPRA Plan, to collect bids and offers, and send them to OPRA for dissemination. However, under the amended Quote Rule, the options exchanges will be required to either collect and make available to vendors quotation sizes associated with such bids and offers, or to establish by rule and periodically publish the sizes for which a quote must be firm, and to file proposed rule changes to identify unusual market conditions.

If an exchange chooses not to collect and make available to vendors quotation sizes associated with its members' bids and offers, but instead chooses to implement rules and periodically publish such rules establishing the sizes for which its quotes will be firm, it would incur one-time costs to file and obtain approval of these rule changes, as well as other related rules. The Commission estimated that each of the five options exchanges would need to file two rule changes to comply with the proposed amendments to the Quote Rule, for a total of 10 rule changes. The Commission has estimated that a routine rule change requires approximately 25 hours of legal review at an hourly cost of $98.25,[167] plus one hour of secretarial time at an hourly cost of $30.40,[168] for a total cost of $2,487 per proposed rule change submitted for Commission approval. Therefore, the Commission has estimated that the aggregate cost of two proposed rule changes filed by each of the five options exchanges would total approximately $24,867.

Also, as noted in the Proposing Release, broker-dealers that are market makers or specialists have existing obligations under exchange rules to communicate their bids and offers to their exchanges, and already do so. Therefore, they would incur no additional paperwork costs from the amended Quote Rule beyond those related to systems changes, discussed below, to comply with the amended Quote Rule. Market makers and specialists may, to comply with the amended Quote Rule, change their quote-setting practices by changing the factors used to establish quotes through automated quoting systems (*i.e.*, resetting the parameters). The Commission notes that almost all option quotes are currently set by automated quoting systems. The Commission estimated broker-dealer systems changes made to comply with the amended Quote Rule would require changes estimated to take approximately three to five minutes per options class. As there are approximately 3,000 options classes eligible for multiple listing, the Commission estimated that the total burden for one market could range from 180 to 250 hours. For all five markets, the total burden could range from 900 to 1,255 hours. The hourly rate of an exchange clerk that would make the required system changes is $32.50;[169] therefore, the total cost for these changes could range from $29,250 to $40,787.

2. Burden Hours

The Commission estimated that the five options exchanges may, to comply with the Quote Rule, amend their rules at most once per year, for a total of five proposed rule changes. The Commission estimated that a routine proposed rule change takes 25 hours of legal review at an hourly cost of $98.25 [170] plus one hour of secretarial time at an hourly cost of $30.40,[171] for a total cost of $2,487 per proposed rule change. Therefore, the total annual cost of five exchanges' proposed rule changes would impose a burden of $12,433.

Broker-dealers would not incur any additional paperwork cost from the amended Quote Rule beyond the systems changes discussed above. Market makers and specialists already are required to make and provide quotes in options to their exchanges. As a result, the amendments to the Quote Rule to include options would require only that market makers and specialists be firm for their quotes, which would impose no additional paperwork burden on them.

VI. Costs and Benefits of Final Rules

Recent increases in the multiple listing of options classes previously listed on a single exchange have

[163] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* Report on Management and Professional Earnings in the Securities Industry 1999, published by the SIA (''SIA Report'').

[164] The Commission estimates that none of the 41 small broker-dealers who do not have a relationship with a clearing firm regularly represent customer options orders.

[165] 17 CFR 240.15c3–3.

[166] The Commission's adoption of an exception to the disclosure requirement of the Trade-Through Disclosure Rule for block orders would only reduce this burden. Because this burden was already determined to be nominal, this change does not affect the Commission's initial burden estimate. *See* Proposing Release, *supra* note 6.

[167] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 163.

[168] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* Report on Office Salaries in the Securities Industry 1999.

[169] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 163.

[170] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 163.

[171] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* Report on Office Salaries in the Securities Industry 1999.

intensified the competition among the option exchanges and heightened the need to further integrate the options markets into the national market system. While the growth in multiple trading has increased the competition between markets, it also has dramatically altered the environment in which options market participants conduct their trading. In particular, multiple trading raises new best execution challenges for brokers. When an option is listed on only one exchange, brokers do not have to decide where to route an order, and consequently, satisfying their best execution obligations is less complex than when they must consider the relative merits of routing orders to two or more market centers. With as many as five options exchanges currently trading certain options classes, brokers are required to regularly and rigorously evaluate on a more frequent basis the execution quality available at each options exchange.

Directly relevant to a broker's ability to obtain best execution for its customers is the ability to get the best price available. The considerable growth in the number of options classes traded on more than one exchange has significantly increased the likelihood of intermarket trade-throughs. With the current expansion of multiple trading in options, the Commission is increasingly concerned about customer orders, which are sent to one exchange, and executed at prices that are inferior to quotes published by another market. As a result, the Commission believes that adoption of the Trade-Through Disclosure Rule and amendments to the Quote Rule are necessary at this time to encourage the removal of barriers to access to, and the use of efficient vehicles to reach, better prices on another market.

A. Costs and Benefits of the Trade-Through Disclosure Rule

Under the Trade-Through Disclosure Rule, a broker generally will be required to disclose to its customer, in writing at or before the completion of the transaction, when the customer's order for listed options was executed at a price inferior to a better published quote and the better published quote available at that time.[172] A broker-dealer will not be required to make this disclosure if any of the four exceptions to the definition of a trade-through apply, which include when: (1) The market on which the order is executed has verified that the market publishing the better price is experiencing systems problems, which make the quote inaccessible, (2) OPRA is experiencing queuing, (3) the market publishing the better price is relieved of its obligations to publish firm quotes, or (4) the market publishing the better quote fails to respond to an order routed to it within 30 seconds.

A broker-dealer also will not be required to provide such disclosure to its customer if it effects the transaction on an exchange that participates in an approved linkage plan that includes provisions reasonably designed to limit customers' orders from being executed at prices that trade through a better published price or the customer order was executed as part of a block trade.[173] Exchanges also will be required to surveil and sanction specialists or market makers that trade through better prices published by other exchanges, particularly because under the intermarket linkage plan exception, broker-dealers need not disclose to their customers if their orders are executed at a price inferior to a quote published by another market.

1. Comments

In the Proposing Release, the Commission requested comments on all aspects of the costs and benefits of the rule, including identification of additional costs or benefits of the new rule. In addition, the Commission encouraged commenters to identify or supply any relevant data concerning the costs or benefits of the new rule.

None of the commenters specifically addressed the costs or benefits of the proposed Trade-Through Disclosure Rule. However, several commenters discussed certain aspects of the Commission's proposal, which implicitly addressed the costs or benefits of the proposal, such as the likelihood that the rule would help to prevent trade-throughs and therefore, implicitly the associated costs of trade-throughs to investors. For example, one commenter believed that trade-throughs would be virtually eliminated if a broker-dealer were required to disclose to a customer that an order was executed at a price that was inferior to the best-published quote.[174] In addition, another commenter believed that a linkage plan must provide some form of protection against trading through exchanges that do not participate in an approved linkage plan to instill investor confidence in the options markets.[175]

One commenter, however, did not believe that the imposition of a disclosure requirement would have a significant impact on the frequency of trade-throughs.[176] In addition, another commenter believed that the Commission should modify the provisions it requires for a linkage plan to satisfy the exception to the disclosure rule so that the recently approved Linkage Plan[177] qualified as reasonable without further amendment.[178] The commenter believed that the additional factors proposed as elements of a plan reasonably designed to limit trade-throughs would add significant costs to the Linkage Plan without adding significant additional deterrence.[179] In addition, this commenter believed that if all or almost all of the options exchanges are expected to join the Linkage Plan, the Commission should delay the adoption of the rule, because it would not be cost-effective to require firms to re-design their confirmation systems to comply with such a rule if the rule then became obsolete because all of the exchanges were members of an approved linkage that meets the rule's requirements. Another commenter believed that the Commission should not extend trade-through protection to those markets that are not members of the same linkage plan because they would be difficult to access effectively.[180]

2. Benefits

An intermarket trade-through may be costly to an investor primarily because the investor receives an execution at a price that is not the best price available. An intermarket trade-through also has potential costs for the broker-dealer or customer responsible for the best quote because that quote or customer order does not receive the execution it would have if the order that was executed at the inferior price were instead routed to it.[181] Consequently, intermarket trade-throughs may increase the incidence of unexecuted customer limit orders not being executed in a timely manner.

[172] Exchange Act Rule 11Ac1–7(b)(1), 17 CFR 240.11Ac1–7(b)(1). The Commission believes that a broker-dealer should be allowed to rely on the market of execution to notify the broker-dealer of when a trade-through has occurred and the best quote at that time.

[173] Exchange Act Rule 11Ac1–7(b)(2), 17 CFR 240.11Ac1–7(b)(2).

[174] *See* Lek Letter.

[175] *See* ISE Letter.

[176] *See* CBOE Letter.

[177] *See supra* notes 4 and 5 and accompanying text.

[178] *See* JPMorgan Letter.

[179] *See* JPMorgan Letter.

[180] *See* CBOE Letter.

[181] It is possible that an order may not be routed to the market publishing the best quote, if the original market matches the better quote. However, the Commission believes that the Trade-Through Disclosure Rule may ensure that the customer submitting the order will at least receive an execution at the better published price.

To attempt to gauge the incidence of intermarket trade-throughs, the staff looked at trading involving the 50 most active, multiple-listed options classes, in which there is a great deal of investor interest. The staff's review of these trades showed that approximately 5% of all trades (or 7,964 trades for a total of 156,403 contracts) in the 50 most active multiple-listed option classes took place at prices inferior to the best price quoted on a competing exchange during the week of June 26, 2000.[182] To better evaluate the execution quality of small customer orders, the staff also examined automatic execution trades in the 50 most active multiple-listed options classes. The staff also found that approximately 1% of all automatic execution trades (or 464 automatic execution trades for a total of 2,336 contracts) in the 50 most active multiple-listed option classes took place at prices inferior to the best price quoted on a competing exchange during the week of June 26, 2000.[183]

Investors would benefit from the Trade-Through Disclosure Rule because they would be informed when their orders are executed at a price inferior to the best available price. With that information, investors would have the opportunity to reduce the likelihood that their orders would be executed at a price inferior to a price displayed by another market by selecting broker-dealers that effect their transactions on markets that are participants in an approved linkage plan with provisions reasonably designed to limit trade-throughs. Even if only one-half of all orders executed through automatic execution systems were executed at the best-published quote (*i.e.,* trade-throughs of automatic execution trades were eliminated), the estimated annual savings to investors trading through exchanges' automatic execution systems would be approximately $5,500,000 each year.[184] If all trades were considered, the elimination of trade-throughs would result in substantially higher annual savings to investors.[185]

3. Costs

The Trade-Through Disclosure Rule may require broker-dealers and markets to incur capital costs, such as one-time costs to modify existing systems. For example, the new rule could impose one-time costs on markets and broker-dealers that must modify systems to determine when trade-throughs have occurred and to issue notifications to customers of trade-throughs. Further, to identify when an order trades through a posted quote, information systems would need to be developed that could identify the displayed quotes at the time of execution. Because the Commission would allow broker-dealers to rely on notifications from the markets when trade-throughs occur and the better available quote at that time, the costs of such information systems may be borne by the options markets.

In addition, implementing the rule could require broker-dealers to provide customer notifications at or before the completion of the transaction. A broker-dealer may provide this disclosure to its customers in conjunction with the confirmation statements routinely sent to customers and could be issued in either electronic or paper form.[186] An alternative to changing confirmation statements would be for broker-dealers to route orders to exchanges participating in an approved linkage plan.[187] Although the new rule does not require the implementation of such a plan, it does envision that an approved plan could be implemented. Thus, one possible cost to the options markets of the Trade-Through Disclosure Rule could be the capital investment to establish a linkage. In addition to the capital costs of establishing the linkage, costs could include regulatory costs, such as obtaining Commission approval of a linkage and of SRO rule changes necessary to implement a linkage. Further, there may be economic implications if a market chooses to participate in an approved linkage plan, because members may then be more likely to use the linkage to route orders to other exchanges that are quoting a better price. The Commission estimates that capital costs for a linkage plan range from $1,000,000 to $1,500,000 initially, and yearly costs could range from $300,000 to $1,000,000.[188]

The Commission recognizes that broker-dealers may incur certain capital costs to implement the Trade-Through Disclosure Rule. While the Commission recognizes that these costs cannot be avoided, the Commission believes that most of these costs will be one-time costs for broker-dealers with continuing savings to investors through the elimination of trade-throughs. Also, as members of the options exchanges, broker-dealers may have input into a decision by an exchange to participate in an options linkage plan and therefore, influence decisions that will impact their costs, including potential exchange fees.

The Commission is also sympathetic to the comment that the rule may become obsolete if all the options exchanges participate in an approved intermarket linkage plan.[189] The Commission is not mandating participation in a particular intermarket linkage plan to allow the options exchanges to retain greater flexibility. Because participation in an options linkage plan is voluntary and because, under the current terms of the Linkage Plan, any participant may withdraw from the plan at any time with 30 days prior written notice to each of the other plan participants and the facilities manager, if any,[190] the Commission continues to believe that the Trade-Through Disclosure Rule is needed to ensure that, if the exchange on which their orders are executed do not belong to an approved linkage plan with provisions designed to limit trade-throughs, investors at least receive

[182] The staff relied on data from OPRA for this analysis. All trades marked as spreads, straddles, late, or stopped were excluded from the sample. To determine the quote in effect at the time of the trade, the highest offer and lowest bid on each competing exchange for a period of one minute prior and two minutes after the reported execution were identified. Quotes from an exchange that indicated it was experiencing fast market conditions during the time when the trade was executed were not included. Quotes that indicated that an option class was in rotation were also excluded. The staff recognizes that not all these trades in the sample could be fully executed at the best available quoted price because of size or other factors.

[183] Trades executed through automatic execution systems account for about 36% of all trades and about 12% of all contracts traded in the 50 most active multiple-traded options classes during the week of June 26, 2000. The procedure used for the analysis of automatic execution trades is similar to that described for all trades, except only trades executed through the exchanges' automatic execution systems are included.

[184] The annual benefit estimate is obtained by applying the staff's trade-through findings for automatic execution trades in the 50 most active multiple-traded options classes to all multiple-listed classes and extending the results from one week to a full year. In the options market, market makers are almost always on the other side of the transaction and therefore, investors benefit from avoiding trade-throughs. If investors were on both sides of the transactions, any savings for avoiding trade-throughs would be offset by losses to investors on the opposite side of the transactions.

[185] The staff estimates the benefits of executing a maximum of 20 contracts at the best-quoted price for those trades identified as trade-throughs could total several hundred million dollars per year.

[186] See Securities Exchange Act Release No. 37182 (May 9, 1996), 61 FR 24644 (May 15, 1996).

[187] The Commission notes that Trade-Through Disclosure Rule creates strong incentives for the options exchanges to participate in an approved intermarket linkage plan to attract order flow from broker-dealers wishing to avoid the disclosure requirement.

[188] The Commission published these numbers in the Proposing Release and specifically solicited comment on the costs of developing a linkage between the markets, as well as the costs for individual markets to integrate their systems into such a plan. The Commission did not receive any comments on the above data.

[189] *See* JPMorgan Letter.

[190] *See* Linkage Plan, Section 12.

disclosure if their orders are not executed at the best price.

The Commission recognizes that by providing an incentive for markets to cooperate in developing effective means to access other markets, trade-throughs will be minimized. However, to the extent that: (1) One or more options exchanges decide not to participate in a linkage plan; (2) trade-throughs are not minimized by the implementation of an intermarket linkage plan because the plan fails to provide protection across all markets, including markets that do not participate in a linkage plan; (3) away markets fail to complain about trade-throughs; or (4) broker-dealers are not subject to potential sanctions for trade-throughs, the value of the Trade-Through Disclosure Rule would be greatly diminished. Therefore, the Commission believes that despite the existing exchanges' participation in the Linkage Plan, the Trade-Through Disclosure Rule adopted by the Commission is also needed for the protection of investors. The Commission believes that the rule can only be effective if trade-throughs of any market are disclosed to investors, or effectively limited by an approved linkage plan.

B. Costs and Benefits of Amendments to the Quote Rule

The Commission is adopting amendments to the Quote Rule to extend its application to options traded on national securities exchanges. Generally, the Quote Rule requires exchanges to collect quotations and sizes from its responsible broker-dealers and make those quotations and sizes available to quotation vendors for each subject security listed and admitted to unlisted trading privileges on the exchange.

The Commission is adopting amendments to the Quote Rule to accommodate the unique structure of the options market to permit options exchanges to decide whether or not to collect from their members and make available to vendors the size associated with each quotation in listed options. Instead, exchanges may choose to establish by rule and periodically publish the size for which its best bid or offer in each options series that is listed on the exchange is firm. If the rules of the exchange do not require its members to communicate quotation sizes for listed options, responsible broker-dealers that are members of that exchange will be relieved of their obligations under the Quote Rule to communicate to that exchange their quotation sizes. Instead, each responsible broker-dealer may satisfy its firm quote obligation by executing any order to buy or sell a listed option that is a subject security, in an amount up to the size established by the exchange's rules.[191] An exchange may establish in its rules different firm quote sizes for broker-dealer orders than for customer orders.[192]

If, on the other hand, an options exchange chooses to establish procedures for collecting from its members, and making available to vendors, the sizes of its members' quotes, the exchange may permit its members' quotes to be firm for different sizes for customer orders than for broker-dealer orders.[193] In addition, an exchange will have the flexibility to collect and disseminate quote sizes for customer orders and establish by rule quote sizes for broker-dealer orders.

As discussed above, under the Trade-Through Disclosure Rule, if a responsible broker-dealer fails to respond to an incoming order within the 30 seconds, the routing broker-dealer may execute its customer's order at its own inferior quote and would not be required to disclose the trade-through to its customer because the quote traded through was unavailable. The Commission also is adopting an amendment to the Quote Rule to require a responsible broker-dealer to respond to an order to buy or sell a listed option in an amount greater than its firm quote size within 30 seconds by either: (1) executing the entire order; or (2) executing at least that portion of the order equal to the applicable firm quote size and revising its bid or offer.[194] The Quote Rule requires responsible brokers and dealers to *immediately* execute an order to buy or sell listed options in an amount equal to or less than its firm quote size.[195]

1. Comments

One commenter stated that the lack of a Quote Rule in the options markets has impeded firms' ability to execute customer orders in an efficient manner while they explore posted quotes to see whether they are firm for the entire order or only for an order of minimal size.[196] Another commenter suggested that a true linkage cannot occur so long as market makers are permitted to refuse to honor displayed quotes.[197] Two commenters also believe that the Quote Rule will promote efficiency and increase customer confidence in our markets.[198] In addition, another commenter argued that the supposition that market makers would widen their spreads if their quotes were exposed to other market professionals is unjustified and unsupported by empirical data, and in any case, the public is more harmed by non-competitive un-real quotes than by wider spreads.[199]

Alternatively, one commenter stated that extending the Quote Rule to options will not significantly improve the current situation because the options markets are already subject to exchange-created firm quote rules, and despite such rules, public investors have often found that quotations in these markets are not firm, and neither are many of their transactions.[200] In addition, one commenter suggested that current competition among market makers for public customer orders is intense, but the proposed amendments will force the allocation of capital into areas of unacceptable risk, such as trading against other broker-dealers, and away from the facilitation of public customer orders.[201] Two commenters believed that to compensate for the increased exposure to broker-dealers the amendments will cause market makers to be less aggressive, widen spreads, limit quote size, and reduce overall liquidity to public customers, despite the fact that the proposal is suppose to draw more liquidity into the market by requiring market makers to be firm to broker-dealers.[202]

One commenter also believed there is no need for an exception to the Quote Rule for exchanges whose aggregate trading volume in a listed option is less than or equal to one percent of the total trading volume reported by OPRA.[203] This commenter argues that the possibility of a chilling effect on the liquidity of inactively traded securities does not justify the monitoring burden that the exception would impose on brokers, who would be forced to keep

[191] Exchange Act Rule 11Ac1–1(d)(2), 17 CFR 240.11Ac1–1(d)(2).

[192] Exchange Act Rule 11Ac1–1(d)(1), 17 CFR 240.11Ac1–1(d)(1). Exchange rules must require responsible broker-dealers to be firm for orders for the account of broker-dealers for at least one contract.

[193] Exchange Act Rule 11Ac1–1(d)(1)(iii), 17 CFR 240.11Ac1–1(d)(1)(iii).

[194] Exchange Act Rule 11Ac1–1(d)(3)(i), 17 CFR 240.11Ac1–1(d)(3)(i). A responsible broker's or dealer's applicable firm quote size would be its published quote size or, if a responsible broker or dealer has been relieved of the obligation to communicate its quotation sizes, the minimum firm quote size established by its exchange's rules.

[195] Exchange Act Rule 11Ac1–1(c)(2), 17 CFR 240.11Ac1–1(c)(2).

[196] *See* JPMorgan Letter.

[197] *See* Lek Letter.

[198] *See* Lek Letter and PCX Letter.

[199] See Lek Letter.

[200] *See* Brunelle Letter. This commenter noted that subsequent to execution, specialists or market makers frequently change the terms of the transaction or ''break'' the trade.

[201] *See* Susquehanna Letter.

[202] *See* Susquehanna Letter and Botta Letter.

[203] See JPMorgan Letter.

track of which quotes were firm and which, because of the one percent exception, were not.

2. Benefits

Amending the Quote Rule would reduce discrepancies between the treatment of quotes in the options markets and the equity markets.[204] Although options trading is not currently covered by the Commission's Quote Rule, each exchange's rules require their members' quotes to be firm up to a certain minimum size and establish the process for handling orders in excess of the exchange's firm quote size. Exchange rules also establish whether members' quotes must be firm for all orders or only some orders, such as only for public customer orders.

The Commission believes that applying the Quote Rule to the options market would provide a number of benefits. Firm quotes reduce uncertainty surrounding order routing decisions for broker-dealers that are seeking to fill customer orders at the best available price. If broker-dealers are confident that quotes are firm, investor orders may be routed to the market with the best price and receive an execution at that price. Under current practices, because broker-dealers cannot be confident that a price on another market is firm (due to existing market rules, including trade-or-fade rules), orders do not always receive the best available price. As discussed above, the staff estimates that five percent of all trades in the 50 most active multiply-listed classes took place at prices inferior to the best price quoted on a competing market during a one-week period in June 2000. Broker-dealers often state that such trade-throughs occur when market makers believe the better price on the other market may not be firm and the quote may ''fade'' if the broker-dealer were to attempt to execute against it. By requiring that posted prices be firm up to a published size, a great deal of uncertainty about order execution quality could be reduced. This would be true even if the quote were permitted to be firm for different sizes for customer orders than for broker-dealer orders.

In addition to providing certainty to broker-dealers making order routing decisions and seeking to fill orders at the best available price, extending the Quote Rule to the options markets may benefit broker-dealers by enhancing their ability to satisfy their regulatory obligations, including best execution. The Commission believes that the Quote Rule may help broker-dealers to satisfy their best execution obligations by providing firm quote information and reducing concerns about ''fading'' quotes. In addition, the Commission believes that enhancing the ability of broker-dealers to satisfy their best execution obligations may reduce the liability exposure faced by broker-dealers as to their best execution obligations.

The Commission also believes that the proposed amendments to the Quote Rule would bolster investor confidence in the options markets by ensuring that quotes made by market makers or specialists are available for a specified number of options contracts, thus providing greater certainty for investors. The Commission believes that as a result of increased investor confidence, more investors may trade options and thereby, increase volume and reduce spreads on the options exchanges. In addition, by requiring the quotations in listed options to be firm, the amendments may also lead to better-informed investors, which should increase investor confidence in the market.

Another benefit of applying the Quote Rule to options trading is that it would likely increase competition between markets. Because all quotes would be firm, a market participant would know that a posted quote would be recognized as firm. Therefore, the posted quote may attract order flow. The ability to attract order flow with a market-improving quote encourages intermarket price competition, which benefits investors. In addition, the Commission believes that its proposal would result in (1) fewer unexecuted investor orders due to quote changes after order arrival, or (2) fewer orders executed at prices less favorable to the investor than those prevailing at the time of order arrival.

3. Costs

Applying the Quote Rule to the options market would require exchanges to collect bids and offers from their members. This would not impose a significant burden on the exchanges because bids and offers generally are collected already by the markets and sent to (and disseminated through) OPRA. Currently, each of the options markets has rules that establish the maximum size of orders that its automatic execution system will execute. The exchanges would, however, be required to publish the size (or sizes, if different categories are used) for which their quotes must generally be firm. There are likely to be expenses incurred by the markets related to collecting and making available to quotation venders or periodically publishing their firm quote sizes.

Amendment of the Quote Rule to include options may require markets to incur one-time costs. For example, options markets may need to enhance surveillance and enforcement mechanisms to ensure that its members are complying with the Quote Rule. Further, options market makers and specialists may need to reevaluate and change their quotes in light of the obligation to be firm that would be imposed by the amendment to the Quote Rule.[205]

The Commission recognizes that these costs cannot be avoided, although the impact of the costs may be minimized to the extent that a market already has surveillance and enforcement procedures in place to monitor its members for compliance with the existing rules of the Commission and the exchange. However, the Commission believes that the current situation, wherein the options markets are permitted to fade from their quotes without consequence, pursuant to their trade-or-fade rules,[206] is no longer acceptable. Currently, options investors cannot fully rely on the disseminated quotation information on which they base their order routing decisions. The Commission believes that options investors deserve the same protections as equity investors and therefore, the Commission is adopting amendments to extend the coverage of the Quote Rule to the options market.

In addition, with respect to the concern raised by two commenters regarding the increased financial exposure of broker-dealers under the Quote Rule, the Commission notes that under the rule being adopted today, the options exchanges may establish different quote sizes for broker-dealers' orders than for customer orders. The Commission also believes that the options markets and options market makers should be permitted to make use of the one percent exception. The Commission is not persuaded that this exception, applied for years in the equity markets, will impose significant compliance burdens on market participants.

C. Conclusion

With the current expansion of multiple trading in options, the Commission is increasingly concerned

[204] The equities markets have been subject to a firm quote requirement since 1978. See Securities Exchange Act Release No. 14415, *supra* note and accompanying text.

[205] In the Proposing Release, the Commission stated that it was unable to quantify these costs and further solicited comments on these costs. *See* Proposing Release, *supra* note 7. No commenters explicitly addressed this issue.

[206] *See supra* note 33.

about customer orders, which are sent to one exchange, and executed at prices that are inferior to quotes published by another market. The Commission, therefore, believes that adoption of the Trade-Through Disclosure Rule and amendments to the Quote Rule are necessary at this time to encourage the removal of barriers to access to, and the use of efficient vehicles to reach, better prices on other markets. The Commission recognizes that there may be some costs associated with the implementation of these rules, however, the Commission believes that the likely benefits justify the possible costs.

VII. Effects on Competition, Efficiency, and Capital Formation

Section 3(f) of the Exchange Act[207] requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. In the Proposing Release, the Commission requested comment on these issues.[208]

With regards to the amendments to the Quote Rule, several commenters supported the Commission's proposals because they believed that the amendments would promote efficiency and enhance public confidence in the options markets.[209] Another commenter that argued that the current lack of a Quote Rule in the options markets impeded firms' ability to execute customer orders in an efficient manner because firms are forced to explore quotes to determine the size for which the quotes represent.[210]

The Commission believes that the amendments to the Quote Rule are necessary and appropriate in the public interest. The amendments to the Quote Rule should bolster investor confidence in the options markets by ensuring that quotes made by market participants are available for a specified number of contracts, thus providing greater certainty for investors. Similarly, the increased investor confidence should promote market efficiency and capital formation.

The amendments to the Quote Rule should also assist broker-dealers in making their best execution determinations. Further, the amendment to the Quote Rule will help to ensure that important information relating to the size associated with disseminated quotes is available to all market participants. This should promote market efficiency, competition, and capital formation.

With regards to the Trade-Through Disclosure Rule, the Commission believes that it will bolster confidence in the options markets by better informing investors about the quality of their executions and the implications of their broker-dealers' execution decisions. This increased investor confidence should promote market efficiency and capital formation. The Trade-Through Disclosure Rule also should help to minimize the number of customer orders that do not receive an execution at the best available quote.

The Commission also believes that the Trade-Through Disclosure Rule will assist broker-dealers in evaluating and complying with their best execution obligations. Moreover, the Trade-Through Disclosure Rule will provide an incentive to develop effective means of access between the markets to avoid trade-throughs. One commenter agreed, stating that the Trade-Through Disclosure Rule should assure that the options markets participate in either the Linkage Plan or that they will develop alternative plans that will effectively address and limit trade-throughs.[211] The Commission believes that this will result in the more efficient execution of orders in the options markets.

Section 23(a)(2) of the Exchange Act[212] requires that the Commission, when promulgating rules under the Exchange Act, to consider the impact any rule would have on competition and not to adopt any rule that would impose a burden on competition that is not necessary or appropriate in the public interest. In the Proposing Release, the Commission noted that because both the proposed amendments to the Quote Rule and the proposed Trade-Through Disclosure Rule would apply equally to all relevant market participants, the Commission believed the proposals would not have any anti-competitive impact.[213] The Commission, however, requested comment on any anti-competitive effects of the proposals. The Commission did not receive any comments regarding the competitive impact of the Trade-Through Disclosure Rule. Thus, the Commission continues to believe that the Trade-Through Disclosure Rule adopted today will not have an anti-competitive impact on the options markets because the rules apply equally to each options market and other relevant options market participants.

The Commission did, however, receive comments on the potential competitive impact of the amendments to the Quote Rule. Several commenters that addressed the potential competitive impact of a Commission-mandated firm quote size believed that the Commission should not mandate a firm quote size because they argued that competitive market forces should dictate an appropriate firm quote size minimum.[214] Another commenter, however, argued that the Commission should mandate that the exchanges be firm for one contract for non-customer orders, which would permit the exchanges to compete by providing greater than the one contract minimum to attract non-customer order flow.[215]

While agreeing that the Commission should not dictate a firm quote size minimum, two commenters disagreed on whether the options exchanges or options market makers should be permitted to establish firm quote minimums.[216] For example, one commenter noted that the options exchanges compete for order flow by establishing firm quote guarantees.[217] Another commenter, however, argued that it is the options market makers that compete for order flow by establishing quote sizes for which they are willing to guarantee and that requiring the exchanges to set minimum quote sizes would eliminate this competition.[218]

As discussed above, the Commission agrees that the minimum firm quote size for each exchange should be determined independently by each exchange as a competitive issue and should not be dictated by government regulation. Further, the Commission also agrees that each disseminated quote must be firm for at least one contract. The Commission believes that this approach will encourage competition among the exchanges, which should benefit all investors.

The amendments to the Quote Rule adopted by the Commission today permit the options exchanges to establish by rule and periodically publish the sizes for which quotes will be firm for listed options. While one commenter argued that options market makers should be able to compete on this basis, the Commission believes, at this time, that it is appropriate to permit the exchanges to determine firm quote

[207] 15 U.S.C. 78c(f).

[208] *See* Proposing Release, *supra* note 7.

[209] *See* Lek Letter; PCX Letter; and CBOE Letter.

[210] *See* JPMorgan Letter.

[211] *See* PCX Letter. *See also* ISE Letter.

[212] 15 U.S.C. 78w(a)(2).

[213] *See* Proposing Release, supra note 7.

[214] *See* Botta Letter; CBOE Letter; PCX Letter; and Susquehanna Letter.

[215] *See* ISE Letter.

[216] *See* CBOE Letter and Botta Letter.

[217] *See* CBOE Letter.

[218] *See* Botta Letter.

sizes. Currently, the options exchanges, other than the ISE, do not accept quotes from each competing market maker on their floors. Further, OPRA does not, at this time, have the capability to accept and disseminate to vendors quotes with size, although it plans to have such capability early next year. Thus, the Commission believes that, at this time, it is appropriate for the exchanges to establish by rule and periodically publish the size associated with quotes in listed options. The Commission will continue to consider this issue as technology advances because the Commission believes that permitting individual market makers to compete on the basis of size on each exchange floor as well as among competing exchanges could further enhance the competitiveness of the options markets.

Finally, the Commission received two comments on the potential competitive impact of the two alternative proposals regarding establishing firm quote sizes for broker-dealer orders and customer orders. As discussed above, proposed Alternative A would have required that firm quote size minimums be the same for all orders, while proposed Alternative B would have permitted the options exchanges to establish different firm quote size minimums for broker-dealer and customer orders. One commenter, while supporting proposed Alternative A, suggested that it believed that distinctions between broker-dealer and customer orders would ultimately be eliminated through competitive measures of the exchanges.[219] Another commenter, who supported Alternative A, argued that broker-dealers play an important role in keeping prices fair and should be permitted to participate in the competitive pricing process.[220]

As noted above, the amendments to the Quote Rule adopted today permit the exchanges to establish different firm quote sizes for broker-dealer orders than for customer orders. Due to the tremendous number of options products that must be continuously quoted by options market makers and specialists, the Commission believes that this distinction is appropriate at this time. The Commission will continue to consider whether this distinction is appropriate. The Commission notes, however, that the amendments to the Quote Rule do not mandate that the exchanges establish different quote sizes for broker-dealer orders and customer orders, it only permits the distinction. Thus, the options exchanges are free to establish their individual firm quotes sizes for broker-dealer and customer orders as they deem appropriate.[221] The Commission thinks that it is likely that the options exchanges will compete on this basis.

[219] *See* PCX Letter.

[220] *See* Lek Letter.

VIII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with the Regulatory Flexibility Act.[222] It relates to the adoption of the Trade-Through Disclosure Rule and amendments to the Quote Rule. An Initial Regulatory Flexibility Analysis (''IRFA'') was prepared in accordance with 5 U.S.C. 603 and was made available to the public.[223] The Commission is adopting the Trade-Through Disclosure Rule and the amendments to the Quote Rule substantially as proposed.

The Trade-Through Disclosure Rule, Exchange Act Rule 11Ac1–7,[224] will require a broker-dealer to disclose to its customer when the customer's order is executed at a price inferior to a price published by another market. However, a broker-dealer will not be required to provide such disclosure to its customer if it effects the customer's transaction on a market that participates in an approved linkage plan that includes provisions reasonably designed to limit customers' orders from being executed at prices that trade through a better published price, even if the better price is on a market that is not part of the linkage plan.

The Quote Rule, Exchange Act Rule 11Ac1–1,[225] currently requires exchanges to establish procedures for collecting from their members bids, offers, and quotation sizes for certain equity securities available to quotation venders. It also requires that the quotation information made available to vendors be firm, subject to certain exceptions. The amendments to the Quote Rule adopted by the Commission today apply the Quote Rule to options traded on a national securities exchange or an automated facility of a national securities association.

A. Need for, and Objectives of, the Rules

The significant increase in multiple trading that has occurred during the past year has dramatically altered the options trading environment and raised a number of issues, including new best execution challenges for broker-dealers. When an option is listed on only one market, broker-dealers do not have to decide where to route the order, and, consequently, satisfying their best execution obligations with respect to such options orders is less complex than when they must consider the relative merits of executing orders on several markets. Directly relevant to a broker's ability to get best execution for its customers is the ability to get the best price available. Currently, it is difficult to ensure that a customer order sent to one market will receive the best available price because there is no effective mechanism that allows broker-dealers on one market to access a better price displayed on another.

[221] Of course, Exchange Act Rule 11Ac1–1(d)(1) requires that exchange rules must require responsible broker-dealers to be firm for orders for the accounts of broker-dealers for at least one contract. 17 CFR 240.11Ac1–1(d)(1).

[222] 5 U.S.C. 604.

[223] *See* Proposing Release *supra* note 7.

[224] *See* Exchange Act Rule 11Ac1–7, 17 CFR 240.11Ac1–7.

[225] *See* Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

The Commission is adopting the Trade-Through Disclosure Rule and the amendments to the Quote Rule to help address this situation. The Trade-Through Disclosure Rule and the amendments to the Quote Rule are intended to bolster investor confidence in the options markets by better informing customers about the quality of their executions and the implications of their broker-dealers' execution decisions. The Trade-Through Disclosure Rule will require a broker-dealer to disclose to its customer when the customer's order is executed at a price inferior to the best-published quote. A broker-dealer will not be required to make this disclosure if the broker-dealer transacts the customer order on a market that participates in a Commission-approved intermarket linkage plan that has rules reasonably designed to limit trade-throughs, even when the better price is displayed by a market that is not a participant in the linkage plan. Amending the Quote Rule to apply it to the options markets should provide greater certainty about both options quotes and pricing generally in the options markets. The amendments to the Quote Rule, along with the Trade-Through Disclosure Rule, should assist broker-dealers in making their best execution evaluations.

The Trade-Through Disclosure Rule should help minimize the number of customer orders that do not receive an execution at the best available published quote. Further, the Trade-Through Disclosure Rule will assist broker-dealers in evaluating and complying with their best execution obligations. Finally, it will provide an incentive for options markets to develop effective means to access quotes on other markets to avoid trade-throughs.

The amendments to the Quote Rule also should bolster investor confidence in the options markets by ensuring that quotes made by market participants are available for a specified number of options contracts, thus providing greater certainty for investors. The amendments to the Quote Rule also will assist broker-dealers in making their best execution determinations. Further, the amendments will provide information to the market as a whole as to the various factors affecting the market, including the current levels of buying and selling interest.

B. Significant Issues Raised by Public Comment

As required by the Regulatory Flexibility Act, this section (i) summarizes the significant issues raised by public comments in response to the IRFA, (ii) summarizes the Commission's assessment of such issues, and (iii) states any changes made in the proposed rules as a result of such comments.[226]

No comments were received in response to the IRFA.

C. Small Entities Subject to the Rules

Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person) that is not a small entity.[227] The Commission estimates that as of December 31, 1999, approximately 41 Commission-registered broker-dealers were small entities that would be subject to the Trade-Through Disclosure Rule.[228] However, the Commission estimates that none of the 41 registered broker-dealers that would be considered small entities for purposes of the statute regularly represent options orders on behalf of their customers. In addition, the Commission notes that only those broker-dealers that are also options specialists or market makers will be required to comply with the amendments to the Quote Rule. As of December 31, 1999, our data indicates that only one broker-dealer that was a small entity was an options specialist or market maker.

The amendments to the Quote Rule also will directly affect the national securities exchanges that trade listed options, none of which is a small entity as defined by Commission rules. Paragraph (e) of Exchange Act Rule 0–10 [229] states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Exchange Act Rule 11Aa3–1.[230] The amendments to the Quote Rule also will directly affect national securities associations. There is one national securities association, which is not a small entity, as defined by 13 CFR 121.201.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The Trade-Through Disclosure Rule will require a broker-dealer to disclose to its customer at or before the completion of the transaction when an options trade executed for the customer was made at a price inferior to a price published by another exchange. The broker-dealer will not be required to provide such disclosure to its customer if the options trade was executed on an exchange that participates in an approved linkage plan that has rules reasonably designed to limit customers' orders from being executed at prices that are inferior to a published price, even if that better published price is on a market that is not part of the linkage plan.

The amendments to the Quote Rule will require a broker-dealer that is either a specialist or market maker to honor its quote for a size determined and published by the options exchange where the specialist or market maker is quoting. The amendments also will require national securities exchanges and national securities associations either to collect from their members the size associated with their quotes and disseminate that information to quotation venders, or to establish by rule and periodically publish such information.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entity issuers. In connection with adopting the Trade-Through Disclosure Rule and the amendments to the Quote Rule, the Commission considered the following alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rules, or any part thereof, for small entities.

The Commission believes that different compliance or reporting requirements or timetables for small entities would interfere with achieving the primary goals of bolstering investor confidence, assisting broker-dealers in best execution determinations, and providing information as to the various factors affecting the market, including the current levels of buying and selling interest. For example, if all broker-dealers quoting prices in options are not required to comply with the amendments to the Quote Rule, investors and market participants would be unable to determine true buying and selling interest, undermining investor confidence and the ability of a broker-dealer to make best execution decisions. Further, broker-dealers would not be certain that a quote was firm without knowing whether the broker-dealer making the quote is a small broker-dealer. In addition, if all broker-dealers were not obligated to comply with the Trade-Through Disclosure Rule, all investors (those that are customers of small broker-dealers) would not benefit fully from the rule, potentially reducing the benefits of the rule.

For the same reasons, the Commission believes that exempting small entities from the rules, in whole or in part, is not appropriate. In addition, the Commission has concluded that it is not feasible to further clarify, consolidate, or simplify the rules for small entities. The Commission has used performance elements in the rules. Specifically, the rules do not require a broker-dealer to satisfy its obligations in accordance with any specific design, but rather provide each broker-dealer, including small entities, with the flexibility to select the method of compliance that is most efficient and appropriate for its business operations. The Commission does not believe different performance standards for small entities would be consistent with the purpose of the Trade-Through Disclosure Rule and the amendments to the Quote Rule.

Further, the Commission believes that none of the above alternatives is applicable to the amendment with regard to national securities exchanges or national securities associations. The markets are directly subject to the requirements of the rules and are not

[226] *See* 5 U.S.C. 604(a)(2).

[227] 17 CFR 240.0–10(c).

[228] The Commission's estimate of 41 small entities includes all of the registered broker-dealers that do not have relationships with clearing firms.

[229] 17 CFR 240.0–10(e).

[230] Exchange Act Rule 11Aa3–1, 17 CFR 240.11Aa3–1.

''small entities'' because they are all national securities exchanges or national securities associations that do not meet the definition of small entity. Therefore, the Commission does not believe the alternatives to the rules are applicable to the markets.

IX. Statutory Authority

The Commission is adopting the Trade-Through Disclosure Rule and amendments to the Quote Rule pursuant to its authority under Exchange Act Sections 3(b), 5, 6, 15, 11A, 17 (a) and (b), 19, and 23(a).

List of Subjects in 17 CFR Part 240

Brokers-dealers, Fraud, Issuers, Reporting and recordkeeping requirements, Securities.

Text of the Final Rules

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll(d), 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.11Ac1–1 is amended by revising paragraphs (a)(5), (a)(20) and (d); in the second sentence of paragraph (b)(3)(i) by revising the phrase ''under paragraph (c)(2)'' to read ''under paragraphs (c)(2) and (d)(3)'', and adding paragraphs (a)(26), (a)(27), (a)(28), (a)(29), and (a)(30), and (e) to read as follows:

§ 240.11Ac1–1 Dissemination of quotations.

(a) *Definitions.* * * *

(5) The term *consolidated system* means the consolidated transaction reporting system, including a transaction reporting system operating pursuant to an effective national market system plan.

* * * * *

(20) The term *reported security* means any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.

* * * * *

(26) The term *customer* means any person that is not a registered broker-dealer.

(27) The term *listed option* means any option traded on a registered national securities exchange or automated facility of a national securities association.

(28) The term *options class* means all of the put option or call option series overlying a security, as defined in Section 3(a)(10) of the Act (15 U.S.C. 78c(a)(10)).

(29) The term *options series* means the contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions.

(30) The term *trading rotation* means, with respect to an options class, the time period on an exchange during which:

(i) Opening, re-opening, or closing transactions in options series in such options class are not yet completed; and

(ii) Continuous trading has not yet commenced or has not yet ended for the day in options series in such options class.

* * * * *

(d) *Transactions in listed options.*

(1) An exchange or association:

(i) Shall not be required, under paragraph (b) of this section, to collect from responsible brokers or dealers who are members of such exchange or association, or to make available to quotation vendors, the quotation sizes and aggregate quotation sizes for listed options, if such exchange or association establishes by rule and periodically publishes the quotation size for which such responsible brokers or dealers are obligated to execute an order to buy or sell an options series that is a subject security at its published bid or offer under paragraph (c)(2) of this section;

(ii) May establish by rule and periodically publish a quotation size, which shall not be for less than one contract, for which responsible brokers or dealers who are members of such exchange or association are obligated under paragraph (c)(2) of this section to execute an order to buy or sell a listed option for the account of a broker or dealer that is in an amount different from the quotation size for which it is obligated to execute an order for the account of a customer; and

(iii) May establish and maintain procedures and mechanisms for collecting from responsible brokers and dealers who are members of such exchange or association, and making available to quotation vendors, the quotation sizes and aggregate quotation sizes in listed options for which such responsible broker or dealer will be obligated under paragraph (c)(2) of this section to execute an order from a customer to buy or sell a listed option and establish by rule and periodically publish the size, which shall not be less than one contract, for which such responsible brokers or dealers are obligated to execute an order for the account of a broker or dealer.

(2) If, pursuant to paragraph (d)(1) of this section, the rules of an exchange or association do not require its members to communicate to it their quotation sizes for listed options, a responsible broker or dealer that is a member of such exchange or association shall:

(i) Be relieved of its obligations under paragraph (c)(1) of this section to communicate to such exchange or association its quotation sizes for any listed option; and

(ii) Comply with its obligations under paragraph (c)(2) of this section by executing any order to buy or sell a listed option, in an amount up to the size established by such exchange's or association's rules under paragraph (d)(1) of this section.

(3) *Thirty second response.* Each responsible broker or dealer, within thirty seconds of receiving an order to buy or sell a listed option in an amount greater than the quotation size established by an exchange's or association's rules pursuant to paragraph (d)(1) of this section, or its published quotation size must:

(i) Execute the entire order; or

(ii)(A) Execute that portion of the order equal to at least:

(*1*) The quotation size established by an exchange's or association's rules, pursuant to paragraph (d)(1) of this section, to the extent that such exchange or association does not collect and make available to quotation vendors quotation size and aggregate quotation size under paragraph (b) of this section; or

(*2*) Its published quotation size; and

(B) Revise its bid or offer.

(4) Notwithstanding paragraph (d)(3) of this section, no responsible broker or dealer shall be obligated to execute a transaction for any listed option as provided in paragraph (c)(2) of this section if:

(i) Any of the circumstances in paragraph (c)(3) of this section exist; or

(ii) The order for the purchase or sale of a listed option is presented during a trading rotation in that listed option.

(e) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, exchange, or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

3. Section 240.11Ac1–4 is amended by revising paragraph (a)(10) to read as follows:

§ 240.11Ac1–4 Display of customer limit orders.

(a) *Definitions.* * * *

(10) The term *reported security* means any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.

* * * * *

4. Section 240. 11Ac1–7 is added to read as follows:

§ 240.11Ac1–7 Trade-through disclosure rule.

(a) *Definitions.* For purposes of this section:

(1) The term *block trade* means a transaction in an option series that is for 500 or more contracts and has a premium value of at least $150,000.

(2) The term *customer* means any person that is not a registered broker-dealer.

(3) The term *effective national market system plan* shall have the meaning provided in § 240.11Aa3–2.

(4) The term *listed option* means any option traded on a registered national securities exchange or automated facility of a national securities association.

(5) The term *options class* means all of the put option or call option series overlying a security, as defined in Section 3(a)(10) of the Act (15 U.S.C. 78c(a)(10)).

(6) The term *options series* means the contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions.

(7) The term *receipt* means, with respect to an order sent to an away market displaying a superior price, the time at which the order is either represented in the trading crowd or received by the specialist.

(b) *Broker-dealer disclosure requirements.* (1) Any broker or dealer that effects a transaction in a listed option for the account of its customer must disclose in writing to such customer, at or before completion of such transaction, as defined in § 240.15c1–1:

(i) When such transaction is effected at a price that trades through a better price published at the time of execution; and

(ii) That better published price.

(2) A broker-dealer shall not be required to provide the disclosure set forth in paragraph (b)(1) of this section if:

(i) It effects such transaction on a market that is a sponsor or participant in an effective national market system options linkage plan that includes provisions reasonably designed to limit the incidence of customer orders being executed at prices that trade through a better published price, including prices published other than by a linkage plan sponsor or participant, or

(ii) The customer order is executed as part of a block trade.

(3) A customer order is executed at a price that trades through a better published price if:

(i) The price at which an order to purchase a listed option is executed is higher than the lowest offer, at the time the order was executed, published pursuant to a national market system plan for reporting quotations in listed options; or

(ii) The price at which an order to sell a listed option is executed is lower than the highest bid, at the time the order was executed, published pursuant to a national market system plan for reporting quotations in listed options.

(4) Notwithstanding paragraph (b)(3) of this section, a customer order is not considered to be executed at a price that trades through a better published price if:

(i) The market on which the order is executed has verified that the market publishing such better price is experiencing a failure, material delay, or malfunction of its systems;

(ii) The quotations disseminated pursuant to the national market system plan for reporting quotations indicates that it is experiencing delays in transmitting such quotations;

(iii) Such better published price was published by an exchange whose members are relieved of their obligations under paragraph (c)(2) of § 240.11Ac1–1 because, pursuant to paragraphs (b)(3) or (d)(4) of § 240.11Ac1–1, such exchange is not required to meet its obligations under paragraph (b)(1) of § 240.11Ac1–1; or

(iv) The customer order is executed only after the market publishing the better price fails to respond to an order routed to it within 30 seconds of the order's receipt by that market.

(c) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any broker or dealer if the Commission determines that such exemption is consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets, or the removal of impediments to and perfection of the mechanism of a national market system.

Dated: November 17, 2000.

By the Commission.

Jonathan G. Katz,

Secretary.

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