

change is consistent with Section 6(b)(5) of the Act⁹ because it provides objective criteria and well-defined procedures for: (1) Disengaging and reengaging AUTO-X, which should increase the likelihood that AUTO-X will not be disengaged in a discriminatory manner; and (2) excluding another market's quote from the PCX's NBBO, which should increase the likelihood that PCX's NBBO will more accurately reflect the actual state of the market at a given time. Specifically, the Commission notes that the determination of a Floor Official to exclude unreliable quotes is limited to circumstances in which the away market has either directly communicated or confirmed that its quotes are unreliable. In this way, the discretion afforded to PCX officials to determine that another market's options quotes are unreliable is appropriately limited. Moreover, the record keeping requirements and other proposed procedures are not unreasonable.

IV. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,¹⁰ that the proposed rule change (SR-PCX-2001-13), as amended by Amendment No. 1, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹¹

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-45937; File No. SR-PCX-2002-13)

Self-Regulatory Organization; Order Approving Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Priority of Bids and Offers on the Options Floor and the Manner in Which Orders Must Be Allocated in Connection With Options Transactions

May 15, 2002.

I. Introduction

On February 15, 2002, the Pacific Exchange, Inc. ("PCX" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a

proposed rule change relating to priority of bids and offers on the options floor and the manner in which orders must be allocated in connection with options transactions. On March 12, 2002, the PCX submitted Amendment No. 1 to the proposed rule change. The proposed rule change, as amended, was published for comment in the **FEDERAL REGISTER** on April 2, 2002.³ The Commission received no comments on the proposed rule change. This order approves the proposed rule change.

II. Description of Proposal

The PCX is proposing to adopt new rules, and to amend existing rules, to include practices and procedures whereby option orders are allocated on the Exchange's Options Trading Floor to address situations where the rules are currently silent. This rule filing is being submitted to the Commission pursuant to subparagraph IV.B.j. of the Commission's Order of September 11, 2000.⁴

The proposed rule change includes provisions that concern several areas, as described below:

a. Obligations of Market Makers

The Exchange is proposing to adopt new PCX Rule 6.37(e)(2), which would prohibit any practice or procedure whereby Market Makers trading any particular option issue determine by agreement the allocation of orders that may be executed in that issue.

b. Simultaneous Bids and Offers

Currently, PCX Rule 6.75(a) provides that the highest bid has priority, but where two or more bids for the same option contract represent the highest price and one is displayed by the Order Book Official, that bid receives priority over any other bid at the post. If two or more bids represent the highest price and a bid displayed by an Order Book Official is not involved, the rule provides that priority is afforded to those bids in the sequence in which they are made. PCX Rule 6.75(b) applies the same priority principles to offers.

The Exchange is now proposing to adopt new PCX Rule 6.75(c), entitled "Simultaneous Bids and Offers." This proposed provision states that, except as

otherwise provided, if the bids (or offers) of two or more members are made simultaneously, or if it is impossible to determine clearly the order of time in which they were made, such bids (or offers) will be deemed to be on parity and priority will be afforded to them, insofar as practicable, on an equal basis.

c. Order Allocation Procedures

1. In General: Determination of Priority Sequence

Proposed PCX Rule 6.75(f)(1) states that a Floor Broker is responsible for determining the sequence in which bids or offers are vocalized on the Trading Floor in response to the Floor Broker's bid, offer, or call for a market. It further states that any disputes regarding a Floor Broker's bid, offer, or call for a market. It further states that any disputes regarding a Floor Broker's determination of time priority sequence will be resolved by the Order Book Official, provided that such determinations of the Order Book Official are subject to further review by two Floor Officials, pursuant to PCX Rule 6.77.

Proposed PCX Rule 6.75(f)(2) provides that when a Floor Broker's bid or offer has been accepted by more than one member, that Floor Broker must designate the members who were first, second, third, and so forth. It further states that, except as otherwise provided, the member with first priority is entitled to buy or sell as many contracts as the Floor Broker may have available to trade. If there are any contracts remaining, the member with second priority will be entitled to buy or sell as many contracts as there are remaining in the Floor Broker's order, and so on, until the Floor Broker's order has been filled entirely.

Proposed PCX Rule 6.75(f)(3) provides that a Market Maker is responsible for determining the sequence in which bids and offers are vocalized on the Trading Floor in response to that Market Maker's bid, offer, or call for a market. Likewise, an Order Book Official is responsible for determining the sequence in which bids and offers are vocalized on the Trading Floor in response to the Order Book Official's bid, offer, or call for a market. The proposed rule further provides that the order allocation procedures for Market Makers and Order Book Officials, including the determination of time priority sequence, are the same as those for Floor Brokers as set forth in proposed PCX Rule 6.75(f)(1) as described above.

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ *Id.*

¹¹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

³ See Securities Exchange Act Release No. 45634 (March 22, 2002), 67 FR 15649 (April 2, 2002) ("Notice"). Although the Notice stated that the date of filing of the proposed rule change was February 19, 2002, the proposal was deemed filed on February 15, 2002.

⁴ See Order Instituting Public Administrative Proceedings Pursuant to section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Securities Exchange Act Release No. 43268 (September 11, 2000).

2. LMM Guaranteed Participation

Proposed PCX Rule 6.75(f)(4)(A) provides that if a Lead Market Maker ("LMM") establishes first priority during the vocalization process, the LMM will be entitled to buy or sell as many contracts as the Floor Broker may have available to trade. However, if the LMM does not establish first priority during the vocalization process, but does establish second, third, or some other time priority sequence, the LMM will be entitled to buy or sell the number of contracts equal to the LMM's guaranteed participation level (pursuant to PCX Rule 6.82(d)(2)) plus any contracts the Floor Broker has remaining after the bids or offers of other members with higher time priority than the LMM have been satisfied.

Proposed PCX Rule 6.75(f)(4)(B) provides that if one or more orders in the limit order book have priority over an LMM's bid or offer, then the LMM's guaranteed participation level will apply only to the number of contracts remaining after all contracts in the limit order book that are at, or better than, the LMM's bid or offer have first been satisfied.

Proposed PCX Rule 6.75(f)(4)(C) provides that LMMs may waive some or all of their guaranteed participation on particular trades, but only to the extent that doing so is permissible under PCX Rule 6.86 ("Firm Quotes"). In such circumstances, if the LMM has waived the right to trade a certain number of option contracts, those option contracts will then become available for execution by the member (or members) who are next in priority sequence.

Proposed PCX Rule 6.75(f)(4)(D) provides that LMMs may direct some or all of their guaranteed participation to competing public orders in the trading crowd pursuant to PCX Rule 6.82(d).

Proposed PCX Rule 6.75(f)(4)(E) provides that bid and offering prices that are disseminated by an automatic quotation system are presumed to be the bid and offering prices of the LMM for purposes of PCX Rule 6.86 ("Firm Quotes") and PCX Rule 6.82(d)(2) ("Guaranteed Participation"). Nevertheless, LMMs must vocalize all of their bids and offers in response to a call for a market and in acceptance of another member's bid or offer. If a Floor Broker enters the trading crowd and vocalizes acceptance of a bid or offer that is then being disseminated, the LMM will be entitled to guaranteed participation on that transaction.

3. Parity Due to Simultaneous Bidding or Offering

Proposed PCX Rule 6.75(f)(5)(A) states that if the bids or offers of more than

one member are made simultaneously, such bids or offers will be deemed to be on parity and priority will be afforded to them, insofar as practicable, on an equal basis, pursuant to PCX Rule 6.75(c). Accordingly, the proposed rule change states that efforts will be made to assure that each member on parity receives an equal number of contracts, to the extent mathematically possible. One or more members on parity may waive their rights to some of their share (or shares) of contracts, but only to the extent that doing so is permissible under PCX Rule 6.86 ("Firm Quotes"). In such circumstances, the remaining number of contracts will be allocated, to the extent practicable, on an equal basis. However, an LMM who has received guaranteed participation on a transaction may not participate in the waived portion of the order unless there are contracts remaining to be allocated after all other members have been satisfied.

Proposed PCX Rule 6.75(f)(5)(B) provides that if the bids and offers of more than one member, including the LMM, are on parity, then the LMM's guaranteed participation will first be applied to the entire order and the remainder of the order will be allocated, to the extent practicable, on an equal basis among the members other than the LMM who are on parity. The LMM may participate in such remainder of the order only if there are contracts remaining after all members other than the LMM have first been satisfied.

Proposed PCX Rule 6.75(f)(5)(C) states that if the LMM waives priority or guaranteed participation when the LMM and one or more other members are on parity, then the portion of the order that the LMM has waived will be made available to the other members who are on parity.

4. Size Pro Rata Allocations (Collective Response Situations)

Proposed Rule 6.75(f)(6) states that if the members of the trading crowd provide a collective response to a member's request for a market in order to fill a large order, pursuant to PCX Rule 6.37(f)(2), then if the size of the trading crowd's market, in the aggregate, is less than or equal to the size of the order to be filled, the members of the trading crowd will each receive a share of the order that is equal to the size of their respective bids or offers. However, if the size of the trading crowd's market exceeds the size of the order to be filled, that order will be allocated on a size rata basis, with the members of the trading crowd each receiving, to the extent practicable, the percentage of the order that is the ratio of the size of their

respective bids or offers to the total size of all bids or offers.

d. Procedures of Lead Market Makers

PCX Rule 6.82(d)(2) currently provides, in part, that LMMs at their own discretion may direct their guaranteed participation to competing public orders in the crowd. The Exchange is proposing to modify this provision to provide that LMMs may direct "some or all" of their guaranteed participation to competing public orders (i.e., competing orders for the accounts of non-broker-dealers) in the crowd.

PCX Rule 6.82(d)(2) currently provides, in part, that LMMs "shall be allocated 50% participation in transactions occurring at their disseminated bids and/or offers in their allocated issue(s)." The Exchange is proposing to amend this rule so that it provides that LMMs "shall be allocated 50% participation (or such lesser percentage as the Options Allocation Committee may establish in allocating an issue to an LMM) in transactions occurring at their disseminated bids and/or offers in their allocated issues."

Finally, PCX Rule 6.82(e)(2)(a) currently provides, in part, that LMMs "shall have a right to participate pro rata with the trading crowd in trades that take place at the LMM's principal bid or offer." The Exchange is proposing to modify this provision to state that LMMs "have a right to participate with the trading crowd in trades that take place at the LMM's principal bid or offer, pursuant to the priority rule set forth in PCX Rule 6.75."

III. Discussion

After careful consideration, the Commission has determined to approve the proposed rule change.⁵ For the reasons discussed below, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. Specifically, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act.⁶

⁵ In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁶ 15 U.S.C. 78f(b)(5). Section 6(b)(5) of the Act requires that the rules of an exchange, among other things, be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest; and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission believes that the proposed provision concerning "Obligations of Market Makers," which prohibits agreements among Market Makers with respect to the allocation of trades, should help to preclude anti-competitive conduct and prevent fraudulent and manipulative acts and practices.

The Commission believes further that the proposed provision concerning "Simultaneous Bids and Offers" fills a significant gap in the Exchange's current rules by setting forth the method for allocating an order among market participants in situations when their competing bids or offers are made simultaneously, or when the sequence in which their bids or offers were made cannot be clearly determined. In the Commission's view, the proposed rule change establishes a fair and equitable manner of apportioning an order in these situations by providing that the bids or offers will be deemed to be an parity, so that each maker receives, as far as practicable, an equal share of the order.

With respect to "Order Allocation Procedures," the Commission believes that the proposed rule change provides an important clarification by specifying the market participant with responsibility for determining the time priority sequence of bids and offers vocalized on the Trading Floor in response to a bid, offer, or call for a market. As discussed above, the proposed rule change assigns this duty to the Floor Broker, the Order Book Official, or Market Maker to whose bid, offer, or call for a market the participants responded. The Commission believes that this is a reasonable method of assigning responsibility for allocating a trade, particularly because the market participant who initiated the bid, offer, or call for a market is the best position to determine the identity and sequence of who responded.

The Commission notes that the proposal also provides for the resolution of disputes regarding the determination of time priority sequence, which should contribute to fair allocation of orders. The PCX also has represented that it has the ability to determine the identity of the individual who allocated a particular trade,⁷ and the Commission believes that the ability to identify such individuals is important to the Exchange's ability to monitor for violation of Exchange allocation rules.

The Commission notes that the provisions of the proposed rule change concerning the "LMM Guaranteed

Participation" provide a more specific description of how this guaranteed participation is to be applied than that provided in the PCX's current rules. Among other things, the proposal specifies that the LMM Guaranteed Participation applies only to the number of contracts remaining after all customer orders in the limit order book have first been satisfied. Although PCX Rule 6.82(d)(2) already provides that public order placed in the book take priority over the LMM guarantee, the Commission believes that the new provision is an important clarification of the Exchange's rules regarding application of the LMM guarantee.

Existing PCX Rule 6.82(d)(2) provides that the LMM Guaranteed Participation applies in "transaction occurring at the [LMMs'] disseminated bids and/or offers." The proposal fills in a significant gap in the Exchange's current rules, in the Commission's view, by clarifying that prices disseminated by an automatic quotation system are presumed to be the prices of the LMM so as to qualify the LMM for the Guaranteed Participation. The proposed rule change also establishes that the prices disseminated by an automatic quotation system are presumed to be the bid and offer of the LMM for purposes of PCX Rule 6.86 on "Firm Quotes."⁸ The proposal further states that LMMs must nevertheless vocalize all their bids or offers in response to a call for a market or in acceptance of a bid or offer that is being disseminated. In the Commission's view, this requirement is appropriate to harmonize the proposed rule change with the PCX's other rules on vocalization.

The Commission also believes that it is reasonable to permit members and LMMs to waive all or some of their share of contracts, as provided in the proposed provisions concerning "Parity Due to Simultaneous Bidding or Offering," consistent with the PCX's rule on firm quote obligations. The Commission further believes that it is fair and equitable to allocate such waived contracts among the other members on parity on an equal basis, to

the extent practicable, as the proposed rule change provides.⁹

The Commission notes that, as made clear by the proposal, an LMM who has received a guaranteed participation may not participate in the waived portion of an order unless there are remaining contracts to be allocated after all other members have been satisfied. Similarly, the proposed rule change clarifies generally that when one or more members are on parity with the LMM, after the LMM receives its Guaranteed Participation, the LMM is not entitled to a share in the remainder of the order with the other members unless all such other members have been satisfied. The Commission believes that these provisions will help assure fair allocation of orders and maintain a competitive environment on the Exchange.

As detailed above, the proposed rule change also clarifies how orders are allocated in the situation where members of the trading crowd provide a collective response to a member's request for a market in order to fill a large order pursuant to PCX Rule 6.37(f)(2).¹⁰ In the Commission's view, allocating participating members their respective sizes when their aggregate size is less than or equal to the size of the order, and allocating them their shares on a pro rata basis when their aggregate size exceeds the size of the order, is a reasonable way to apportion participation in such trades.

With respect to "Procedures of Lead Market Makers," the Commission believes that it is reasonable to amend PCX Rule 6.82(d)(2) to give the Options Allocation Committee the ability to reduce the LMM Guaranteed Participation percentage from the maximum permitted under PCX Rule 6.82(d) when it allocates an issue to an LMM. The Commission notes that subparagraphs (A) and (B) of Rule 6.82(d)(2) already permit the Committee to reduce the LMM guarantee under certain conditions.

The additional amendment clarifying that an LMM may direct *some* of its participation to a public order in the crowd—not just all of it, as the current rules implies—is reasonable, in the

⁸ The Commission notes that PCX Rule 6.86 provides that "with respect to any bid or offer for any listed option made available by the Exchange to quotation vendors, the Lead Market Maker and any registered Market Makers constituting the trading crowd in such option series will collectively be the Responsible Broker or Dealer to the extent of the aggregate quotation size specified." Accordingly, if the Exchange's quotation is established by an automatic quotation system, such quotation is the quotation of all members of the crowd.

⁹ The Commission notes that the proposed rules on the LMM Guaranteed Participation provide that if the LMM waives some of that participation, the contracts will become available to the members who are next in the priority sequence. The Commission believes this, too, is a reasonable allocation method that conforms with the time priority principles reflected elsewhere in the PCX's rules.

¹⁰ See Securities Exchange Act Release No. 45578 (March 15, 2002), 67 FR 13393 (March 22, 2002) (SR-PCX-2001-50).

⁷ See Notice, *supra* note 3, at n.6.

Commission's view, as it conforms with the original purpose of this provision.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹¹ that proposed rule change (SR-PCX-2002-13) be, and hereby is, approved.

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

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45931; File No. SR-Phlx-2001-35]

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Granting Approval To Proposed Rule Change, As Amended By Amendment Nos. 1, 2, 3, 4, and 5 Thereto, Relating To Providing Automatic Executions For Public Customer Orders When Another Market Is Disseminating Quotes Deemed Not To Be Reliable

May 15, 2002.

I. Introduction

On March 12, 2001, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change³ relating to providing automatic executions for public customer orders at the national best bid or offer ("NBBO"). On September 19, 2001, January 11, 2002, March 1, 2002, March 8, 2002,

and April 3, 2002, Phlx submitted Amendment Nos. 1,⁴ 2,⁵ 3,⁶ 4,⁷ and 5,⁸ respectively. The proposed rule change, as amended by Amendment Nos. 1, 2, 3, 4, and 5, was published for comment in the **Federal Register** on April 15, 2002.⁹ The Commission received no comments on the amended proposal. This order approves the proposed rule change, as amended by Amendment Nos. 1, 2, 3, 4, and 5.

II. Description of the Proposal

The Phlx proposes to permit the Exchange to exclude from the calculation of the NBBO certain quotes from other markets that are deemed not to be reliable.¹⁰ Upon the request of a specialist, the Chairman of the Options Committee or his designee¹¹ (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials) would be authorized to determine that quotes in specified options or series of options or in respect of specified markets are not reliable under any of the following circumstances: notification from another market that its quotes are not firm or are

unreliable; administrative message from OPRA indicating that another market's quotes are unreliable; receipt of quotes from another market designated as "not firm" using the appropriate indicator; and/or telephonic or electronic inquiry to, and verification from, another market that its quotes are not firm.

The Exchange would be permitted to determine to exclude quotes from its calculation of the NBBO on a series-by-series basis or issue-by-issue basis, or would be permitted to determine to exclude all options quotes from an exchange, where appropriate.¹²

Phlx also proposes to amend the rule text to require the Exchange to maintain a record of each instance in which another exchange's quotes are excluded from the Exchange's calculation of the NBBO, and to notify such other exchange that its quotes have been so excluded.¹³

In addition, Phlx proposes to amend the rule text to provide that documentation of each instance in which another exchange's quotes are excluded from the Exchange's calculation of NBBO shall include: identification of the option(s) affected by such action; the date and time such action was taken and concluded; identification of the other exchange(s) whose quotes were excluded from the Exchange's calculation of NBBO; identification of the Chairman of the Options Committee, his designee, or two Floor Officials (as applicable) who approved such action; the reasons for which such action was taken; and identification of the specialist and the specialist unit. The Exchange would maintain these documents pursuant to the record retention requirements of the Act and the rules and regulations thereunder.¹⁴ The Chairman of the Options Committee or his designee (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials), would be authorized to determine that quotes in options on the Exchange or other markets previously deemed not to be reliable are again reliable, and such quotations would again be included in the calculation of NBBO for such options.

Such determination would be permitted to be made by way of notification from another market that its quotes are firm; administrative message from OPRA indicating that another market's quotes are no longer unreliable; and/or telephonic or electronic inquiry to, and verification from, another market

¹¹ 15 U.S.C. 78s(b)(2).

¹² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Exchange filed this proposed rule change pursuant to the requirements of Section IV.B.h.(i)(bb) of the Commission's September 11, 2000 Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Act, which required the Phlx (as well as the other floor-based options exchanges) to adopt new, or amend existing, exchange rules concerning automatic quotation and execution systems which specify the circumstances, if any, by which automatic execution systems would be disengaged or operated in any manner other than the normal manner set forth in the exchange's rules; and, requires the documentation of the reasons for each decision to disengage an automatic execution system or operate it in any manner other than the normal manner. See Securities Exchange Act Release No. 43268 (September 11, 2000), Administrative Proceeding File No. 3-10282.

⁴ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated September 18, 2001 ("Amendment No. 1").

⁵ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated January 11, 2002 ("Amendment No. 2"). Amendment No. 2 supersedes and replaces Amendment No. 1 in its entirety.

⁶ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated February 28, 2002 ("Amendment No. 3").

⁷ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated March 7, 2002 ("Amendment No. 4").

⁸ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated April 2, 2002 ("Amendment No. 5").

⁹ See Securities Exchange Act Release No. 45713 (April 9, 2002), 67 FR 18292 (April 15, 2002).

¹⁰ Under current Exchange rules, certain AUTO-X eligible orders may be automatically executed at the NBBO disseminated by another options exchange, provided that the NBBO is not better than the specialist's best bid/offer by a predetermined "step-up parameter." The enhancement is known as the "NBBO Step-Up Feature." The NBBO Step-Up Feature would execute AUTO-X eligible orders at the NBBO for certain options designated by the Options Committee as eligible for the NBBO Step-Up Feature, called "automatic step-up options." See Exchange Rule 1080(c)(i). This proposal would apply to all situations in which the NBBO Step-Up Feature was not engaged. The Commission, in a separate order, is approving a related proposed rule change regarding the exclusion of certain quotes from the Phlx's calculation of the NBBO when the NBBO Step-Up Feature is engaged. See Securities Exchange Act Release No. 45932 (May 15, 2002) (File No. SR-Phlx-00-93).

¹¹ Such designee must be a member of the Options Committee.

¹² See Amendment No. 3, *supra* note 6.

¹³ See Amendment No. 4, *supra* note 7.

¹⁴ See Amendment No. 5, *supra* note 8.