

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47027; File No. 4-429]

### Joint Industry Plan; Notice of Filing of Amendment to the Options Intermarket Linkage Plan To Provide a Process for Potential New Options Exchanges To Have Interim Access to Linkage Information

December 18, 2002.

Pursuant to section 11A of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and rule 11Aa3-2 thereunder,<sup>2</sup> notice is hereby given that on November 8, 2002, November 14, 2002, November 15, 2002, November 26, 2002, and December 6, 2002, the Philadelphia Stock Exchange, Inc. ("Phlx"), International Securities Exchange LLC ("ISE"), Chicago Board Options Exchange, Inc. ("CBOE"), American Stock Exchange LLC ("Amex"), and Pacific Exchange, Inc. ("PCX") (collectively the "Participants") respectively submitted to the Securities and Exchange Commission ("SEC" or "Commission") Amendment No. 5 to the Options Intermarket Linkage Plan (the "Linkage Plan").<sup>3</sup> The amendment proposes to provide a process for potential new options exchanges to have interim access to Linkage information to help such exchanges prepare to join the Linkage. The Commission is publishing this notice to solicit comments from interested persons on the proposed Linkage Plan amendment.

#### I. Description and Purpose of the Amendment

Currently, the Plan allows a new exchange to join the Linkage by executing the Plan, filing an amendment to the Plan including themselves as a participant, and paying the then-applicable participation fee. Thus, the Plan provides new entrants with the ability to join the Linkage unilaterally, without requiring any action by the current Participants.

However, before an exchange can join the Linkage, it first must be a participant exchange in The Options Clearing

Corporation and be a party to the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information ("OPRA Plan").<sup>4</sup> This effectively requires that the applicant exchange have effective rules for the trading of options approved by the Commission. While this is a reasonable requirement for full participation in the Linkage, the Participants acknowledge that this structure does not recognize that exchanges proposing to develop an options market reasonably need access to Linkage information, particularly technical information, in order to build their market and prepare for Linkage participation. The proposed amendment will provide conditional interim access to Linkage information.

The Participants anticipate that a new entrant will require the existing Participants to spend considerable time working with an applicant on both technical and policy issues. Accordingly, the proposed amendment includes certain requirements as a safeguard to limit access to serious applicants fully committed to pursuing the development of an options market. Specifically, an applicant will have access to Linkage documentation, testing and other necessary Linkage facilities upon the Commission having published for comment the applicant's proposed rules governing the trading of standardized options. The applicant also must affirm that it is seriously pursuing the establishment of an options market and must pay a refundable deposit towards the participation fee. Once an applicant is granted interim access, such access will remain in effect for one year. If the applicant has not yet joined the Linkage after this time period, it can request an additional period of access, and the Linkage participants will not unreasonably deny such a request.

<sup>4</sup> OPRA is a national market system plan approved by the Commission pursuant to section 11A of the Exchange Act, 15 U.S.C. 78k-1, and rule 11Aa3-2 thereunder, 17 CFR 240.11Aa3-2. See Securities Exchange Act Release No. 17638 (March 18, 1981). The OPRA Plan provides for the collection and dissemination of last sale and quotation information on options that are traded on the participant exchanges. The five signatories to the OPRA Plan that currently operate an options market are the American Stock Exchange, the Chicago Board Options Exchange ("CBOE"), the International Securities Exchange ("ISE"), the Pacific Exchange, and the Philadelphia Stock Exchange. The New York Stock Exchange is a signatory to the OPRA Plan, but sold its options business to the Chicago Board Options Exchange in 1997. See Securities Exchange Act Release No. 38542 (April 23, 1997), 62 FR 23521 (April 30, 1997).

#### II. Implementation of the Plan Amendment

The Participants intend to make the proposed amendment to the Linkage Plan reflected in this filing effective when the Commission approves the amendment.

#### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed Linkage Plan amendment is consistent with the Act. Persons making written submission should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed Linkage Plan amendment that are filed with the Commission, and all written communications relating to the proposed Linkage Plan amendment between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filings will also be available for inspection and copying at the principal offices of the Amex, CBOE, ISE, Phlx, and PCX. All submissions should refer to File No. 4-429 and should be submitted by January 16, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47029; File No. SR-ISE-2002-19]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by International Securities Exchange, Inc., Relating to Rules Governing the Intermarket Linkage

December 18, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on

<sup>5</sup> 17 CFR 200.30-3(a)(29).

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

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

<sup>1</sup> 15 U.S.C. 78k-1.

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

<sup>3</sup> On July 28, 2000, the Commission approved a national market system plan for the purpose of creating and operating an intermarket options market linkage proposed by the Amex, CBOE, and ISE. See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000). Subsequently, upon request by the Phlx and PCX, the Commission issued orders to permit these exchanges to participate in the Linkage Plan. See Securities Exchange Act Release Nos. 43573 (November 16, 2000), 65 FR 70850 (November 28, 2000) and 43574 (November 16, 2000), 65 FR 70851 (November 28, 2000).

September 24, 2002, the International Securities Exchange, Inc. ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which items have been prepared by the self-regulatory organization.

The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The ISE is proposing to adopt new Chapter 19 of its rules, governing the operation of the intermarket linkage (the "Linkage"). The Linkage Rules will become effective once the Commission approves this filing and as the Exchange implements the operation of the applicable provisions of the Linkage. For example, the provisions of Chapter 19 regarding order protection will not become effective until the Exchange implements the Linkage operations governing Satisfaction Orders (as defined in Chapter 19 of the Rules) and trade-through processing. Below is the text of the proposed rule change; proposed new text is italicized.

\* \* \* \* \*

#### **Chapter 19**

##### *Intermarket Linkage*

##### **Rule 1900. Definitions**

*The following terms shall have the meaning specified in this Rule solely for the purpose of this Chapter 19:*

(1) "Aggrieved Party" means a member of a Participant Exchange whose bid or offer was traded-through.

(2) "Block Trade" means a trade on a Participant Exchange that:

(i) involves 500 or more contracts and has a premium value of at least \$150,000;

(ii) is effected at a price outside of the NBBO; and

(iii) involves either:

(A) a cross (where a member of the Participant Exchange represents all or a portion of both sides of the trade), or

(B) any other transaction i.e., in which such member represents an order of block size on one side of the transaction only) that is not the result of an execution at the current bid or offer on the Participant Exchange.

Contemporaneous transactions at the same price on a Participant Exchange shall be considered a single transaction for the purpose of this definition.

(3) "Complex Trade" means the execution of an order in an option series

*in conjunction with the execution of one or more related orders(s) in different options series in the same underlying security occurring at or near the same time for the equivalent number of contracts and for the purpose of executing a particular investment strategy.*

(4) "Crossed Market" means a quotation in which the Exchange disseminates a bid (offer) in a series of an Eligible Option Class at a price that is greater than (is less than) the price of the offer (bid) for the series then being displayed from another Participant Exchange.

(5) "Eligible Market Maker," with respect to an Eligible Option Class, means a market maker that:

(i) is assigned to, and is providing two-sided quotations in, the Eligible Option Class; and

(ii) is in compliance with the requirements of Rule 1904.

(6) "Eligible Option Class" means all option series overlying a security (as that term is defined in Section 3(a)(10) of the Exchange Act) or group of securities, including both put options and call options, which class is traded on the Exchange and at least one other Participant Exchange.

(7) "Firm Customer Quote Size" with respect to a P/A Order means the lesser of: (a) the number of option contracts that the Participant Exchange sending a P/A Order guarantees it will automatically execute at its disseminated quotation in a series of an Eligible Option Class for Public Customer orders entered directly for execution in that market; or (b) the number of option contracts that the Participant Exchange receiving a P/A Order guarantees it will automatically execute at its disseminated quotation in a series of an Eligible Option Class for Public Customer orders entered directly for execution in that market. This number shall be at least 10.

(8) "Firm Principal Quote Size" means the number of options contracts that a Participant Exchange guarantees it will execute at its disseminated quotation for incoming Principal Orders in an Eligible Option Class. This number shall be 10.

(9) "Linkage" means the systems and data communications network that link electronically the Participant Exchanges for the purposes specified in the Plan.

(10) "Linkage Order" means an order routed through the Linkage as permitted under the Plan. There are three types of Linkage Orders:

(i) "Principal Acting as Agent ("P/A") Order," which is an order for the principal account of a Primary Market Maker (or equivalent entity on another

Participant Exchange that is authorized to represent Public Customer orders), reflecting the terms of a related unexecuted Public Customer order for which the Primary Market Maker is acting as agent;

(ii) "Principal Order," which is an order for the principal account of a market maker (or equivalent entity on another Participant Exchange) and is not a P/A Order; and

(iii) "Satisfaction Order," which is an order sent through the Linkage to notify a Participant Exchange of a Trade-Through and to seek satisfaction of the liability arising from that Trade-Through.

(11) "Locked Market" means a quotation in which the Exchange disseminates a bid (offer) in a series of an Eligible Option Class at a price that equals the price of the offer (bid) for the series then being displayed from another Participant Exchange.

(12) "NBBO" means the national best bid and offer in an options series as calculated by a Participant Exchange.

(13) "Non-Firm" means, with respect to quotations, that members of a Participant Exchange are relieved of their obligation to be firm for their quotations pursuant to Rule 11Ac1-1 under the Exchange Act.

(14) "Participant Exchange" means a registered national securities exchange that is a party to the Plan.

(15) "Plan" means the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage, as such plan may be amended from time to time.

(16) "Reference Price" means the limit price attached to a Linkage Order by the sending Participant Exchange. Except with respect to a Satisfaction Order, the Reference Price is equal to the bid disseminated by the receiving Participant Exchange at the time that the Linkage Order is transmitted in the case of a Linkage Order to sell and the offer disseminated by the receiving Participant Exchange at the time that the Linkage Order is transmitted in the case of a Linkage Order to buy. With respect to a Satisfaction Order, the Reference Price is the bid or offer price reflecting order(s) of Public Customers disseminated by the sending Participant Exchange that was traded through, except in the case of a Trade-Through that is a Block Trade, in which case the Reference Price shall be the price of the Block Trade that caused the Trade-Through.

(17) "Trade-Through" means a transaction in an option series at a price that is inferior to the NBBO.

(18) "Third Participating Market Center Trade-Through" means a Trade-

Through in a series of an Eligible Option Class that is effected by executing a Linkage Order, and such execution results in a sale (purchase) at a price that is inferior to the best bid (offer) being disseminated by another Participant Exchange.

(19) "Verifiable Number of Customer Contracts" means the number of Public Customer contracts in the book of a Participant Exchange.

#### Rule 1901. Operation of the Linkage

By subscribing to the Plan, the Exchange has agreed to comply with, and enforce compliance by its Members with, the Plan. In this regard, the following shall apply:

(a) Pricing. Members may send P/A Orders and Principal Orders through the Linkage only if such orders are priced at the NBBO.

##### (b) P/A Orders.

(1) Sending of P/A Orders for Sizes No Larger than the Firm Customer Quote Size. A Primary Market Maker may send through the Linkage a P/A Order for execution in the automatic execution system of a Participant Exchange if the size of such P/A Order is no larger than the Firm Customer Quote Size. Except as provided in subparagraph (b)(2)(ii) below, a Primary Market Maker may not break up an order of a Public Customer that is larger than the Firm Customer Quote Size into multiple P/A Orders, one or more of which is equal to or smaller than the Firm Customer Quote Size, so that such orders could be represented as multiple P/A Orders through the Linkage.

(2) Sending of P/A Orders for Sizes Larger than the Firm Customer Quote Size. If the size of a P/A Order is larger than the Firm Customer Quote Size, a Primary Market Maker may send through the Linkage such P/A Order in one of two ways:

(i) The Primary Market Maker may send a P/A Order representing the entire Public Customer order. If the receiving Participant Exchange's disseminated quotation is equal to or better than the Reference Price when the P/A Order arrives at that market, that exchange will execute the P/A Order at its disseminated quotation for at least the Firm Customer Quote Size. Within 15 seconds of receipt of such order, the receiving Participant Exchange will inform the Primary Market Maker of the amount of the order executed and the amount, if any, that was canceled.

(ii) Alternatively, the Primary Market Maker may send an initial P/A Order for the Firm Customer Quote Size pursuant to subparagraph (b)(1) above. If the Participant Exchange executes the P/A Order and continues to disseminate the

same quotation at the NBBO 15 seconds after reporting the execution of the initial P/A Order, the Primary Market Maker may send an additional P/A Order to the same Participant Exchange. If sent, such additional P/A Order must be for at least the lesser of 100 contracts or the entire remainder of the Public Customer order.

In any situation where a receiving Participant Exchange does not execute a P/A Order in full, such exchange is required to move its quotation to a price inferior to the Reference Price of the P/A Order.

##### (c) Principal Orders.

(1) Sending of an Initial Principal Order. An Eligible Market Maker may send a Principal Order through the Linkage at a price equal to the NBBO. Subject to the next paragraph, if the Principal Order is not larger than the Firm Principal Quote Size, the receiving Participant Exchange will execute the order in its automatic execution system, if available, if its disseminated quotation is equal to or better than the price specified in the Principal Order when that order arrives at the receiving Participant Exchange. If the Principal Order is larger than the Firm Principal Quote Size, the receiving Participant Exchange will (a) execute the Principal Order at its disseminated quotation for at least the Firm Principal Quote Size and (b) within 15 seconds of receipt of such order, reply to the sending Participant Exchange, informing such Participant Exchange of the amount of the order that was executed and the amount, if any, canceled. If the receiving Participant Exchange does not execute the Principal Order in full, it will move its quote to a price inferior to the Reference Price of the Principal Order.

(2) Receipt of Multiple Principal Orders. Once the Exchange provides an automatic execution of a Principal Order in a series of an Eligible Option Class (the "initial execution"), the Exchange may reject any Principal Order(s) in the same Eligible Option Class sent by the same Participant Exchange for 15 seconds after the initial execution unless: (a) There is a change of price in the Exchange's disseminated offer (bid) in the series of the Eligible Option Class in which there was the initial execution; and (b) such price continues to be the NBBO. After this 15 second period, and until the sooner of (y) one minute after the initial execution or (z) a change in the Exchange's disseminated bid (offer), the Exchange is not obligated to provide an automatic execution for any Principal Orders in the same Eligible Option Class received from the Participant Exchange that sent

the order resulting in the initial execution, and thus may treat any such Principal Orders as being greater than the Firm Principal Quote Size.

##### (d) Responses to Linkage Orders.

(1) Failure to Receive a Timely Response. A Member who does not receive a response to a P Order or a P/A Order within 20 seconds of sending the order may reject any response received thereafter purporting to report an execution of all or part of that order. The Member so rejecting the response shall inform the Exchange Participant sending that response of the rejection within 15 seconds of receipt of the response.

(2) Failure to Send a Timely Response. If a Member responds to a P Order or P/A Order more than 20 seconds after receipt of that order, and the Participant Exchange to whom the Member responded cancels such response, the Member shall cancel any trade resulting from such order and shall report the cancellation to OPRA.

(e) Receipt of Linkage Orders. The Exchange will provide for the execution of P/A Orders and Principal Orders if its disseminated quotation is (i) equal to or better than the Reference Price, and (ii) equal to the then-current NBBO. Subject to paragraph (c) above, if the size of a P/A Order or Principal Order is not larger than the Firm Customer Quote Size or Firm Principal Quote Size, respectively, the Exchange will provide for the execution of the entire order, and shall execute such order in its automatic execution system if that system is available. If the size of a P/A Order or Principal Order is larger than the Firm Customer Quote Size or Firm Principal Quote Size, respectively, the Primary Market Maker must address the order within 15 seconds to provide an execution for at least the Firm Customer Quote Size or Firm Principal Quote Size, respectively. If the order is not executed in full, the Exchange will move its disseminated quotation to a price inferior to the Reference Price.

#### Rule 1902. Order Protection

(a) Avoidance and Satisfaction of Trade-Throughs.

(1) General Provisions. Absent reasonable justification and during normal market conditions, Members should not effect Trade-Throughs. Except as provided in paragraph (b) below, if a Member effects a Trade-Through with respect to the bid or offer of a Participant Exchange in an Eligible Option Class and the Exchange receives a Satisfaction Order from an Aggrieved Party, either:

(i) the Member who initiated the Trade-Through shall satisfy, or cause to

be satisfied, the Aggrieved Party by filling the Satisfaction Order in accordance with subparagraph (a)(2) below; or

(ii) if the Member elects not to do so (and, in the case of Third Participating Market Center Trade-Through, the Member obtains the agreement of the contra party that received the Linkage Order that caused the Trade-Through), then the price of the transaction that constituted the Trade-Through shall be corrected to a price at which a Trade-Through would not have occurred. If the price of the transaction is corrected, the Member correcting the price shall report the corrected price to OPRA, notify the Aggrieved Party of the correction and cancel the Satisfaction Order.

(2) Price and Size. The price and size at which a Satisfaction Order shall be filled is as follows:

(i) Price. A Satisfaction Order shall be filled at the Reference Price. However, if the Reference Price is the price of an apparent Block Trade that caused the Trade-Through, and such trade was not, in fact, a Block Trade, then the Member may cancel the Satisfaction Order. In that case, the Member shall inform the Aggrieved Party within three minutes of receipt of the Satisfaction Order of the reason for the cancellation. Within three minutes of receipt of such cancellation, the Aggrieved Party may resend the Satisfaction Order with a Reference Price of the bid or offer that was traded through.

(ii) Size. An Aggrieved Party may send a Satisfaction Order up to the size of the Verifiable Number of Customer Contracts that were included in the disseminated bid or offer that was traded through. Subject to subparagraph (2)(i) above and paragraph (b) below, a Member shall fill in full all Satisfaction Orders it receives following a Trade-Through, subject to the following limitations:

(A) If the number of contracts to be satisfied exceeds the size of the transaction that caused the Trade-Through, the size of the Satisfaction Order(s) that must be filled with respect to each Participant Exchange(s) shall be limited to the size of the transaction that caused the Trade-Through, and the remainder of any Satisfaction Order(s) shall be canceled;

(B) If the transaction that caused the Trade-Through was for a size larger than the Firm Customer Quote Size with respect to any of the Participant Exchange(s) traded through, the total number of contracts to be filled, with respect to all Satisfaction Orders received, shall not exceed the size of the transaction that caused the Trade-Through. In that case, the Member shall

fill the Satisfaction Orders pro rata based on the Verifiable Number of Customer Contracts traded through on each Participant Exchange, and shall cancel the remainder of such Satisfaction Order(s); and

(C) Notwithstanding paragraphs (A) and (B) above, if the transaction that caused the Trade-Through occurred during the five minutes prior to the regularly-scheduled close of trading in the principal market in which the underlying security is traded, the maximum number of contracts to be satisfied with respect to any one Participant Exchange is 10 contracts.

(3) Rejection of Fills of Satisfaction Orders. Within 30 seconds of receipt of notification that another Participant Exchange has filled a Member's Satisfaction Order, the Member that sent the Satisfaction Order may reject such fill, but only to the extent that either: (i) the order(s) for the customer contracts underlying the Satisfaction Order already have been filled; or (2) the customer order(s) to buy (sell) the contracts underlying the Satisfaction Order were canceled.

(4) Protection of Customers. Whenever subparagraph (a)(1) applies, if Public Customer orders (or P/A Orders representing Public Customer orders) constituted either or both sides of the transaction involved in the Trade-Through, each such Public Customer order (or P/A Order) shall receive:

(i) the price that caused the Trade-Through; or

(ii) the price at which the bid or offer traded through was satisfied, if it was satisfied pursuant to subparagraph (a)(1)(i), or the adjusted price, if there was an adjustment, pursuant to subparagraph (a)(1)(ii), whichever price is most beneficial to the Public Customer order. Resulting differences in prices shall be the responsibility of the Member who initiated the Trade-Through.

(b) Exceptions to Trade-Through Liability. The provisions of paragraph (a) pertaining to the satisfaction of Trade-Throughs shall not apply under the following circumstances:

(1) the Member who initiated the Trade-Through made every reasonable effort to avoid the Trade-Through, but was unable to do so because of a systems/equipment failure or malfunction;

(2) the Member trades through the market of a Participant Exchange to which such Member had sent a P/A Order or Principal Order, and within 20 seconds of sending such order the receiving Participant Exchange had neither executed the order in full nor

adjusted the quotation traded through to a price inferior to the Reference Price of the P/A Order or Principal Order;

(3) the bid or offer traded through was being disseminated from a Participant Exchange whose quotes were Non-Firm with respect to such Eligible Option Class;

(4) the Trade-Through was other than a Third Participating Market Center Trade-Through and occurred during a period when, with respect to the Eligible Option Class, the Exchange's quotes were Non-Firm; provided, however, that, unless one of the other conditions of this paragraph (b) applies, during any such period: (i) Members shall make every reasonable effort to avoid trading through the firm quotes of another Participant Exchange; and (ii) it shall not be considered an exception to paragraph (a) if a Member regularly trades through the firm quotes of another Participant Exchange during such period;

(5) the bid or offer traded through was being disseminated by a Participant Exchange during a trading rotation in the Eligible Option Class;

(6) the transaction that caused the Trade-Through occurred during a trading rotation;

(7) the transaction that caused the Trade-Through was the execution of a Complex Trade;

(8) in the case of a Trade-Through other than a Third Participating Market Center Trade-Through, a Satisfaction Order with respect to the Trade-Through was not received by the Exchange from the Aggrieved Party promptly following the Trade-Through and, in any event, (i) except in the final five minutes of trading, within three minutes from the time the report of the transaction(s) that constituted the Trade-Through was disseminated over OPRA, and (ii) in the final five minutes of trading, within one minute from the time the report of the transaction(s) that constituted the Trade-Through was disseminated over OPRA; or

(9) in the case of a Third Participating Market Center Trade-Through, a Satisfaction Order with respect to the Trade-Through was not received by the Exchange promptly following the Trade-Through. In applying this provision, the Aggrieved Party must send the Exchange a Satisfaction Order within three minutes from the time the report of the transaction that constituted the Trade-Through was disseminated over OPRA. To avoid liability for the Trade-Through, the Member receiving such Satisfaction Order must cancel the Satisfaction Order and inform the Aggrieved Party of the identity of the Participant Exchange that initiated the

Trade-Through within three minutes of the receipt of such Satisfaction Order (within one minute in the final five minutes of trading). The Aggrieved Party then must send the Participant Exchange that initiated the Trade-Through a Satisfaction Order within three minutes of receipt of the cancellation of the initial Satisfaction Order (within one minute in the final five minutes of trading).

(c) Responsibilities and Rights Following Receipt of Satisfaction Orders.

(1) When a Member receives a Satisfaction Order, that Member shall respond as promptly as practicable pursuant to Exchange procedures by either:

(i) specifying that one of the exceptions to Trade-Through liability specified in paragraph (b) above is applicable and identifying that particular exception; or

(ii) taking the appropriate corrective action pursuant to paragraph (a) above.

(2) If the Member who initiated the Trade-Through fails to respond to a Satisfaction Order or otherwise fails to take the corrective action required under paragraph (a) within three minutes of receiving notice of a Satisfaction Order, and the Exchange determines that:

(i) there was a Trade-Through; and

(ii) none of the exceptions to Trade-Through liability specified in paragraph (b) above were applicable;

then, subject to the next paragraph, the Member who initiated the Trade-Through shall be liable to the Aggrieved Party for the amount of the actual loss resulting from non-compliance with paragraph (a) and caused by the Trade-Through.

If either (a) the Aggrieved Party does not establish the actual loss within 30 seconds from the time the Aggrieved Party received the response to its Satisfaction Order (or, in the event that it did not receive a response, within four minutes from the time the Aggrieved Party sent the Satisfaction Order) or (b) the Aggrieved Party does not notify the Exchange Participant that initiated the Trade-Through of the amount of such loss within one minute of establishing the loss, then the liability shall be the lesser of the actual loss or the loss caused by the Trade-Through that the Aggrieved Party would have suffered had that party purchased or sold the option series subject to the Trade-Through at the "mitigation price."

The "mitigation price" is the highest reported bid (in the case where an offer was traded through) or the lowest reported offer (in the case where a bid

was traded through), in the series in question 30 seconds from the time the Aggrieved Party received the response to its Satisfaction Order (or, in the event that it did not receive a response, four minutes from the time the Aggrieved Party sent the Satisfaction Order). If the Participant Exchange receives a Satisfaction Order within the final four minutes of trading (on any day except the last day of trading prior to the expiration of the series which is the subject of the Trade-Through), then the mitigation price shall be the price established at the opening of trading in that series on the Aggrieved Party's Participant Exchange on the next trading day. However, if the price of the opening transaction is below the opening bid or above the opening offer as established during the opening rotation, then the mitigation price shall be the opening bid (in the case where an offer was traded through) or opening offer (in the case where a bid was traded through). If the Trade-Through involves a series that expires on the day following the day of the Trade-Through and the Satisfaction Order is received within the four minutes of trading, the "mitigation price" shall be the final bid (in the case where an offer was traded through) or offer (in the case where a bid was traded through) on the day of the trade that resulted in the Trade-Through.

(3) A Member that is an Aggrieved Party under the rules of another Participant Exchange governing Trade-Through liability must take steps to establish and mitigate any loss such Member might incur as a result of the Trade-Through of the Member's bid or offer. In addition, the Member shall give prompt notice to the other Participant Exchange of any such action in accordance with subparagraph (c)(2) above.

(d) Limitations on Trade-Throughs. Members may not repeatedly trade through better prices available on other exchanges, whether or not the exchange or exchanges whose quotations are traded through are Participant Exchanges, unless one or more of the provisions of paragraph (b) above are applicable. In applying this provision:

(1) The Exchange will consider there to have been a Trade-Through if a Member executes a trade at a price inferior to the NBBO even if the Exchange does not receive a Satisfaction Order from an Aggrieved Party pursuant to subparagraph (a)(1);

(2) The Exchange will not consider there to have been a Trade-Through if a Member executes a Block Trade at a price inferior to the NBBO if such Member satisfied all Aggrieved Parties

pursuant to subparagraph (a)(2) following the execution of the Block Trade; and

(3) The Exchange will not consider there to have been a Trade-Through if a Member executes a trade a price inferior to the quotation being disseminated by an exchange that is not a Participant Exchange if the Member made a good faith effort to trade against the superior quotation of the non-Participant Exchange prior to trading through that quotation. A "good faith effort" to reach a non-Participant Exchange's quotation requires that a Member at least had sent an order that day to the non-Participant Exchange in the class of options in which there is a Trade-Through, at a time at which such non-Participant Exchange was not relieved of its obligation to be firm for its quotations pursuant to Rule 11Ac1-1 under the Exchange Act, and such non-Participant Exchange neither executed that order nor moved its quotation to a price inferior to the price of the Member's order within 20 seconds of receipt of that order.

Rule 1903. Locked and Crossed Markets

(a) Eligible Market Maker Locking or Crossing a Market. An Eligible Market Maker that creates a Locked Market or a Crossed Market shall unlock (uncross) that market or shall direct a Principal Order through the Linkage to trade against the bid or offer that the Eligible Market Maker locked (crossed).

(b) Members Other than an Eligible Market Maker Locking or Crossing a Market. A Member other than an Eligible Market Maker that creates a Locked Market or a Crossed Market shall unlock (uncross) the market.

Rule 1904. Limitation on Principal Order Access

A Market Maker shall not be permitted to send Principal Orders in an Eligible Option Class through the Linkage for a given calendar quarter if the market maker effected less than 80 percent of its volume in that Eligible Option Class on the Exchange in the previous calendar quarter (that is, the market maker effected 20 percent or more of its volume by sending Principal Orders through the Linkage). This "80/20" is represented as follows:

$$\frac{X}{X+Y}$$

"X" equals the total contract volume the market maker effects in an Eligible Option Class against orders of Public Customers on the Exchange during a calendar quarter (a) including contract volume effected by executing P/A

*Orders sent to the Exchange through the linkage, but (b) excluding contract volume effected by sending P/A Orders through the Linkage for execution on another Participant Exchange. "Y" equals the total contract volume the market maker effects in such Eligible Option Class by sending Principal Orders through the Linkage during that calendar quarter.*

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## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### 1. Purpose

The purpose of the proposed rule change is to adopt Chapter 19 of the ISE rules, governing operation of the Linkage. These rules implement the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage (the "Plan").<sup>3</sup> The Exchange is proposing the following five new rules:

- ISE Rule 1900, Definitions: This proposed rule contains definitions unique to the Linkage; all other definitions in the Exchange's rules continue to apply to this chapter. Generally, these definitions would incorporate into the Exchange's rules the definitions contained in the Plan.

- ISE Rule 1901, Operation of the Linkage: This rule would incorporate Section 7 of the Plan into the ISE's rules. It would establish the conditions pursuant to which market makers may enter Linkage orders and imposes obligations on the Exchange on how it

must process incoming Linkage orders. Pursuant to a proposed amendment to the Plan being submitted concurrently with this filing, the proposed rule provides that a member of the ISE may reject an execution of certain Linkage orders received more than 20 seconds after sending the order. This would be a reduction from the 30 seconds currently in the Plan.

- ISE Rule 1902, Order Protection: This proposed rule contains the trade-through provisions required under Section 8(c) of the Plan. First, it would establish a general standard that members should avoid trade-throughs (defined in ISE Rule 1900 to be a trade at a price inferior to the national best bid and offer). If a member does effect a trade-through, the member would be responsible for satisfying a member of another exchange pursuant to paragraphs (a)(2) and (c) of the rule, subject to the exceptions in paragraph (b) of the rule. Both the satisfaction procedures and the exceptions to the satisfaction requirements would incorporate the relevant provision of the Plan. Finally, paragraph (d) of the rule would establish potential regulatory liability for members who repeatedly trade through other exchanges, whether or not the exchanges traded through participate in the Linkage. This proposed rule also reflects two pending amendments to the Plan:

- As with ISE Rule 1901, this proposed rule reflects the pending amendment to reduce from 30 seconds to 20 seconds the time period a member must wait for a response to a Linkage order. If the member does not receive the response within 30 seconds, the member can trade through the non-responding exchange without liability.

- In addition, this proposed rule reflects a pending Plan amendment that would limit liability for trade-throughs in the last few minutes of a trading day to 10 contracts per exchange. The purpose of that amendment is to provide protection for small customer orders, but also to limit the potential risk to members who may not be able to hedge options positions they assume near the close of trading.

- ISE Rule 1903, Locked and Crossed Markets: This proposed rule implements Section 7(a)(i)(C) of the Plan by indicating that locked and crossed markets should be avoided and providing procedures to unlock and uncross markets that do occur.

- ISE Rule 1904, Limitation on Principal Order Access: This proposed rule codifies the "80/20 Test" contained in Section 8(b)(iii) of the Plan. Specifically, a market maker on the Exchange would be restricted from

sending principal orders (other than P/A orders, which reflect unexecuted customer orders) through the Linkage if the market maker effects less than 80 percent of specified order flow on the Exchange. The Exchange would apply this test on a calendar quarter basis.

With respect to the proposed fee change, the Exchange is proposing to clarify that its existing fees will apply to Principal Orders ("P Orders") and Principal Acting as Agent Orders ("P/A Orders"). Thus, market makers on other exchanges sending orders for their own account to the ISE would pay the same fees that the ISE levies generally on all non-customer transactions. Today, these fees are applicable to such market maker transactions if they send their orders to the ISE through existing order-routing facilities. These fees also are the same fees applicable to ISE market makers. The Exchange believes that it is appropriate to charge market makers on the other exchanges the same fees members pay for proprietary transactions when such market makers access the liquidity available on the ISE.

This proposal also specifies that the existing ISE fees would not apply to Satisfaction Orders. The Plan amendments pending at the Commission would prohibit a Party to the Plan from charging a fee to a member of another exchange that is seeking to satisfy customer orders on its book that were traded-through.

#### 2. Basis

The Exchange believes that the basis under the Exchange Act for the Linkage rules generally is the requirement under Section 6(b)(5)<sup>4</sup> that an exchange have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. The proposed fee change is based on Section 6(b)(4)<sup>5</sup> that requires an exchange to have an equitable allocation of reasonable dues, fees and other charges among its members and other persons using its facilities. With respect to the proposed disciplinary sanctions for engaging in a pattern of trade-throughs,

<sup>3</sup> Approved by the Commission in Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000), as subsequently amended. See Securities Exchange Act Release No. 44482 (June 27, 2001), 66 FR 35470 (July 5, 2001) ("Initial Amendment Order") and Securities Exchange Act Release No. 46001 (May 30, 2002), 67 FR 38687 (June 5, 2002). In addition, this proposed rule change reflects additional changes to the Plan that the ISE is filing concurrently with this filing. Such pending changes are noted in the discussion of the proposals.

<sup>4</sup> 15 U.S.C. 78f(b)(5).

<sup>5</sup> 15 U.S.C. 78f(b)(4).

the proposal is based on Section 6(b)(6)<sup>6</sup> that requires an exchange to have rules that provide for the appropriate discipline of members for violations of the Exchange Act, the rules and regulation thereunder, and the rules of the Exchange.

#### *B. Self-Regulatory Organization's Statement on Burden on Competition*

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (a) by order approve such proposed rule change; or
- (b) institute proceedings to determine whether the proposed rule change should be disapproved.

### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be

available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-ISE-2002-19 and should be submitted by January 16, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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**BILLING CODE 8010-01-P**

### **SECURITIES AND EXCHANGE COMMISSION**

**[Release No. 34-47021; File Nos. SR-NASD-2002-162; SR-NYSE-2002-36]**

#### **Self-Regulatory Organizations; Notice of Extension of Comment Period for the Proposed Rule Changes by the National Association of Securities Dealers, Inc. and New York Stock Exchange, Inc. Relating to Supervisory Control Amendments**

December 18, 2002.

On August 16, 2002, the New York Stock Exchange ("NYSE" or "Exchange"), and on November 4, 2002, the National Association of Securities Dealers, Inc. ("NASD"), filed with the Securities and Exchange Commission ("SEC" or "Commission") proposed rule changes pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> regarding the supervisory and supervisory control procedures of member firms. A complete description of the proposed rule changes is found in the notices of filing, which were published in the **Federal Register** on November 27, 2002.<sup>3</sup> The comment periods expire on December 18, 2002.

To give the public additional time to comment on the proposed rule changes, the Commission has decided to extend the comment periods pursuant to Section 19(b)(2) of the Act.<sup>4</sup> Accordingly the comment periods shall be extended until January 17, 2003.

Interested persons are invited to submit written data, views, and arguments concerning the foregoing,

<sup>7</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See Securities Exchange Act Release Nos. 46858 (November 20, 2002), 67 FR 70994 (SR-NYSE-2002-36) and 46859 (November 20, 2002), 67 FR 70990 (SR-NASD-OP2002-162); see also Securities Exchange Act Release No. 46858A (November 27, 2002, 67 FR 72261 (SR-NYSE-2002-36 Correction)).

<sup>4</sup> 15 U.S.C. 78s(b)(2).

including whether the proposed rule is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NYSE-2002-36 or SR-NASD-2002-162 and should be submitted by January 17, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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**BILLING CODE 8010-01-P**

### **SECURITIES AND EXCHANGE COMMISSION**

**[Release No. 34-47022; File No. SR-NASD-2002-158]**

#### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Establishment of a Nasdaq Official Closing Price and a Trade Report Modifier With Which To Identify That Price to the Public**

December 18, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 1, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in items I, II, and III below, which items have been prepared by Nasdaq. The Commission is publishing this notice to solicit

<sup>5</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>6</sup> 15 U.S.C. 78f(b)(6).