Federal Register

Thursday,
March 2, 2000

Part III

Securities and Exchange Commission

In the Matter of the Application of The International Securities Exchange LLC for Registration as a National Securities Exchange; Findings and Opinion of the Commission and Order Granting Registration; Notices

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

SECURITIES AND EXCHANGE COMMISSION

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

In the Matter of the Application of The International Securities Exchange LLC for Registration as a National Securities Exchange; Findings and Opinion of the Commission

February 24, 2000.

I. Introduction

On February 2, 1999, the International Securities Exchange LLC (''ISE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''Commission'') a Form 1 application (''Form 1'') under the Securities Exchange Act of 1934 (''Exchange Act''), seeking registration as a national securities exchange pursuant to Section 6 of the Exchange Act. Notice of the application was published for comment in the **Federal Register** on June 1, 1999.[1] The Commission received twenty-one comments on the proposal.[2] The ISE filed an amendment to its application on September 27, 1999.[3] Notice of the amendment was published for comment in the **Federal Register** on October 26, 1999.[4] The Commission received nine comments on Amendment No. 1.[5] On February 23, 2000, the ISE filed another amendment to its application.[6] This order approves the ISE's application for registration as a national securities exchange, as amended.

II. Discussion

Under Sections 6 and 19(a) of the Exchange Act, the Commission will grant an order for registration as a national securities exchange if it finds that the exchange is so organized and has the capacity to carry out the purposes of the Exchange Act and can comply, and can enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange. The rules of the exchange must be adequate to insure fair dealing and to protect investors, and may not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

After a review of the ISE's amended application in accordance with these standards, the Commission has determined to grant the registration of the Exchange. In taking this action, the Commission notes that the ISE will not be permitted to begin trading until after it satisfies a number of conditions, which are discussed below.

The Commission finds that the ISE's Constitution and rules are consistent with Section 6 of the Exchange Act in that they are designed to: (1) Assure fair representation of an exchange's members in the selection of its directors and administration of its affairs and provide that, among other things, one or more directors shall be representative of investors and not be associated with the exchange, or with a broker or dealer; (2) 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 mechanisms of a free and open market and a national market system; and (3) to protect investors and the public interest. Finally, the Exchange's rules do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Overall, the Commission believes that granting registration to the ISE as a national securities exchange offers the promise of important benefits to the public and should provide U.S. market participants with a new, innovative method of trading options. As a fully electronic options market, the ISE's entrance to the marketplace should potentially reduce the costs of trading to investors and market professionals, enhance innovation, and increase competition between and among the options exchanges, resulting in better prices and executions for investors.

This discussion does not review every rule and representation made by the ISE that has been filed as a part of its application; rather, it focuses on the most prominent rules and policy issues considered in review of the ISE's application.

III. Consideration of Certain of ISE's Governance Provisions and Trading Rules

A. Corporate Structure

The ISE is organized as a limited liability company (''LLC'') under New York law and will be owned by certain of its members. This corporate structure is substantially the same as the existing exchanges are structured, with one exception. As an LLC, the Exchange will not pay state and federal taxes on its income. Instead, the income will be ''allocated'' to the Class A and Class B memberships (described below), and the owner of each membership will pay taxes on the income. The Exchange will distribute to each owner of a membership the amount necessary to pay the taxes on its allocated portion of the Exchange's net income.

Several commenters believed that, because ISE is organized as a for-profit entity,[7] it is structured to provide owners of memberships a profit from Exchange-generated revenue. Although ISE's expectation is to have net income and it will create a budget and set fees based upon that expectation, it will not distribute profits to its owners. Net income will be used by the ISE to finance capital improvements and to provide for financial reserves. Generally, existing exchanges control the amount of annual net income by adjusting their fees. Some exchanges rebate fees collected, or reduce or eliminate fees temporarily when they exceed projected earnings. ISE's LLC structure provides for a similar financial model as the existing exchanges with the exception of the manner in which taxes are paid.

Many commenters also suggested that because the ISE is organized as a ''for-profit'' entity, its structure creates the potential for conflicts of interest. The Commission notes that conflicts of interest are an inherent part of self-regulation. To the extent that ISE's organization as an LLC, rather than as a not-for-profit corporation, heightens or changes those conflicts of interest, the Commission has evaluated the conflicts of interests and believes that a number

[1] *See* Exchange Act Release No. 41439 (May 24, 1999), 64 FR 29367 (June 1, 1999).

[2] A summary of comments received on the original application is available in the Public Reference Room at the Commission (File No. 10–127).

[3] *See* Letter from David Krell, President and CEO, ISE, to Jonathan G. Katz, Secretary, Commission, dated September 23, 1999 (''Amendment No. 1''). The ISE included a narrative response to the comment letters in Amendment No. 1. *See* Amendment No. 1, Exhibit 6.

[4] *See* Exchange Act Release No. 42042 (October 20, 1999), 64 FR 57668 (October 26, 1999).

[5] A summary of comments received on Amendment No. 1 is available in the Public Reference Room at the Commission (File No. 10–127).

[6] *See* Letter from David Krell, President and CEO, ISE, to Jonathan G. Katz, Secretary, Commission, dated February 17, 2000 (''Amendment No. 2''). Although Amendment No. 2 was not published for comment, the changes are either responsive to comment letters and the concerns of the Commission or technical in nature. Any other substantive changes to the ISE's rules will be published in the **Federal Register** for notice and comment.

[7] Seven of the eight current U.S. exchanges are ''not-for-profit'' organizations. In its release concerning the regulation of exchanges and alternative trading systems, the Commission expressed its view that registered exchanges may structure themselves as for-profit exchanges. *See* Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) (''ATS Release'').

of factors alleviate these concerns.[8] First, ISE will not be the Designated Examining Authority (''DEA'') or Designated Options Examining Authority (''DOEA'') for its members. In other words, ISE is not the primary SRO and, therefore, will not be responsible for the financial oversight of its members, or for disciplining or enforcing common SRO rules. Nor will ISE be responsible for enforcing the rules of another SRO. This alleviates concerns that possible profit-making motives could influence ISE to use its examining authority to profit its members or to harm a competitor-SRO for which it had assumed regulatory obligations. Second, the ISE has filed an interpretation, which will be considered a rule of the Exchange pursuant to Section 3(a)(27) of the Exchange Act, that states that the ISE will make distributions solely to cover members' tax liability for the ISE's income. Cash available for distributions to members will not include revenues received by the Exchange from regulatory fees or regulatory penalties. This will prevent the possibility that regulatory fines and fees might be ''dividended'' out to members.[9] Third, non-industry directors comprise a majority (eight out of fifteen) of the ISE's Board of Directors. Because these non-industry directors are not affiliated with members of the Exchange, they provide a significant safeguard against possible abuse by limiting the influence and control of any one group over the activities of the Exchange. In sum, given that ISE is not a DEA or DOEA, is not a publicly-owned entity, and is not structured to provide its members a profit from Exchange-generated revenue, the Commission does not believe that the concerns regarding a ''for-profit'' exchange functioning as an SRO are serious in the ISE context.

B. Corporate Governance

1. Fair Representation

Section 6(b)(3) of the Exchange Act requires that the rules of an exchange assure fair representation of its members in the selection of its directors and administration of its affairs and, among other things, provide that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, or with a broker or dealer. Public representation and individuals who are not affiliated with broker-dealers on an exchange's board of directors helps to satisfy this requirement. This provision is designed to ensure that members have a voice in the use of self-regulatory authority that may affect the members, and to protect members from unfair, unfettered disciplinary actions under the rules of the exchange.

a. ISE's Board of Directors

The Commission finds that the ISE has been structured in such a manner as to satisfy the principles of fair representation as required by Section 6(b)(3) of the Exchange Act. The ISE's Board of Directors will be the governing body of the Exchange and possess all the powers necessary for the management of the business and affairs of the Exchange and for the promotion of its welfare, objects and purposes. The Board will consist of 15 directors: (i) 6 member representatives, comprised of two Class A member representatives (''Primary Market Maker'' or ''PMM''), two Class B member representatives (''Competitive Market Maker'' or ''CMM''), two Class C member representatives (''Electronic Access Member'' or ''EAM''); (ii) eight non-industry directors,[10] at least two of whom must be representatives of the public; [11] and (iii) the President of ISE. Thus, the Board provides members six representatives, yet still consists of a majority of non-industry representatives.

Representatives of Class A, B, and C members will be nominated by a nominating committee [12] and elected to the Board by a plurality of their respective classes.[13] No member organization may have more than one representative elected to the Board.[14] Non-industry directors will be nominated by the nominating committee and elected by an affirmative vote of a majority of the Class A members, a majority of the Class B members and a majority of the Class C members voting by class if the election is uncontested.[15] Industry and non-industry candidates may also be placed on the ballot by petition.[16] All directors will serve for a two-year term,[17] except that the President will serve until removed. No director, other than the President, who has been elected to three consecutive terms is eligible for election as a director again except after a minimum of a two-year interval.

The Chairman and Vice Chairman of the Board will be appointed from among the directors by the affirmative vote of at least two-thirds of the directors then in office. The Chairman and Vice Chairman each will serve for a one-year term and will not be officers of the Exchange.

PMM and CMM directors have special voting rights regarding the approval of proposed rule changes by the Board. Specifically, in order to adopt, amend or repeal certain governance and trading rule changes, there must be a majority of the entire Board that votes in favor of the proposed change. In addition, at least one PMM director *and* one CMM director must vote in favor of the proposed change.[18] One commenter asserts that this provision gives an effective veto power to the PMM and CMM classes.[19] In response to this comment, the ISE has amended its Constitution to reflect that approval of a proposed rule change will now require a favorable vote by a majority of the Board, including *either* one PMM director and one CMM director *or* five out of eight of the non-industry directors.[20] The revised provision therefore permits an override of the objecting PMM and CMM directors in a situation where a majority of the non-industry directors vote in favor of the

[8] The Commission believes that assessing conflicts of interest concerns in the context of an SRO can be highly dependent on, among other things, corporate and membership structure, which must be analyzed on a continuous case-by-case basis. Although the factors described in this release are helpful in allaying concerns over the ISE's for-profit status, the Commission recognizes that there may be other factors that could be considered in addressing these concerns in the future.

[9] *See* Amendment No. 2.

[10] A ''non-industry representative'' means any person that would not be considered an ''industry representative,'' as well as (i) a person affiliated with a broker or dealer that operates solely to assist the securities-related activities of the business of non-member affiliates, (ii) an employee of an entity that is affiliated with a broker or dealer that does not account for a material portion of the revenues of the consolidated entity and who is primarily engaged in the business of the non-member entity. *See* ISE Constitution, Article I, Section 1(r).

[11] A ''representative of the public'' means a non-industry representative who has no material business relationship with a broker or dealer or the Exchange. *See* ISE Constitution, Article I, Section (1)(v).

[12] *See* ISE Constitution, Article VI, Section 3(c). *See, e.g.*, National Association of Securities Dealers, Inc. (''NASD'') Bylaws, Article VII, Section 10. The Nominating Committee is composed of a representative from each class, as well as three non-industry representatives, at least one of which must be public.

[13] *See* ISE Constitution, Article IV, Section 1(a).

[14] *See* ISE Constitution, Article IV, Section 1(c).

[15] If there are more candidates than the number of vacancies to be filled, non-industry directors are elected by a plurality of all members using a weighting system. *See* ISE Constitution, Article V, Section 1(d).

[16] *See* ISE Constitution, Article VI, Section 3(e).

[17] One half of each class of directors will be elected at each annual meeting of the members. *See* ISE Constitution, Article IV, Sec. 1(b). At the initial election meeting, the Board will randomly select one Class A director, one Class B director, one Class C director, and four non-industry directors (at least one of which must be a public director) who will serve for an initial term of three years. *See* ISE Constitution, Article IV, Sec. 1(e)(6).

[18] *See* ISE Constitution, Article VII, Sec. 1.

[19] *See* American Stock Exchange (''Amex'') Letter.

[20] *See* Amendment No. 2.

proposed rule change.[21] Essentially, a PMM director and a CMM director who vote against a proposed rule change will only succeed in vetoing the proposed change if four or more non-industry directors also vote against the proposal.

Although this special voting provision provides a limited veto power to PMMs and CMMs with regard to proposed rule changes, the Commission believes that a certain level of protection to the equity owners-members in the Exchange is reasonable.[22] Inherent in the concept of a for-profit entity is the notion that those with equity interests in the entity should be afforded rights to protect those interests. It is impractical to expect persons to take up an equity interest in an exchange if they are not permitted to protect that interest in some fair and reasonable manner. In the scheme of self-regulation, however, this notion must be balanced with the requirement of fair representation of all members, not just those with equity interests. The Commission believes that the ISE's voting provision with respect to approval of proposed rule changes reaches an acceptable balance between protecting owner-members, non-owner-members, and the public interest.

b. Rights to Vote on Certain Corporate Actions

Each of the current exchanges has several different types of memberships with differing equity interests and voting rights.[23] ISE's voting structure is set up to recognize the difference in ownership interests among its members. PMMs and CMMs own memberships that represent equity interests in the Exchange. These memberships may be leased or sold to approved persons or entities. In contrast, EAMs do not own an equity interest in the Exchange. EAMs essentially have rights to trade on the Exchange, which are not transferable. Although all three classes of memberships elect representatives to the Board, as well as participate in the election of the non-industry directors,[24] when a vote of the membership is required to take certain action, the EAMs do not have the same rights as the PMMs and CMMs. Specifically, PMM members and CMM members have the right to vote on corporate actions like mergers, consolidations or dissolution of the Exchange, changes to the structure of the Exchange such as adding additional classes of members or increasing the number of memberships in a class, and amendments to the Constitution.[25] EAMs, however, do not generally have the right to vote on such actions.[26] EAMs only have the right to vote on changes to the Constitution or Operating Agreement that would affect their economic status on the Exchange, alter their voting rights, or change the composition of the Board of Directors.[27]

c. ISE's Structure Provides Fair Representation

Two commenters believe that the ISE's proposed governance structure provides the two classes of market makers, PMMs and CMMs, with undue influence over the operation of the Exchange, thereby not satisfying the fair representation requirement of the Exchange Act.[28] The Commission disagrees. First, only four out of the fifteen Board members will be representative of market makers (who are the equity owners). Second, the nominating committee is composed of a representative from each class and three non-industry representatives, at least one of whom must be a public representative, thereby providing for input in the nominating process from more than just the market makers. Third, the Board is composed of a majority of non-industry directors. Finally, although voting rights are determined by the type of ownership interest in the Exchange, *i.e.*, equity versus non-equity, all members and classes have an input in Exchange governance. Specifically, each class of members elects two representatives to the Board of Directors and participates equally in the election of the non-industry directors. Given these provisions, the Commission believes that the ISE's governance structure satisfies the fair representation requirement under the Exchange Act.

2. Chairman's Affiliation with a Member

The rules of certain national securities exchanges currently do not permit their respective chairmen to be a member of the exchange or affiliated with a member of the exchange.[29] The ISE's first Chairman, however, is affiliated with a member of the Exchange.[30]

As many commenters note, the affiliation of the Chairman with one of the Exchange's members implicates certain conflicts of interest, or at least gives the appearance of such conflicts. ISE asserts that the choice of their first chairman is very important to the success and credibility of the Exchange. To address the conflicts raised, the ISE's Constitution provides certain protections limiting the functions and role of the Chairman. First, the Chairman of the ISE is not an officer of the Exchange.[31] Thus, the Chairman does not have the authority to bind the Exchange. Second, no later than two years after the start-up of trading on the ISE, the Chairman will be appointed from among the non-industry directors.[32] Third, the functions that the Chairman will perform are substantially limited. The Chairman may preside over meetings of the Board of Directors, vote at meetings of the Board, serve on the Executive Committee of the Exchange,[33] call a special meeting of the ISE's members,[34] and receive resignations from Board members.[35] Given these safeguards and given the highly limited role of the Chairman, the Commission believes that the conflict concerns related to an affiliated chairman have been adequately addressed. Furthermore, the Commission notes that an interested director is prohibited from participating as a member of the Board or of any committee in any matter that would substantially affect his interest or the interests of any person in whom he is directly or indirectly interested.[36] This prohibition provides additional assurance that the Chairman will not participate in a matter in which he may have an interest by virtue of his

[21] *See* Amendment No. 2.

[22] The Commission notes that this analysis applies only to situations where the equity owners are also members of the exchange. The analysis would be different where equity owners in an exchange were not also members of the exchange. In the event that equity owners were not also members of an exchange, the Commission might find that the non-equity members of the exchange were entitled to further special protections or rights.

[23] *See, e.g.*, New York Stock Exchange (''NYSE'') Constitution, Article II, Section 1 (concerning regular memberships, electronic access members and physical access members).

[24] *See* ISE Constitution, Article IV, Section 1(a) and (d).

[25] *See* ISE Constitution, Article III, Section 11(a).

[26] *See* ISE Constitution, Article III, Section 11(b).

[27] *See* ISE Constitution, Article III, Section 11(b).

[28] *See* Chicago Board Options Exchange (''CBOE'') Letter I, Amex Letter.

[1] *See, e.g.*, CBOE Constitution, Article VIII, Section 8.1; Amex Constitution, Article II, Section 3. *But see* File No. SR–Amex–99–25. Amex has filed a proposed rule change with the Commission that would permit the Amex Chairman to be affiliated with a member.

[30] The ISE's Chairman is Mr. William Porter. Mr. Porter is also Chairman of Adirondack Trading Partners, LLC (''ATP''), a founding member of the ISE and a proposed PMM on the Exchange. *See* ISE Form 1, Exhibit G.

[31] *See* ISE Constitution, Article IV, Section 2.

[32] *Id.*

[33] The ISE's Executive Committee is composed of six directors, including the Chairman, the Vice Chairman, President of the Exchange, and three non-industry directors (at least one of whom must be public). The President of the Exchange is the Chairman of the Executive Committee. *See* ISE Constitution, Article VI, Section 2(a).

[34] A majority of the Board, as well as a set number of members may also call a special meeting. *See* ISE Constitution, Article III, Section 3.

[35] *See* ISE Constitution, Article IV, Section 4(a).

[36] *See* ISE Constitution, Article IV, Section 11. Interested directors may be counted in determining the presence of a quorum.

affiliation with a member of the Exchange.

3. Officers

The Exchange will have a President, one or more Vice Presidents, a Treasurer, a Secretary and any other officers as may be appointed by the President. The President will be elected by a majority of the Board and is the Chief Executive Officer.

Generally, officers of the Exchange are not permitted to be members of the Exchange or be affiliated with members of the Exchange. If an officer owns a membership or is affiliated with a member upon his election to office, the officer must abstain from exercising voting rights with respect to the membership and must also lease the membership. The terms of the lease by an officer must be reasonable and approved by a majority of the non-industry directors.[37]

An exception to the general prohibition on officers owning memberships has been provided with respect to two individuals who are founders and who own CMM memberships.[38] Specifically, the initial President and Chief Executive Officer of the ISE is Mr. David Krell. The initial Senior Vice President of Marketing and Business Development is Mr. Gary Katz. As founders of ISE, Mr. Krell and Mr. Katz are to be compensated with memberships. Mr. Krell will receive four memberships and Mr. Katz will receive two. Again, commenters note that conflicts of interest arise where officers are permitted to own memberships or be affiliated with members. The ISE has provided a number of safeguards to protect against such conflicts. First, an officer of the Exchange who owns one or more memberships must abstain from exercising any voting rights associated with the membership(s).[39] Second, an officer who owns a membership must lease that membership and the terms of the lease must be reasonable and approved by a majority of non-industry directors.[40] Finally, except in the case where one or more officers is also a founder, the ISE will only permit one officer to be an owner of one or more memberships.[41] The Commission believes that these provisions should protect against an officer allowing his economic interest in the success of his membership from affecting his duties as an officer of the Exchange.

4. Delegation of Authority

Several commenters criticize the manner in which the ISE will delegate decision-making authority within the Exchange. These commenters believe that the ISE should be required to specify who or what will have the relevant decision-making authority, rather than stating that such authority resides with ''the Exchange.'' In response, the ISE has amended several of its rules to provide more specificity.[42] The Commission believes that these and other rules are sufficiently specific to insure fair dealing and to protect investors.

C. Membership

As noted above, there will be three types or classes of members at the ISE: PMMs, CMMs, and EAMs.[43] The Exchange has established limitations on the number of memberships that a member may own, as well as on the number of memberships for which a member may be approved to trade on the Exchange.

1. Concentration Limits on Memberships

Several commenters criticize the concentrated ownership of the ISE in a few founders. Specifically, these commenters contend that a large portion of the ISE will be controlled or owned for a significant number of years by individuals, namely the ISE's founders, who will own the memberships for investment purposes and not for the purpose of conducting a securities business. Commenters also criticize the ISE for not requiring members to lease memberships if they are not engaged in trading on the ISE.[44]

The ISE has adopted concentration limits to restrict the number of memberships that one person, together with any person who directly or indirectly controls, is controlled by, or is under common control with the person, may own or lease. Generally, one person may not own or lease more than twenty percent of any class of memberships. The Exchange has the authority to further limit the number of Class A and Class B memberships that may be owned or leased by a member.[45] Specifically, ISE Rule 303(g) states that an applicant will be denied approval to purchase a membership if, together with any person who directly or indirectly controls, is controlled by, or is under common control with the applicant, that approval would result in the applicant owning and/or leasing more than one PMM membership or more than ten CMM memberships, unless the restriction is waived by the Board for good cause shown.

Many commenters noted that the ISE's Rules 303(g) and 317(a)[46] failed to define ''good cause shown.'' In response, the ISE has defined ''good cause shown'' to mean a demonstrated operational, business or regulatory need. The ISE states that in those cases where such a need has been demonstrated to the Board, the Board will also consider any operational, business or regulatory concerns that might be raised if such a waiver were granted. Furthermore, the Board will only waive such limitations when, in its judgment, such action is in

[37] *See* ISE Constitution, Article V, Section 2.

[38] *See* ISE Form 1, Exhibit I.

[39] *See* ISE Constitution, Article V, Section 2.

[40] *Id.* As founders, Mr. Krell and Mr. Katz will not be required to immediately lease or sell their respective memberships. *See* ISE Rules 300(a)(5) and 310. During the time that their memberships are held without being leased, however, there will be no voting rights associated with the memberships.

[41] *See* ISE Constitution, Article V, Section 2.

[42] *See* Amendment No. 2. Specifically, the ISE has amended the following rules: (1) Rule 411(h) (Significant Business Transaction) has been amended to specify that any exemption from the requirements of the rule receive approval by the Chief Regulatory Officer of the ISE; (2) Rule 417 (Limit on Uncovered Short Positions) has been amended to specify that the Board or a committee or Exchange official designated by the Board will make determinations or take action under this rule; (3) Rules 702 (Trading Halts), 704 (Unusual Market Conditions) and 717(g) (Limitations on Orders—Orders for the Account of Another Member) have been amended to specify that an Exchange official designated by the Board will make determinations and take actions under these rules; (4) Rule 802 (Appointment of Market Makers) has been amended to specify that the Exchange's Board or a committee designated by the Board will have responsibility for appointing, reviewing and suspending market makers; (5) Rule 804(e)(2)(iii) (Market Maker Quotations) has been amended to specify that an official designated by the Board will be responsible for calling upon a CMM to submit a single quote or to maintain continuous quotes in options when in the judgment of such official, it is necessary to do so in the interest of fair and orderly markets; and (6) Rule 1500 (Imposition of Suspension) has been amended to specify that the Board or a committee or Exchange official designated by the Board will determine when and if summary suspension is necessary or whether access to services by the Exchange may be limited or prohibited with respect to any person or member. In addition, ISE Rule 801 (Designated Trading Representatives) has been amended to remove reference to a ''registration'' requirement for Designated Trading Representatives (''DTR''). The text of the rule now makes clear that a DTR must be approved by the Exchange before he or she will be permitted to enter quotations and orders into the ISE's system on behalf of an ISE market maker member. The reference to a ''registration'' requirement had implied that the ISE was creating a new registration category for purposes of Form U–4, which it was not. ISE Rule 801(b)(4) also has been amended to specify that any conditional approvals of DTRs will be made by the Chief Regulatory Officer.

[43] Brokers that clear for other members must be approved EAMs. *See* ISE Constitution, Article I, Section 1(a)(f).

[44] *See, e.g.*, CBOE Letter 1.

[45] *See* ISE Constitution, Article II, Section 11(a); ISE Rule 303(g).

[46] ISE Rule 317(a), discussed below, concerns the limitation on the number of memberships with respect to which a member may be approved to trade on the Exchange.

the best interest of the Exchange.[47] As a general matter, the Exchange states that it anticipates granting such waivers primarily on a temporary basis when needed to address mergers, acquisitions and similar business combinations.[48] Accordingly, only in truly necessary circumstances will the Exchange permit a member to own or operate more than one PMM membership, and even in that case the member may not own or operate more than two PMM memberships.

Although founders of the Exchange have a temporary exemption from the above ownership concentration limits, not to exceed ten years,[49] a number of other limitations have been placed on founders' ownership of memberships. First, founders may not vote on changes to the Constitution (other than those that fall within ownership voting rights, *i.e.*, mergers, consolidations, dissolution). Second, founders may not exercise the right to vote for directors except with respect to those memberships that have been approved for trading on the Exchange. Third, when a founder leases a membership, it is required to transfer the membership voting rights to the lessee. Fourth, membership voting rights with respect to memberships for which a founder has not been approved to trade on the Exchange or which have not been leased are not considered ''active'' or ''outstanding'' either for voting or quorum purposes. Finally, to address the concern that founders might retain control of the exchange indefinitely, they are required to sell all of their memberships that exceed the concentration limitations within ten years of initiation of trading on the Exchange. The Commission believes that these restrictions adequately prevent the founders from having an undue ability to control the election of directors or the operation of the Exchange. In the Commission's view, the ISE's concentration limits and divestiture requirements address both the economic needs of the Exchange as a start-up venture and the statutory requirements that all members are fairly represented and that conflicts of interest are minimized.

2. Restrictions on the Number of Memberships That May Be Approve for Trading

a. Generally

The Exchange has established limitations on the number of memberships with respect to which the Exchange will approve a member to trade on the Exchange. Generally, the Exchange will approve a member to effect Exchange transactions pursuant to only one PMM membership. If a member can show good cause,[50] the Exchange may approve a member to effect Exchange transactions with respect to two PMM memberships.[51] Founders are subject to the same limits on how many memberships they may use for trading.

b. Initial Approval of Memberships

The Exchange also has established further limitations on the number of memberships that a member initially may use for trading.[52] These limits are based upon the number of members in each class that have been approved to effect Exchange transactions. Specifically, the Exchange will not initially approve a member to effect Exchange transactions with respect to more than one PMM membership until the Exchange has approved at least five other members to effect exchange transactions with respect to PMM memberships.[53] In addition, the Exchange has adopted a tiered approach with respect to multiple CMM memberships. The Exchange will not initially approve a member to use multiple CMM memberships for trading until the Exchange has approved a minimum number of different members to effect Exchange transactions with respect to CMM memberships.[54] The Commission believes that the ISE's approach to activating trading rights will protect against one or a few market makers dominating trading on the Exchange and, therefore, will promote competition.

3. Divestiture of Memberships Owned by Founders

To diversify the Exchange's membership, the Exchange's rules require the transfer of the memberships owned by founders that exceed the concentration limits over a certain timeframe. As noted above, founders will be permitted to exceed the ownership concentration limits on a temporary basis. The Exchange, however, has the authority to assure that founders make memberships available and divest their ownership of memberships within a reasonable time period where they exceed the concentration limits. Specifically, six years after trading begins on the ISE, the Exchange can offer those membership(s) for sale if a founder fails to lease or sell at least forty percent of the memberships that exceed the concentration limitations.[55] Within ten years of initiation of trading on the Exchange, founders must sell all memberships that exceed the concentration limitations. Again, if a founder does not meet this requirement, the Exchange may sell the number of memberships that exceed the concentration limits for the benefit of the founder.[56] The Commission believes that providing the ISE with the authority to sell off memberships where a founder does not dispose of memberships exceeding the concentration limits is appropriate to ensure that, over time, the interests on, and control over, the Exchange become increasingly diversified.

D. Discipline and Oversight of Members

As a prerequisite for the Commission's approval of an exchange's application for registration, the exchange must be organized and have the capacity to carry out the purposes of the Exchange Act. Specifically, an exchange must be able to enforce compliance by its members, and persons associated with its members, with the federal securities laws and the rules of the exchange.[57]

The ISE's rules generally provide that it has disciplinary jurisdiction over its

[47] *See* Amendment No. 2.

[48] The ISE states that the Exchange's management currently anticipates recommending that the Board grant a waiver of this provision only to ATP, a founder of the Exchange. This recommendation is due to ATP's position in funding the Exchange, and also due to the unique nature of ATP's membership. Specifically, ATP is owned by a consortium of broker-dealers and other entities, and thus ATP itself represents widespread ownership in the securities industry. The Board, which will have a majority of non-industry Directors, must determine that approval of management's recommendation is in the best interest of the ISE.

[49] *See* ISE Constitution, Article II, Section 11(c).

[50] *See supra* notes 46–48 and accompanying text (defining ''good cause shown'').

[51] *See* ISE Rule 317(a).

[52] *See* ISE Constitution, Article II, Section 11(b); ISE Rule 317(b)(1) and (2).

[53] *See* ISE Rule 317(b)(1).

[54] *See* ISE Rule 317(b)(2). To reiterate, although founders are exempt from the concentration limits on ownership of memberships for ten years, they are not exempt with respect to limitations on the number of memberships for which they may approve for trading on the Exchange. *See* ISE Constitution, Article II, Section 11(b).

[55] *See* ISE Rule 310(b)(5).

[56] *See* ISE Rule 310(b)(4). For example, if a member owned twenty CMM memberships, it would be required to lease or sell at least four (40% of 10 is 4) prior to six years after the date trading on the Exchange commences. If that member only leases or sells two of the memberships by six years after the date trading began on the Exchange, the Exchange would take control of two memberships and sell them for the member's benefit.

[57] Section 6(b)(1) of the Exchange Act, 15 U.S.C. 78f(b)(1). For purposes of ISE's regulatory authority and rules, EAMs are ''Members'' of the Exchange. *See also* Section 3(a)(3)(A) of the Exchange Act, 15 U.S.C. 78c(a)(3)(A) (defining the term ''member'').

members to enforce their compliance with the ISE's rules and the federal securities laws.[58] The ISE's rules also permit it to sanction members for violations of the Exchange's rules and violations of the federal securities laws by, among other things, expelling or suspending members, limiting members' activities, functions or operations, fining or censuring members, or suspending or barring a person from being associated with a member.[59] The Exchange's rules also provide for the imposition of fines for minor rule violations in lieu of commencing disciplinary proceedings.[60]

The Commission finds that the ISE's Constitution and rules concerning its disciplinary and oversight programs are consistent with the requirements of Sections 6(b)(7) and 6(d) of the Exchange Act in that they provide for fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the rules of the Exchange adequately provide it with the ability to comply, and with the authority to enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the Exchange.

1. Exchange Act Rule 17d–2 Agreements

Section 17 of the Exchange Act and Rule 17d–2 thereunder permit self-regulatory organizations (''SROs''), through so-called Rule 17d–2 agreements, to allocate certain regulatory responsibilities. Under Exchange Act Rule 17d–1,[61] a broker-dealer that is a member of more than one SRO has only one DEA, an SRO that is responsible for financial aspects of that broker-dealer's regulatory oversight. Exchange Act Rule 17d–2 [62] permits SROs to enter into agreements whereby one SRO assumes regulatory responsibilities for member firms (so-called ''joint members'') that are members of both the examining SRO and another SRO. SROs that delegate an area of regulation to another SRO under a Rule 17d–2 arrangement are relieved of regulatory responsibility under the Exchange Act for that area. These agreements help to avoid duplicative oversight and regulation. Generally, these agreements cover such regulatory functions as personnel registration, branch office examinations and sales practices. All existing SROs have entered into such agreements. These agreements must be filed with and approved by the Commission.[63]

The ISE intends to enter into a Rule 17d–2 agreement with NASD Regulation and with the DOEAs under the Options Designation Plan (''examining SROs''). The ISE's rules require that all EAMs be members of at least one of the examining SROs.[64] Under these agreements, the examining SROs will examine firms that are joint members of the ISE and the particular examining SRO for compliance with certain provisions of the Exchange Act, certain of the rules and regulations adopted thereunder, certain examining SRO rules, and certain ISE rules. As noted above, these agreements must be filed with, and approved by, the Commission. Once filed, the Commission will publish these agreements for comment.

2. ''Contracting Out'' of Certain Regulatory Functions

Not all of the ISE's regulatory responsibilities will be allocated to another SRO under a Rule 17d–2 agreement. For those responsibilities that fall outside the scope of any Rule 17d–2 agreement, the ISE has contracted with NASD Regulation on a payment for services basis (''Regulatory Services Agreement'').[65] Under the Regulatory Services Agreement, NASD Regulation will perform certain regulatory functions as an agent on behalf of the ISE. Specifically, NASD Regulation will process membership applications, will conduct certain ''upstairs'' investigations and will prosecute ISE enforcement actions. The ISE also intends to use the hearing panel infrastructure of NASD Regulation to conduct enforcement hearings.[66] Notwithstanding the fact that the Exchange will contract with NASD Regulation to perform these functions, the Exchange continues to bear ultimate regulatory responsibility.

Several commenters suggest that the ISE is attempting to abdicate its self-regulatory responsibilities by contracting out many of these functions to another SRO. The Commission disagrees. The Commission has previously recognized that contractual regulatory agreements between SROs outside of the Rule 17d–2 context may be permissible in instances where it is consistent with the public interest.[67] The Commission believes that it is reasonable and consistent with the public interest to allow an SRO to contract with another SRO to perform disciplinary and enforcement functions. Discipline and enforcement are fundamental elements to a regulatory program, and constitute core self-regulatory functions. It is essential to the public interest and the protection of investors that these functions are carried out in an exemplary manner, and the Commission believes that NASD Regulation has the expertise and experience to perform these functions.

At the same time, the Commission believes that it is important for, and that the Exchange Act requires, the ultimate responsibility and primary liability for self-regulatory failures to rest with the Exchange itself, rather than the SRO retained to perform the disciplinary and enforcement functions. Thus, the ISE will bear ultimate legal responsibility for the performance of its self-regulatory obligations. The SRO performing the function, however, may nonetheless bear liability for causing or, in appropriate circumstances, aiding and abetting the Exchange's violations.[68]

[58] *See* ISE Rules, Chapter 16.

[59] *See* ISE Rules, Chapter 15.

[60] *See* ISE Rule 1614. Minor ISE rule violations include, for example, violating the position limit rules, failing to file FOCUS reports, failing to provide trade data, violating conduct and decorum policies, violating the order entry rules (Rule 717(a), (c)—(e)), violating the quotation parameters, or failing to execute orders in appointed options.

[61] 17 CFR 240.17d–1.

[62] 17 CFR 240.17d–2.

[63] For example, the Commission has approved a regulatory plan (''Options Designation Plan'') filed by the Amex, CBOE, NASD, NYSE, Pacific Exchange (''PCX'') and Philadelphia Stock Exchange (''Phlx'') that allocates the regulatory responsibilities among these SROs for common members, by designating four of the participating SROs as the options examination authority for a portion of the common members. The SRO designated under the plan as a broker-dealer's options examination authority is responsible for conducting options-related sales practice examinations and investigating option-related customer complaints and terminations for cause of associated persons. The designated SRO is also responsible for examining a firm's compliance with the provisions of applicable federal securities laws and the rules and regulations thereunder, its own rules, and the rules of any SRO of which the firm is a member. *See* Exchange Act Release No. 20158 (September 8, 1983), 48 FR 41265 (September 14, 1983).

[64] *See* ISE Rule 600. Although the rules of the ISE do not require that PMMs and CMMs be members of an SRO with which the ISE has entered into a Rule 17d–2 agreement, the ISE's membership application, which has been included as part of the Exchange's Form 1, states such a requirement. Accordingly, the ISE is not accepting membership applications from entities seeking to be members solely of the ISE. To change this requirement, the ISE would have to file a proposed rule change with the Commission under Exchange Act Rule 19b–4.

[65] Although the ISE's rules provide for disciplinary jurisdiction and procedures, investigatory processes, and arbitration procedures, the Exchange's Constitution provides it with the authority to contract with an SRO to perform some or all of these functions. *See* ISE Rules 1615 (disciplinary functions); 1706 (hearings and review); and 1835 (arbitration).

[66] *See* Amendment No. 1.

[67] *See* ATS Release, *supra* note 7.

[68] For example, if failings by NASD Regulation have the effect of leaving ISE in violation of any aspect of the Exchange's self-regulatory obligations, ISE would bear direct liability for the violation,

Continued

Accordingly, although NASD Regulation will not act on its own behalf under its SRO responsibilities in carrying out these regulatory services for the ISE, NASD Regulation also may have secondary liability if the Commission finds that the contracted functions are being performed so inadequately as to cause a violation of the federal securities laws by the ISE.

The Commission has reviewed the terms of the Regulatory Services Agreement, which provides a detailed description of the functions NASD Regulation agrees to perform.[69] The Commission believes that this agreement provides for oversight of ISE members and enforcement of ISE rules and federal securities laws in a manner consistent with the public interest. Moreover, the terms under which NASD Regulation will perform certain regulatory functions for the ISE are sufficiently described so as to ensure a regulatory program that will satisfy the statutory requirements, including safeguarding against manipulation and fraud. Under this agreement, NASD Regulation will perform various regulatory functions, whereas the ISE will retain decision-making authority. For example, although NASD Regulation will process membership applications to ensure their completeness, the ISE will make all determinations regarding approval or denial of membership on the Exchange. The ISE will also determine whether to bring enforcement actions. Any hearing will be before an ISE hearing panel, consisting of a hearing officer (likely hired from NASD Regulation) and representatives of ISE members. In addition, the ISE's Board will have the opportunity to consider all appeals of ISE disciplinary actions before they can become final actions of the Exchange.

3. Surveillance

A number of commenters expressed concern about ISE's surveillance program, stating that they did not have enough information about it to make a determination concerning its adequacy. The Commission notes that, as a matter of Commission policy, surveillance programs and procedures are generally kept confidential.[70] The ISE has represented that it intends to administer its own surveillance system for trading on the Exchange. The ISE's staff will operate the system and be responsible for conducting all aspects of the daily surveillance of trading and its market activities.[71] These responsibilities will include, among other things, a real-time audit trail to monitor market participants and to detect abusive trading activity.

4. ''Information Barrier'' Between Market Making and ''Other Business Activities''

Currently, the rules of several of the SROs impose certain restrictions on the business activities of a member or member organization that is affiliated with a specialist or member organization. However, a member or member organization that is affiliated with a specialist or market maker may obtain an exemption from these restrictions if certain procedures are established that restrict the flow of material, non-public information between the affiliated member and the specialist or market maker, *i.e.*, an ''information barrier.'' For example, the rules of the NYSE provide that in order to obtain such an exemption, a member or member organization affiliated with a specialist or market maker must, among other things, establish another organization separate and distinct from the specialist or market making business. That is, ''[t]he specialist member organization must function as an entirely freestanding, separate entity responsible for its own trading decisions, and may not function in any manner as a 'downstairs' extension of the 'upstairs' trading desk.''[72] The rules of the PCX, however, do not require that a separate corporate entity be formed with respect to these business activities. PCX requires only functional separation, not organizational separation.[73]

Similar to the rules of the PCX, the ISE will permit its market makers to engage in other business activities, or to be affiliated with broker-dealers that engage in other business activities,[74] if there is an information barrier between the market making activities and the other business activities, *i.e.*, functional separation.[75] In other words, the ISE will not require a separate, affiliated broker-dealer organization to be established. Thus, a market maker on the ISE will be permitted to also be an EAM provided sufficient procedures are in place to ensure that the flow of material, non-public information between the two businesses is restricted. As with the rules of the other SROs, a member seeking an exemption from the restrictions on engaging in other business activities must obtain approval of its information barrier procedures from the Exchange.

The Commission finds that the provisions governing ''other business activities'' of market makers are consistent with Section 6(b)(5) of the Exchange Act in that they are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. The Commission believes that the ISE's Constitution and rules provide for a clear separation of the market making activities of a firm and its affiliated brokerage business.[76] The information barrier between a market maker and affiliated EAM should protect against an inappropriate sharing of information that could result in market manipulation. The Commission expects the ISE to be vigilant in monitoring for possible abuses in this context.

E. The ISE Trading System

The ISE will operate an automated trading system for standardized equity options. It will conduct an agency auction market similar to the exchange markets currently in operation, although the auction will occur electronically and not on a floor. This section describes the most significant rules and procedures governing trading on the ISE.

1. Generally

Generally, each PMM and CMM on the ISE will enter its own independent quotations into the ISE System (''System''). PMMs and CMMs will enter size with their quotations, which must meet the minimum size requirements, established by the Exchange for the execution of customer orders. EAMs will enter agency and principal orders into the System. PMMs will have terminals that provide them with

while NASD Regulation may bear liability for causing or aiding and abetting the violation.

[69] The ISE and NASD Regulation have requested confidential treatment for their contractual agreement pursuant to Section 24(b)(2) of the Exchange Act and 17 CFR 240.24b–2 thereunder.

[70] Disclosure of specific surveillance procedures could provide market participants with information that could aid potential attempts at avoiding regulatory detection of inappropriate trading activity.

[71] The ISE's operations are subject to inspection by the Commission. In addition, the ISE's surveillance plan and procedures, as well as the implementation of them, are subject to Commission inspection to ensure that the ISE adequately monitors its market and its members, and enforces its rules and the federal securities laws, including the anti-fraud provisions.

[72] *See* NYSE Rule 98 (and subsequent Guidelines).

[73] *See* PCX Rule 4.20.

[74] ''Other Business Activities'' means (1) conducting an investment or banking or public securities business; (2) making markets in the stock underlying the options in which it makes markets; or (3) functioning as an Electronic Access Member. *See* ISE Rule 810(a).

[75] *See* ISE Rule 810.

[76] One of the commenters asserts that the information barrier requirement is not sufficient to address concerns over internalization of order flow. *See* Sutherland Asbill Letter 2. This concern is discussed in conjunction with internalization below.

information on all of the orders and quotations pending in the System, while CMMs and EAMs will have terminals that display the best bid and offer (''BBO'') currently quoted on the ISE in each options series, as well as the aggregate size of the BBO.

On the existing exchanges, market makers are appointed to options classes within particular physical ''zones'' on the trading floor.[77] Because the ISE will not have a physical trading floor, options classes will be divided into Groups of options classes.[78] Each Class A membership will represent the right to be the PMM in one Group,[79] and each Class B membership will represent the right to be a CMM in one Group.[80] One PMM and at least two CMMs will be appointed to each options class traded on the Exchange.[81]

Overall, there will be a total of 10 PMMs (one in each Group) and 100 CMMs (ultimately 10 in each Group). In addition to being able to enter quotations, PMMs and CMMs will be able to enter ''immediate or cancel'' orders [82] for options in their assigned Groups. Subject to certain limitations, PMMs and CMMs also will be permitted to place orders in any of the other Groups of options classes, but will not be allowed to enter quotations outside their assigned Group(s).[83] EAMs will not be permitted to enter orders that would effectively result in market making on the Exchange.[84]

2. Order Execution and Priority Rules

a. Generally

Trades will occur when orders or quotations match in the System. A customer order in the System (on the book) will always have priority. If more than one customer order has been entered into the System at the same price, priority will be based on the time of order entry. The System will not automatically execute a public customer order at a price inferior to the price quoted on another options exchange.[85] In this situation, the PMM must address such orders either by establishing parameters for matching away-market quotations or by handling them individually. The ISE states that, if a PMM decides to attempt to get the better price from the away market for the customer order, the order will remain in the System during this process. Thus, while a PMM may be seeking the away market price for the order, that order can be executed against a new incoming ISE market order at a price that would not ''trade through'' the away market.[86]

If a member enters a limit order into the System that crosses trading interest already in the System, a trade will occur, to the extent that size is available, at the price of the trading interest already in the System. After executing against that trading interest, the limit order will trade against other trading interest in the System until the limit order is filled in its entirety or the order depletes the available size at that price. If any amount of the limit order remains unexecuted, the balance of the order will become the best bid or offer.[87]

b. Internalization Issues

With the increase of multiple trading of options classes, the options markets are under significant pressure to attract or retain business. One approach to increasing business on an exchange is to allow members, including primary market makers and order entry firms, a preference in trading with customer orders they bring to the market. These preferences have the effect of reducing intramarket price competition by giving priority to a member based on its status as a specialist or as the firm that brought the order to the exchange as opposed to giving priority to a member first to quote at the best price. If exchange rules do not provide a fair opportunity to compete for orders based on price, firms and individuals could have less incentive to be competing market makers on an exchange and price competition may suffer. Eventually, if execution guarantees to particular exchange members become too great, competitive market makers within markets could diminish, and with them active or potential intramarket price competition. As a result, the published quotations, and the prices available on a market, could deteriorate—ultimately harming investors.

A number of commenters expressed concerns that the ISE's trading system would not foster vigorous intramarket competition, and would permit an inordinate amount of internalization of order flow on the ISE.[88] The Commission does not view the basic trading structure of the ISE as inconsistent with intramarket competition, or necessarily resulting in the pervasive internalization of order flow.[89] Therefore, the Commission finds that the ISE's trading system is consistent with Section 6(b)(5) of the Exchange Act in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.[90] As with any other options market, however, the degree of intramarket competition is determined by the market's specific trading procedures, which will be set forth in the ISE's rules. As explained further below, for purposes of beginning trading, the ISE will need to file certain rule change proposals with the Commission pursuant to Exchange Act Rule 19b–4 to specify in the rules how it intends to allocate order flow.[91]

(i) Allocation Algorithm

ISE Rule 713(e) states that the Exchange will determine a procedure for allocating executions among non-customer orders and market makers in cases where all public customer orders have been executed and there are two or more non-customer orders or market maker quotes at the best price. The ISE, however, did not include this allocation algorithm in its Form 1 registration application. Commenters assert that the absence of the algorithm from the rule made meaningful comment unfeasible. The Commission does not believe it is necessary to address the allocation algorithm referred to in this provision for the purposes of registering the ISE as a national securities exchange. Following the approval of the ISE's

[77] *See, e.g.*, PCX Rule 6.35 (providing that market makers may select up to six contiguous posts to comprise a ''Primary Appointment Zone)''.

[78] *See* ISE Rule 802(b). The ISE intends to trade all of the series of approximately six hundred actively-traded options classes, which it will divide into ten Groups of approximately sixty classes each. *See* ISE Form 1, Exhibit N.

[79] *See* ISE Constitution, Article II, Section 1(c).

[80] *See* ISE Constitution, Article II, Section 2(c).

[81] *See* ISE Rule 802(c).

[82] An ''immediate-or-cancel'' order requires that all or part of the order be executed as soon as the broker enters a bid or offer; the portion not executed is automatically canceled.

[83] *See* ISE Rules 805(b) and 804(a).

[84] *See* ISE Rule 717(b).

[85] *See* ISE Rule 714(a).

[86] *See* Amendment No. 1, Exhibit 6. The Commission notes that ISE may need to address certain of its order execution and priority rules when a national linkage is developed for the options markets. *See infra* note 108 and accompanying text and section E.2.c (discussing the proposed options linkage plans).

[87] In addition, trades will not necessarily occur when quotes of PMMs and CMMs match or cross each other. Such matches or crosses possibly could occur because market maker auto-quotation systems respond at different speeds. To address this issue, a trade between two or more market makers will only occur after the quotes remain matched for a defined amount of time, which will be less than one second.

[88] *See, e.g.*, Sutherland, Asbill and Brennan Letters 2 and 3, CBOE Letters 1 and 2, and Timber Hill Letter.

[89] ''Internalization'' is generally known as the direction of order flow by a broker-dealer to an affiliated specialist or order flow executed by that broker-dealer as market maker. *See* Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) at n.357 (File No. S7–30–95).

[90] *See* 15 U.S.C. 78f(b)(5).

[91] The Commission intends to publish these proposals in the **Federal Register** for comment.

registration application, the ISE will need to file a rule proposal with the Commission pursuant to Rule 19b–4 under the Exchange Act to establish the Exchange's order allocation algorithm.[92] Although the ISE has not included the allocation algorithm in its rules as currently proposed, it describes generally in its narrative response to the comment letters the principles by which the allocation algorithm will operate.[93] Specifically, all customer orders must be executed in full before any market maker quotes or professional orders are executed. In addition, a market maker quote or professional order must be at the ISE BBO to participate in an execution, and a market maker quote or professional order may never execute in an amount greater than the number of contracts in the quote or order. Priority among CMM quotes and professional orders at the ISE BBO will be based on size, participating in an execution based upon their proportion of the inside displayed size. A PMM, however, will participate in an execution in a somewhat greater proportion in relation to its quote size than a CMM, and when at the BBO will be guaranteed the right to trade against an entire order up to a size determined by the Exchange.[94] In other words, if the PMM is quoting at the ISE's BBO, it will have precedence over non-customer orders and CMM quotes for the execution of orders that are for a specified number of contracts or less (''Minimum Size''). The ISE did not include in its registration application what number of contracts would constitute the Minimum Size for purposes of this provision in ISE Rule 713(e). Two commenters assert that this provision granting PMMs the right to trade ahead of all other market participants (other than public customers) on all orders of less than the Minimum Size not only lacks specificity, but also could discourage other market participants, including CMMs and EAMs, from improving the quotes of a particular option series.[95] The Commission does not believe that failing to specify the Minimum Size referred to in this provision precludes registering the ISE as a national securities exchange because allocating some small orders exclusively to a PMM is not necessarily inconsistent with adequate intramarket competition. Following the approval of the ISE's registration application, however, the ISE will need to file a rule proposal with the Commission pursuant to Rule 19b–4 under the Exchange Act to establish the Exchange's Minimum Size referred to in this Rule.[96] This rule proposal must be consistent with statutory standards.

(ii) Block Order Mechanism

The ISE's rules provide a mechanism for handling block-size orders on the Exchange.[97] This mechanism generally adapts the block trading procedures followed on the existing options exchanges to the ISE's electronic system.[98] Specifically, a special ''block order trading mechanism'' (''BOM'') will be available to EAMs to enable them to solicit market participation for block-size orders of fifty or more contracts.[99] As on the other exchanges, this mechanism is intended to minimize the market impact of large orders and uses a ''quote request'' methodology.

In general, the BOM will permit an EAM to seek out liquidity for the execution of block-size orders by electronically soliciting indications of the prices and sizes at which ''crowd participants''[100] would be willing to trade with block-size orders. The BOM will enable an EAM to enter a block order along with a limit price.[101] The System will then broadcast an anonymous message to the crowd participants. The members of the trading crowd will have a specified amount of time in which to respond to the broadcast message with their indications.[102] The ISE represents that the responses are internal to the System and are not disclosed to any market participants, including the EAM entering the block-size order. At the end of the response period, the order will automatically be executed, unless there is insufficient size to execute the order consistent with the terms of the order.

Bids (offers) on the ISE at the time the block order is executed that are priced higher (lower) than the block execution price, as well as responses to the broadcast message that are priced higher (lower) than the block execution price, will be executed at the block execution price. Responses to broadcast messages, quotes and non-customer orders at the block execution price will participate in the execution of the block-size order.[103] After the trade is executed (or if there is no trade), all unexecuted responses are removed from the System and have no further standing.

One commenter contends that fifty contracts is a relatively small order size to be called block-size.[104] The Commission believes that fifty contracts is a reasonable size for use of a special execution mechanism like the BOM. First, the BOM is a mechanism by which EAMs must take the time to work an order on an order-by-order basis. Such effort should encourage EAMs to use this mechanism for larger orders they believe require special handling. Second, given that the average retail order is for less than ten contracts (thereby falling outside the definition of block), the BOM will not be available for most small retail orders.

Three commenters also criticize the ISE's limited dissemination of broadcast messages.[105] They assert that such a limitation inhibits opportunities for price improvement. The ISE responds that its limited broadcast is designed to involve those ISE members who express an active interest in trading the options series. The ISE also asserts that limiting the broadcast to market makers and members at the ISE BBO acts as an incentive to those members to provide additional liquidity at that price.[106] It appears that the ISE is attempting to emulate electronically the floor environment by limiting the persons to

[92] The Commission intends to publish the proposal in the **Federal Register** for comment.

[93] The ISE's narrative response is included in Amendment No. 1. *See* Amendment No. 1, Exhibit 6.

[94] *See* ISE Rule 713(e).

[95] *See* CBOE Letter and Amex Letter.

[96] The Commission intends to publish the proposal in the **Federal Register** for comment.

[97] *See* ISE Rule 716. The ISE defines a block-size order as an order for fifty (50) contracts or more. *See* ISE Rule 716(a).

[98] Generally, on a traditional options exchange, a broker will represent a block-size order in the trading crowd (located on the trading floor) to discover what price and associated size is available to trade with the block order.

[99] *See* ISE Rule 716. Use of the BOM is not required for block-size orders. The fact that this feature is optional is similar to the other options exchanges where a broker has the option of representing a customer order at a trading post on a floor versus entering the order into an exchange's electronic order routing system.

[100] ''Crowd Participants'' is defined as market makers appointed to an options class under Rule 803, as well as other members with proprietary orders at the ISE BBO for a particular series. See ISE Rule 716(b).

[101] The functionality of the System allows the EAM to specify exactly what information will be disseminated to the market. The EAM using the BOM may determine the amount of information that will be disclosed in the broadcast to crowd participants. For example, the broadcast can disclose that there is a sell or a buy order, or it could ask for size on either side. The broadcast also may or may not display size or price or any conditions on the block-size order.

[102] The ISE's registration application did not contain the time period that crowd participants would have to respond to a block trade broadcast. The ISE will file a rule change prior to beginning trading to establish this time period.

[103] As noted above, the ISE will be required to file a rule change with the Commission proposing the Exchange's order allocation algorithm. *See supra* note 91.

[104] *See* CBOE Letter 1.

[105] *See* CBOE Letter 1, Amex Letter, and Sutherland, Asbill and Brennan Letter 2.

[106] *See* Amendment No. 1, Exhibit 6.

whom a block (or facilitation) broadcast message is sent. Currently, block and facilitated executions occur on the floors of the options exchanges without ever being exposed to anyone other than those persons standing in the trading crowd. The Commission believes that it may ultimately be desirable to expose block-size and facilitated orders more broadly than to a narrow, privileged audience in order to provide price improvement opportunities prior to their execution. Nonetheless, the floor-based exchanges do not currently operate in that manner. The Commission does not believe that an automated exchange like the ISE should be held to a higher display standard in this particular context by being required to expose these orders to participants that are not displaying interest in the option. To do so could favor non-automated markets. Because the ISE, as an all-electronic auction market for options, is the first of its kind in the options industry, the Commission believes it is appropriate to allow the ISE to limit its definition of ''crowd participants'' as described above. As electronic trading of options becomes more widespread, this issue of limited display may warrant reexamination.

Two commenters also expressed concerns that an order of as small as fifty contracts may be executed outside the NBBO, thereby failing to provide intermarket price protection for the person entering the block-size order.[107] The Commission notes that some block orders, by virtue of their larger size, may indeed need to be executed outside of the NBBO in order to be executed in full. Customers buying or selling large size orders are generally aware that the order may not be filled at the NBBO. This can often be the cost of getting a full execution. The ISE, however, will provide block protection to orders on the ISE book. In the event that there are better-priced quotes and orders on the ISE book at the time the block order is executed, those quotes and orders will have priority, and will receive price protection by being executed at the block price. They will not be executed at a worse price than the block price. It is true that the ISE will not provide intermarket price protection for persons entering block size orders, but, as noted above, this is often the cost of getting an execution in full. This is a cost that market participants entering block size orders generally are willing to pay so as to not grossly impact the market price while trying to have their order executed. Moreover, such orders are still subject to a broker's duty of best execution for its customer.

The Commission notes that it is currently considering several proposed options linkage plans,[108] all of which provide for intermarket price protection by containing a prohibition against trade-throughs.[109] Each of the plans provides that, in the event that a block trade trades through a better-priced market,[110] the better-priced market must be satisfied at the price of the transaction that caused the trade-through (*i.e.,* the block price). However, because the ISE's definition of ''block'' is for fifty contracts or more, block-size orders executed on the ISE that do not satisfy the plans' definition of ''block trade'' would be required to satisfy the price of the bid or offer that was traded through, rather than the block price.[111]

(iii) *Facilitation Mechanism*

The existing options markets have procedures governing the manner in which a member may facilitate a customer's order by trading with the order using its proprietary account.[112] This is referred to as a ''firm facilitation.'' These procedures generally are tailored to exchanges with physical trading floors and traditional open outcry systems. Because the ISE will function as a fully automated auction market and will not have a trading floor, it has adapted a ''firm facilitation'' mechanism to an electronic context.

Specifically, ISE Rule 716(d) provides an EAM with the ability to use a special ''facilitation mechanism'' to enter a block size customer order (minimum of 50 contracts) and execute the order as principal. An EAM is not otherwise permitted to execute an agency order as principal unless the order is first permitted to interact with other interest on the ISE. When an order is entered into the facilitation mechanism, the ISE will send a facilitation broadcast to crowd participants.[113] The broadcast message is anonymous and informs crowd participants of the proposed transaction. The facilitation broadcast will contain information on the terms and conditions of the order, including the facilitation price. The identity of the EAM will not be disclosed. The recipients of the broadcast will have a designated amount of time, set by the Exchange, to respond.[114] The responses must be priced at the price of the order being facilitated and must not exceed the size of the order being facilitated. The responses will not be disseminated. If a crowd participant is willing to improve the price of a facilitation order, it may do so by entering its quote or order in the ISE order book at least ten seconds prior to the expiration of the facilitation broadcast, which provides the facilitating member the opportunity to consider whether it is willing to facilitate the customer order at that better price.

At the end of the set time period given, the facilitation order will be automatically executed in full. The facilitation order will be executed at the facilitation price unless there is sufficient interest on the ISE order book to execute the order in its entirety at a better price. If the order is executed at the facilitation price, any better-priced orders or quotes on the order book will receive price protection in the same manner as the BOM, and thus will be executed at the price of the facilitation order. The EAM entering the facilitation order will be allocated a minimum of forty percent of the original size of the facilitation order, but only after better-priced orders and quotes, as well as public customer orders at the facilitation price are executed.[115] Responses to the broadcast, quotes and non-customer orders at the facilitation price will participate in the execution of the facilitation order according to an

[107] *See* CBOE Letter 1 and Amex Letter.

[108] The Commission recently ordered the current options markets to work jointly toward establishing a national market system plan providing for the linkage of all the options markets. *See* Exchange Act Release No. 42029 (October 19, 1999), 64 FR 57674 (October 26, 1999) (''Options Linkage Order''). Three plans were filed by CBOE/Amex, Phlx and PCX. Copies of these proposed plans are available in the Commission's Public Reference Room under File No. 4–429.

[109] A trade-thorough occurs where a customer's order is executed on one exchange at a price inferior to that available on another exchange. Currently, intermarket trade-throughs can occur in the options markets because there is no efficient means for accessing quotes across these markets.

[110] The proposed plans uniformly define a ''block trade'' as a trade that: (i) is of block size, defined as 500 contracts or more and a premium value of at least $150,000; (ii) is effected at a price outside of the NBBO; and (iii) involves either a cross (where a member of the exchange represents all or a portion of both sides of the trade) or any other transaction that is not the result of an execution at the current bid or offer on the exchange.

[111] The plans differ with respect to the appropriate size of satisfaction.

[112] *See, e.g.,* Amex Rule 950(d), Commentary .02, and CBOE Rule 6.74(b).

[113] *See* supra note 100 (defining crowd participants).

[114] The ISE's registration application did not contain the time period that crowd participants would have to respond to a facilitation broadcast. The ISE will file a rule proposal prior to beginning trading to establish this time period. The Commission understands that the ISE intends this time period to be thirty seconds. The Commission intends to publish the proposal in the **Federal Register** for comment.

[115] In Amendment No. 1, the ISE proposed to give the EAM a guaranteed minimum participation right of fifty percent of the original size of the facilitation order. The ISE has reduced this participation right to forty percent. *See* Amendment No. 2.

allocation algorithm that will be established in ISE Rule 713(e).[116]

The Commission notes that the ISE has adopted an interpretive amendment to Rule 716(d).[117] Under this interpretation, it would be a violation of a member's duty of best execution to its customer if it were to cancel a facilitation order to avoid execution of the order at the better price. Use of the facilitation mechanism does not modify a member's best execution duty to obtain the best price for its customer. Accordingly, while facilitation orders may be canceled during the facilitation timeframe, if a member were to cancel a facilitation order when there was a superior price available on the ISE and subsequently re-enter the facilitation order at the same facilitation price after the better price was no longer available without attempting to obtain that better price for its customer, there would be a presumption that the member did so to avoid execution of its customer order by other market participants. This would violate the member's duty of best execution.

The Commission believes that this interpretation is important to ensure that brokers proposing to facilitate orders as principal fulfill their best execution duties to their customers. In the Commission's view, withdrawing a facilitated order that may be price improved simply to avoid executing the order at the superior price is a violation of a broker's duty of best execution. The Commission expects the ISE to establish procedures to surveil for violations of this best execution obligation.[118]

Commenters expressed concern that the ISE's facilitation mechanism would permit an EAM to internalize a significant amount of order flow. As mentioned above, the Commission is concerned about locking up large portions of order flow from intramarket price competition by granting certain market participants extensive participation guarantees. To address the concerns of the Commission and the commenters, the ISE has amended Rule 716(d)(4)(ii) to reduce a facilitating EAM's minimum participation right to forty percent of the facilitated order. This will leave at least sixty percent of each facilitated order available for participation by other market participants.

It is difficult to assess the precise level at which guarantees may begin to erode competitive market maker participation and potential price competition within a given market. In the future, after the Commission has studied the impact of guarantees, the Commission may need to reassess the level of these guarantees. For the immediate term, the Commission believes that forty percent is not clearly inconsistent with the statutory standards of competition and free and open markets.

c. Trade-or-Fade

PMMs and CMMs will have the ability to set parameters regarding their willingness to trade generally with a broker-dealer's proprietary order. When the Exchange receives such an order, any CMM or PMM quotations in the System will be executable only up to the size of the PMM's or CMM's pre-set parameters. The matching rules discussed above otherwise would remain the same. Upon completion of the trade, if a PMM or CMM that has established parameters for trading against a proprietary order does not provide a complete fill of the order, the PMM or CMM cannot continue to quote at that price and must move its quotation to the next level.[119] Orders of market makers on other options exchanges will be handled on an order-by-order basis by the PMM and CMMs.

One commenter criticizes the ISE's ''trade-or-fade'' rule.[120] It argues that the ISE's ''trade-or-fade'' rule, which replicates an identical rule on the other options exchanges, should not be permitted. It suggests that a ''trade-or-fade'' rule results in phantom quoting by market makers, which, in its opinion, invites market manipulation. It further asserts that a ''trade-or-fade'' rule would be particularly problematic on the ISE, given that the ISE intends to tally and display to members the aggregate size of all orders and quotes entered into the system at the BBO. The commenter argues that, if market makers are permitted to retreat from their quotes when they receive a broker-dealer order, then the quoted market will be illusory to broker-dealers.[121]

Although the Commission agrees that the concept of ''trade-or-fade'' raises some concern, for purposes of registration it will not hold the ISE to a different standard than that to which all of the existing options markets are currently held. Requiring the ISE to maintain firm quotes for non-customer orders at this time would put it at a competitive disadvantage in relation to the other options markets. The proposed options linkage plans would limit ''trade-or-fade'' policies with respect to principal and customer orders from other markets up to a certain size.[122] The Commission expects the options markets, including the ISE, to reassess the relevance of their internal ''trade-or-fade'' provisions at the time the linkage is implemented.

3. Limitations on EAMs and Non-Customer Orders

The ISE's rules contain certain unique provisions restricting competition by EAMs and highly automated customers.[123] The ISE asserts that these provisions are needed in light of its business model and the electronic nature of the Exchange. The ISE business model depends on competition between one PMM and ten CMMs per options class. To encourage participation by these market makers, it limits the ability of non-CMMs/PMMs to compete as market makers on equal terms in its automated system. The Commission does not believe that, given the ISE's fully automated auction market, this balance between market makers and non-market makers is inconsistent with the Exchange Act's requirements. The Commission believes that this determination, however, may require review in light of subsequent rule changes or experience with the extent of competition that develops within the ISE's structure.

a. Limitations on Market and Marketable Limit Orders

ISE Rule 717(a) prohibits EAMs from entering into the System, as principal or agent, non-customer market orders or non-customer limit orders that cross the market and that cannot be executed within two minimum trading increments of the best bid or offer. These orders will be canceled by the System. The ISE has represented that this provision is designed to limit volatility. The ISE believes that, in an electronic market, non-customer market orders have the potential to create market volatility by trading at different price levels until executed in their entirety.

One commenter asserts that this is the type of limitation that the Commission generally has been unwilling to approve

[116] *See supra* note 92 and accompanying text.

[117] *See* Amendment No. 2.

[118] The Commission realizes that ensuring that ISE members do not re-enter facilitated orders on markets other than the ISE may be difficult. Nevertheless, the Commission expects the ISE to work with the other options markets through the Intermarket Surveillance Group to develop methods and procedures to monitor their members trading on other markets for possible best execution violations in this context.

[119] This provision is akin to the ''trade-or-fade'' rules of the other options exchanges. *See, e.g.,* CBOE Rule 8.51(b).

[120] *See* Timber Hill Letter.

[121] *See* Timber Hill Letter.

[122] *See supra* note 108.

[123] *See* ISE Rule 717.

in the past.[124] However, the Commission believes that this provision may be more appropriate in a fully automated auction market. Without such a restriction, it would be possible for non-customers to use large-size orders to quickly take out the entire electronic order book. Ultimately, a non-customer order could walk through the entire ISE book without other market participants having an opportunity to react. Because the book is wholly accessible electronically, the ISE's displayed prices could be eliminated without an opportunity for market makers to respond. In contrast, customer orders are much less likely to have this effect given their typically smaller size. Furthermore, it would be extremely difficult for customer orders to quickly take out the book because these orders receive intermarket price protection. The Commission is concerned that this provision may excessively limit access to broker-dealers to trade with the ISE's published prices. Nonetheless, in view of the untested nature of the ISE's electronic market, the Commission has no reason to believe at this time that this provision is inconsistent with the statute. Once experience is gained in the ISE market, this provision may need to be reassessed.

b. Restrictions on EAMs Acting as Market Makers

ISE Rule 717(b) prohibits EAMs from entering into the System, as principal or agent, limit orders in the same options series, for the account or accounts of the same or related beneficial owners, in such a manner that the EAM or the beneficial owner(s) effectively is operating as a market maker by holding himself out as willing to buy and sell such options contracts on a regular or continuous basis.[125] Essentially, this provision prevents EAMs from using limit orders to effectively quote and make markets on the ISE.

One commenter criticizes this provision. [126] It asserts that the regulatory costs and benefits likely to result from an exchange's prohibition of ''off-floor market making'' must be analyzed on an exchange-by-exchange or crowd-by-crowd basis. It suggests that the European electronic exchange model, which encourages market makers by charging them lower transaction fees rather than giving them monopoly rights, would be more appropriate.[126]

The Commission believes that this provision is reasonable in an effort to prevent EAMs from reaping the benefits of market making activities without having any of the concomitant obligations. Specifically, PMMs and CMMs have affirmative market making obligations, including providing continuous quotations during all market conditions.[128] The Commission also believes that the provision is designed to prevent customers from acting as unregistered market makers, and obtaining an unfair advantage by their orders always appearing at the top of the book by virtue of their public customer status. Moreover, this prohibition is appropriate to prevent public customers from continually entering limit orders of fewer than ten contracts, triggering certain PMM obligations. A PMM has the responsibility to assure that each ISE BBO disseminated market quote in each series of options is for a minimum of ten contracts. When the ISE BBO represents one or more public customer orders for less than a total of ten contracts at that price, the PMM is obligated to buy or sell at that price the number of contracts needed to make the disseminated quote firm for ten contracts.[129] This responsibility arises when the ISE receives a public customer limit order for fewer than ten contracts that would improve the ISE BBO.[130] The Commission believes that, if EAMs or beneficial owners were permitted to enter multiple customer limit orders to such an extent that they were effectively acting as market makers, and, at the same time, jump ahead of all other orders on the book, they would have an inordinate advantage over other participants on the Exchange.

c. Restrictions on Order Size

ISE Rule 717(c) prohibits EAMs from entering into the System, as principal or agent, multiple orders for a single trading interest if one or more orders is for less than ten contracts. This rule is designed to prevent EAMs from abusing a PMM's responsibilities. As noted above, a PMM has the responsibility to assure that each ISE BBO is always firm for a minimum of ten contracts. When the ISE BBO represents one or more public customer orders for less than a total of ten contracts at that price, the PMM is obligated to buy or sell at that price the number of contracts needed to make the disseminated quote firm for ten contracts.[131] Absent this prohibition, an EAM feasibly could break up an order for a single trading interest into several different orders of less than ten contracts each and trigger the PMM's obligation either to trade with each order at the improved price or to make up the difference in the size of the disseminated quote. The Commission believes that, if EAMs, as principal or agent, were permitted to enter multiple orders of less than ten contracts for a single trading interest, this would give them the ability to take advantage of the PMMs.

This provision also provides that non-customer orders for less than ten contracts will be rejected or cancelled automatically if such orders would cause the size of the ISE's BBO to be fewer than ten contracts. The Commission believes that, absent this provision, non-customer orders for less than ten contracts could cause the ISE BBO to be firm for less than ten contracts, in conflict with the ISE's business model of continually displaying a minimum of ten contracts. PMMs are not obligated to trade with these orders or to make up the difference in the disseminated size of the ISE BBO. This provision does not mean that all non-customer orders must be for ten or more contracts. It simply means that if a non-customer wants to improve the ISE BBO, it must do so for at least ten contracts.

d. Limits on Internalization

(i) Restrictions on Principal Transactions

ISE Rule 717(d) limits an EAM's ability to execute as principal orders it represents as agent. Specifically, an EAM may only execute as principal an order it represents as agent if (i) the agency order is first exposed on the ISE for at least two minutes, (ii) the EAM has been bidding or offering on the ISE for at least two minutes prior to receiving an agency order that is executable against such bid or offer, or (iii) the EAM uses the facilitation mechanism.[132] This provision is an attempt to prohibit an EAM from executing, as principal, an order it represents as agent unless the order is

[124] *See* CBOE Letter 1.

[125] The provision provides several factors that the Exchange will consider, among other things, in determining whether an EAM or beneficial owner effectively is operating as a market maker. *See* ISE Rule 717(b).

[126] *See* Timber Hill Letter.

[127] *See* Timber Hill Letter.

[128] *See* ISE Rule 804(e)(1) and (2).

[129] *See* ISE Rule 803(c)(1).

[130] This responsibility arises only when the aggregate ISE BBO falls below ten contracts, not when the size of an individual quote or order falls below this level. Hence, multiple quotes or orders for less than ten contracts may be on the order book at the ISE BBO without creating the need for the PMM to step in, so long as the aggregate size of the ISE BBO is equal to or greater than ten contracts.

[131] *See* ISE Rule 803(c)(1).

[132] The Commission notes that the ISE intends to propose, through a Rule 19b–4 rule filing, that this timeframe be reduced to thirty seconds. The Commission intends to publish the proposal in the **Federal Register** for comment.

first given the opportunity to interact with other trading interest on the Exchange. It is designed to prevent an EAM from internalizing order flow and to provide added opportunity for price competition.

Several commenters express concern that the System would permit its members to internalize a significant amount of order flow.[133] They assert that the ISE's rules contain loopholes that would permit members to internalize order flow. The ISE, in order to preclude internalization of a significant amount of order flow, has rules that would prevent an EAM from entering nearly simultaneous customer and proprietary orders before there is an opportunity for the customer order to interact with other trading interest on the ISE.

The Commission believes that the restrictions on EAMs trading as principal with orders they represent as agent, the limitations on solicited orders, as well as the three interpretations (discussed below) that the ISE has adopted should adequately protect against the internalization of order flow by an EAM.[134]

(1) Prohibition on the Disclosure of Agency Orders

Commenters have said that under the ISE's rules, an EAM might be able to internalize orders indirectly through arrangements with third parties. In response, the ISE has adopted supplementary material to Rule 400 (Just and Equitable Principles of Trade) to address the concerns that a member might disclose certain information to a third party regarding agency orders.[135] Specifically, a member will be prohibited from disclosing to a third party [136] information regarding agency orders represented by the member prior to entering such orders into the ISE's System in order to allow the third party to attempt to execute against the member's agency orders. A member's disclosing information regarding agency orders prior to the execution of such orders on the ISE would provide an inappropriate informational advantage to the third party in violation of Rule 400.

The Commission believes that this interpretation should help to prevent an EAM from doing indirectly what it is prohibited from doing directly. The provision should prove beneficial in preventing members from ''gaming'' the System. Specifically, the interpretation is designed to ensure that members do not circumvent the intent to prohibit a firm from acting as both principal and agent unless the firm's agency orders have been exposed on the ISE for at least two minutes. An EAM generally must expose orders it represents as agent before it may execute them as principal. Absent the prohibition on the disclosure of this type of information, a member and a third party could potentially use the ISE to execute their orders with each other without exposing these orders to other trading interest. The Commission believes that this interpretation will do much to prevent a firm from trading as principal with orders it represents as agent with a third party with whom it shares a beneficial interest. In the Commission's view, this interpretation should prove helpful in curbing a firm's ability to internalize order flow.

(2) Prohibition on Trading Via Prearranged Transactions

The ISE represents that the intent of Rule 717(d) is to prevent an EAM from executing agency orders to increase its economic gain by trading against an order without first giving other trading interest on the ISE an opportunity to either trade with the agency order or to trade at the execution price when the EAM was already bidding or offering on the ISE book. Nevertheless, the ISE recognizes that it may be possible for an EAM to establish a relationship with a customer to realize similar economic benefits as it would achieve by executing agency orders as principal. To address this issue, the ISE has adopted supplementary material to provide that it will be a violation of Rule 717(d) for an EAM to be a party to any arrangement designed to circumvent Rule 717(d) by providing an opportunity for a customer to regularly execute against agency orders handled by the EAM immediately upon their entry into the System.[137] The Commission believes that this interpretation should be helpful in preventing an EAM from thwarting the restrictions on trading as principal. This interpretation is also a suitable prophylactic measure against possible gaming, mentioned above, of trading in the System.

e. Limits on Solicited Orders

ISE Rule 717(e) requires EAMs to expose orders they represent as agent on the ISE for at least two minutes before they may be executed in whole or in part by orders solicited from members and non-member broker-dealers to interact with such orders. This effectively requires an EAM to give agency orders an opportunity to interact with trading interest on the ISE before executing such orders against orders the EAM solicits from other broker-dealers. This provision does not limit an EAM's ability to cross an agency order with a solicited customer order.

One commenter questioned whether the ISE was attempting to distinguish between the solicitation of public customer orders from the solicitation of broker-dealer orders for the purposes of this rule.[138] The ISE represents that it distinguishes between public customer orders and broker-dealer orders in order to achieve a balance between the interests of EAMs and market makers.

The Commission notes that solicited public customer orders are currently treated differently on the CBOE and the Amex. The CBOE requires that orders solicited from a public customer be exposed to the trading crowd prior to an upstairs firm executing an order it represents as agent with that solicited order. In contrast, the Amex does not require an upstairs firm to present to the trading crowd an order solicited from a public customer prior to the upstairs firm crossing that order with an order it represents as agent.[139] The ISE has opted to follow the rule as it exists on Amex.

The ISE has adopted supplementary material to clarify that it will be a violation of ISE Rule 717(e) for an EAM to cause the execution of an order it represents as agent on the ISE by orders it solicited from members and non-member broker-dealers to transact with such orders, whether such solicited orders are entered into the System directly by the EAM or by the solicited party (either directly or through another member), if the member fails to expose those orders on the Exchange as required by ISE Rule 717(e).[140] The Commission believes that this interpretation is appropriate because it clarifies that solicited orders must be exposed on the System regardless of who enters such orders.

Overall, the Commission believes that requiring exposure on the ISE of orders solicited by an EAM should help to proscribe potential internalization of customer order flow by a firm representing an order as agent.

[1] *See, e.g.,* Sutherland, Asbill, and Brennan Letters 2, and 3; CBOE Letter 1.

[134] *See* Amendment No. 2.

[135] *See* Amendment No. 2.

[136] For purposes of this provision, a third party includes any other person or entity, including affiliates of the member.

[137] *See* Amendment No. 2.

[138] *See* CBOE Letter 1.

[139] The Commission notes that in 1998 the Amex proposed to adopt a rule similar to the CBOE's regarding the treatment of solicited public customer orders. The filing was withdrawn by the Amex. *See* File No. SR–Amex–98–19.

[140] *See* Amendment No. 2.

f. Restrictions on the Electronic Generation of Orders

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

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

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

[141] *See* Amendment No. 2.

[142] *See, e.g.,* CBOE Letters 1 and 2.

[143] *See* CBOE Letters 1 and 2. The Commission notes that the proposals that the CBOE is referring to dealt primarily with the definition of a ''public customer.'' See File Nos. SR–CBOE–93–20, SR–CBOE–95–23, and SR–CBOE–96–07.

F. Listing Procedures

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

G. Fees

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

H. Miscellaneous

Recognizing that the ISE is a new, fully electronic options exchange, the Commission believes it would be unwise and impracticable, at the outset, to cast the Exchange into a preconceived mold. The Commission believes that the ISE's governance provisions and trading rules are sufficiently clear for the purposes of granting it exchange registration. Requiring the ISE to provide a high degree of specificity with respect to certain of its rules before registration as an exchange is likely unfeasible because it will be difficult for the ISE to determine exactly who or what decisions may need to be made until the Exchange actually begins operating. As the ISE gains experience, the Commission expects that the Exchange will take appropriate steps to ensure, among other things, that its rules continue to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. However, as noted above, the ISE will be required to file certain rule changes with the Commission pursuant to Rule 19b–4 under the Exchange Act prior to beginning trading.[150]

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

[144] *See* Exchange Act Release No. 29698 (September 17, 1991), 56 FR 48594 (September 25, 1991) (order approving the Joint-Exchange Options Plan).

[145] 15 U.S.C. 78s(b)(3)(A).

[146] 15 U.S.C. 78s(b)(1).

[147] 17 CFR 240.19b-4.

[148] 15 U.S.C. 78f(b).

[149] 15 U.S.C. 78f(b)(4).

[150] *See* 17 CFR 240.19b-4.

IV. Conclusion

An appropriate order granting exchange registration will issue.

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

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 00–4976 Filed 3–1–00; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

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

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

February 24, 2000.

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

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