§ 2.126 Access and inspection of records and property.

* * * * *

(b) The use of a room, table, or other facilities necessary for the proper examination of the records and inspection of the property or animals must be extended to APHIS officials by the dealer, exhibitor, intermediate handler or carrier, and a responsible adult shall be made available to accompany APHIS officials during the inspection process.

21. In § 2.131, paragraphs (a), (b), (c), and (d) would be redesignated as paragraphs (b), (c), (d), and (e), respectively, and a new paragraph (a) would be added to read as follows:

§ 2.131 Handling of animals.

(a) All licensees who maintain wild or exotic animals must demonstrate adequate experience and knowledge of the species they maintain.

* * * * *

22. Section 2.132 would be amended as follows:

a. By revising the section heading.

b. By removing paragraphs (b) and (c), and redesignating paragraphs (d) and (e) as paragraphs (b) and (c), respectively, and by revising newly redesignated paragraph (b).

c. In newly designated paragraph (c)(3), by removing the words ''random source.''

d. By adding a new paragraph (d).

§ 2.132 Procurement of dogs, cats, and other animals; dealers.

* * * * *

(b) No person shall obtain live dogs, cats, or other animals by use of false pretenses, misrepresentation, or deception.

* * * * *

(d) No dealer or exhibitor shall knowingly obtain any dog, cat, or other animal from any person who is required to be licensed but who does not hold a current, valid, and unsuspended license. No dealer or exhibitor shall knowingly obtain any dog or cat from any person who is not licensed, other than a pound or shelter, without obtaining a certification that the animals were born and raised on that person's premises and, if the animals are for research purposes, that the person has sold fewer than 25 dogs and/or cats that year, or, if the animals are for use as pets, that the person does not maintain more than three breeding female dogs and/or cats.

Done in Washington, DC, this 27th day of July 2000 .

Bobby R. Acord,

Acting Administrator, Animal and Plant Health Inspection Service.

[FR Doc. 00–19725 Filed 8–3–00; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–43085; File No. S7–17–00]

RIN 3235–AH96

Firm Quote and Trade-Through Disclosure Rules for Options

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

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

DATES: Comments should be submitted on or before September 18, 2000.

ADDRESSES: All comments should be submitted in triplicate and addressed to Jonathan G. Katz, Secretary, U.S. Securities and Exhange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549–0609. Comments also may be submitted electronically at the following E-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–17–00; this file number should be included on the subject line if E-mail is used. Comment letters will be available for inspection and copying in the Commission's Public Reference Room at the same address. Electronically submitted comment letters will be posted on the Commission's Internet web site (*http://www.sec.gov*).

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

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I. Executive Summary

Recent increases in the multiple listing of options classes previously listed on a single exchange have intensified the competition among the option exchanges and the need to further integrate the options markets into the national market system. The marked increase in multiple trading is indicative of the dynamic environment in which the options markets currently operate. For example, in August 1999, only 32 percent of equity options classes were traded on more than one exchange. By the end of June 2000, the number of equity options classes that were multiply-traded had risen to 48 percent, a 50 percent increase.

While the growth in multiple trading has increased the competition between markets, it also has dramatically altered the environment in which options market participants conduct their trading. In particular, multiple trading raises new best execution challenges for broker-dealers.[1] When an option is listed on only one exchange, broker-dealers do not have to decide where to route an order, and consequently, satisfying their best execution obligations is less rigorous than when they must consider the relative merits of routing orders to two or more market centers. With as many as five options exchanges currently trading certain options classes, broker-dealers are increasingly required to regularly and rigorously evaluate the execution quality available at each options exchange.

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

Because of its concerns about the increasing likelihood of intermarket trade-throughs in the options markets, the Commission, on October 19, 1999, issued an Order directing the options exchanges to act jointly to file a national market system plan within 90 days for linking the options markets.[2] On January 19, 2000, the options exchanges submitted three separate linkage plans,[3] a detailed summary of which was published for comment in the **Federal Register** on March 2, 2000.[4] The Commission received comments on the proposed linkage plans from 24 market participants.[5] A thorough review of the comment letters received on the proposed linkage plans has led the Commission to consider alternate ways in which to accomplish its goal of protecting price priority and minimizing intermarket trade-throughs of customer orders.[6]

In assessing the best way to encourage fair access and linkage among the options markets, the Commission has carefully evaluated not only the comment letters submitted by interested persons, but also the impact of the recent increases in multiple trading and the availability of new technologies. This review has raised concerns that mandating a single linkage system in which all of the options exchanges must participate may have inherent limitations. The linkage plans proposed by the options markets offer significant advantages by reducing barriers to access between the markets. Nonetheless, the Commission is reluctant to mandate one single form of linkage, which may fail to adapt over time to changes in the markets and may impede the entry of new participants with different business models.

Moreover, a mandatory linkage plan may not maintain up-to-date technology. For example, one commenter expressed concern that any linkage system technology would become obsolete before or soon after the system was implemented.[7] The Commission believes that the growth of electronic routing systems may enable the options exchanges to access one another's markets directly through agreed-upon methods, or indirectly through broker-dealers. As a result, there may well be a variety of equally effective, or indeed more effective, ways in which technology may be employed by the markets to encourage price priority and decrease the likelihood of intermarket trade-throughs in the options markets.

Consequently, the Commission's proposals today are purposely limited in scope. The Commission's proposals are intended to facilitate the ability of market participants to obtain the best price for customer orders without mandating a specific linkage. As described below, in conjunction with its approval of an options intermarket linkage plan (''Amex/CBOE/ISE plan''),[8] the Commission today is proposing a new rule and amendments to an existing rule designed to provide customers with

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

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

[3] Amex, CBOE, and ISE submitted identical plans and PCX and Phlx each submitted separate plans.

[4] *See* Securities Exchange Act Release No. 42456 (February 24, 2000), 65 FR 11402. At the same time, the full text of each of the plans was made available to interested persons on the Commission's website.

[5] A summary of comments received on the proposed linkage plans is available in the Commission's Public Reference Room (File No. 4–429).

[6] In its proposed release issued today on Disclosure of Order Routing and Execution Practices, the Commission states that it ''recognizes that fair and efficient linkages to market centers publishing quotes are important to encouraging priced competition and strengthening price priority * * * At the same time, the Commission believes that wherever possible, market-based incentives, not government imposed systems, should determine the connections between markets.'' *See* Securities Exchange Act Release No. 43084 (July 28, 2000).

[7] *See* letter to Jonathan G. Katz, Secretary, Commission, from Peter Hajas, Chief Executive Officer, Knight Financial Products LLC, dated April 3, 2000.

[8] *See* Securities Exchange Act Release No. 43086, (July 28, 2000).

more information with which to evaluate the quality of executions achieved by their brokers and to require market makers to be firm for their quotes. Together these rules would provide incentives for the markets and their members to develop mechanisms to reduce the frequency of intermarket trade-throughs, and would allow market participants to choose the form of mechanism employed.

In addition, some commenters have argued, in the context of the Commission's review of the linkage plans submitted by the exchanges, that the Commission's approval of a linkage plan should be viewed as an opportunity to mandate, among other things, the protection of customer limit orders and price/time priority.[9] The Commission concluded, however, in its Order approving the Amex/CBOE/ISE plan that it does not have sufficient information to satisfy itself that the potential benefits of a mandatory price/time priority requirement clearly justify the potential drawbacks, and that it would be premature at this time to mandate cross-market priority rules as elements of a linkage between the options markets.

A. Proposed Trade-Through Disclosure Rule

To begin, the Commission is proposing a new rule, Exchange Act Rule 11Ac1–7 (''Trade-Through Disclosure Rule''),[10] to require a broker-dealer to disclose to a customer when the customer's order to buy or sell a listed option was executed at a price inferior to the best quote published at the time of execution of the customer's order.

The proposed Trade-Through Disclosure Rule is intended to better inform customers about the implications of their brokers' execution decisions. If the fact of a trade-through was disclosed, along with the better available price, customers would have additional information with which to evaluate the quality of executions achieved by their brokers. The proposed new rule is not an absolute prohibition on trade-throughs. To the contrary, the Commission recognizes that, in certain circumstances, an execution at a price inferior to a quote displayed by another market may be consistent with an investor's particular investment strategy. For example, it is possible that a customer would prefer to receive an immediate execution at one price rather than pursue the opportunity to obtain a superior price. By requiring disclosure of executions at inferior prices when they occur, the rule is intended to ensure that the decision not to pursue publicly-displayed superior prices is rooted in the interests of customers, not intermediaries. Nonetheless, the Commission anticipates that an effective disclosure requirement would minimize the likelihood that a customer order does not receive an execution at the best available published quote.

In addition, as an incentive for markets to cooperate in developing effective means to access other markets to avoid trade-throughs, the Commission's proposal would except broker-dealers from the proposed disclosure requirements if they effect orders on options markets that participate in an intermarket linkage plan that has explicit provisions reasonably designed to limit trade-throughs. In such instances, the Commission expects that the value in requiring a broker-dealer to disclose the rare trade-through that may occur would be substantially reduced. The proposed Trade-Through Disclosure Rule would not, however, mandate that options exchanges participate in a specific linkage plan. Instead, the proposal contemplates that there ultimately may be multiple linkage plans approved by the Commission that contain provisions to effectively limit intermarket trade-throughs.

B. Proposed Amendments to the Quote Rule

The proposed Trade-Through Disclosure Rule would not be meaningful if the market publishing a better quote is not firm for a specified number of contracts at that quote. In particular, members of an exchange cannot develop effective means of access to displayed quotes of another exchange if those quotes are not firm. To that end, the Commission proposes to amend Exchange Act Rule 11Ac1–1 (''Quote Rule'')[11] to require options exchanges and options market makers to publish firm quotes.[12] As discussed in greater detail below, the proposed amendments to the Quote Rule include certain accommodations to reflect the fact that the Options Price Reporting Authority (''OPRA'') does not have the ability to disseminate quotes with size at this time. These accommodations require quotes to be firm for the size specified, but not displayed by, the options markets. The Commission also proposes, as an alternative, rule language that would allow options exchanges to be firm for their quotes in different sizes for orders from customer accounts than for orders from broker-dealer accounts. The Commission is proposing this alternative because options market makers may otherwise be inclined to limit their exposure to other professionals by widening their spreads or limiting their firm quote size, which would be to the detriment of public customers.

C. Approval of Linkage Plan

As noted above, the Commission today, in a separate release, approved the options market linkage plan proposed by the Amex, CBOE, and ISE, the Amex/CBOE/ISE plan.[13] This plan is an important step forward in linking the options markets and, if implemented, would eliminate many existing barriers to access between the participating markets and would provide members of those markets with better methods of access than exist today. Ultimately, it may prove to be the preferred means of linking the options exchanges. Nonetheless, the Commission's approval of the Amex/CBOE/ISE plan does not require those options exchanges that are not participants in the plan to become participants.[14] This approach is premised on the Commission's belief, discussed above, that there may be a number of means of achieving the Commission's goal of encouraging price priority and limiting intermarket trade-throughs of customer orders. The Commission's approval of the Amex/CBOE/ISE plan, coupled with the proposed new Trade-Through Disclosure Rule and amendments to the Quote Rule, is designed to encourage access to, and linkage among, the

[9] Price/time priority generally requires that if an exchange receives an order but was not the first exchange to display the best price, that exchange must route the order to the exchange that first displayed the best price.

[10] Proposed 17 CFR 240.11Ac1–7.

[11] 17 CFR 240.11Ac1–1.

[12] The Quote Rule has, to date, applied only to equity markets and market makers. *See* Securities Exchange Act Release No. 1445 (January 26, 1978), 43 FR 4342 (February 1, 1978), as amended in Securities Exchange Act Release Nos. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996); and 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998).

[13] *See supra* note 8. The Commission's approval of the Amex/CBOE/ISE plan should not be construed as a rejection on the merits of either the Phlx or PCX submissions. Neither of those submissions could be approved as a national market system plan pursuant to Exchange Act Rule 11Aa3–2, 17 CFR 240.11Aa3–2, because neither plan was filed by two or more sponsors as required by the rule. In fact, the Commission would consider approving other national market system plans relating to intermarket linkage between the options markets submitted by two or more markets.

[14] The plan does, however, include express provisions pursuant to which other options exchanges may become participants by executing the plan, paying a fee applicable to new participants, and obtaining the Commission's approval of the plan as amended to reflect the new participant. *See* Amex/CBOE/ISE plan Sections 4(c) and 5(c)(ii).

competing options markets, without mandating the means to achieve this goal. The Commission is today soliciting comment on this flexible approach.

II. Background

Section 11A of the Exchange Act,[15] enacted as part of the Securities Act Amendments of 1975,[16] sets forth Congress' findings concerning the establishment of a national market system. Congress found, among other things, that it was in the public interest, and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the availability to brokers, dealers, and investors of quote and transaction information, and the practicability of brokers executing investors' orders in the best market.[17] Congress asserted that linking all of the markets for qualified securities would ''foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.'' [18]

The national market system was intended by Congress to potentially encompass ''all segments of corporate securities including all types of common and preferred stocks, bonds, debentures, warrants, and options.'' [19] Congress included all types of securities because it believed that many of the goals of a national market system, such as the availability of information with respect to price, volume, and quotations, would be universally beneficial, although perhaps implemented through subsets of a national market system. [20]

Congress did, however, recognize the differences between the markets and granted the Commission broad powers to implement a national market system without forcing all securities markets into a single mold. [21] Accordingly, Congress granted the Commission the authority to implement the objectives of the 1975 Amendments,[22] while allowing the Commission to recognize and classify markets, firms, and securities in any manner appropriate or necessary in the public interest or for the protection of investors.[23]

Many of the national market system initiatives were implemented in the equities markets at a time when standardized options trading was relatively new.[24] Therefore, the Commission deferred applying many of the national market system initiatives to options to give options trading an opportunity to develop.

In October 1977, in response to allegations of wide-spread manipulation in the market for exchange-traded options, the Commission initiated an investigation and special study of the options markets.[25] In the Options Study, the Commission acknowledged that Congress had intended to include options in a national market system, and set forth a number of issues to be explored before the options markets could be fully integrated into the national market system.[26] Subsequently, the Commission approved a national market system plan that collects and disseminates consolidated quotes and trades for the options markets.[27] Today, the options markets continue to operate with limited market integration facilities. [28]

With the onset of widespread multiple trading in options, the Commission is increasingly concerned about customer orders that are sent to one exchange being executed at prices inferior to quotes published by another market. The Commission believes further action is necessary at this time to encourage the removal of barriers to access, and the use of efficient vehicles to reach, better prices on another market. At the same time, the Commission believes that wherever possible, market-based incentives, not government-imposed systems, should determine the connections between the markets. For this reason, the Commission is today proposing an alternative to a government-imposed single intermarket linkage that would remove certain barriers to access and create incentives for options market

[15] 15 U.S.C. 78k–1.

[16] Pub. L. No. 94–29, 89 Stat. 97 (1975) (''1975 Amendments''). In the 1975 Amendments, Congress directed the Commission to oversee the development of a national market system. Congress granted the Commission broad, discretionary powers to oversee the development of a fully integrated national system for the processing and settlement of securities transactions. *See also infra* note 19.

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

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

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

[20] *Id.*

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

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

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

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

[25] The result of the Commission's investigation was The Report of the Special Study of the Options Markets, issued on December 22, 1978 (''Options Study''). Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. (Comm. Print No. 96–IFC3, December 22, 1978) (examining the major issues of market structure in standardized options markets, including multiple trading).

[26] Options Study at 1029–1030. The Commission stated that it had ''not begun to consider whether standardized options are appropriate for inclusion as qualified securities or whether it would be more appropriate to design a 'subsystem' of a national market system to comprehend standardized options trading.'' The Options Study delineated the following as among the issues to be explored in the options market: (1) A comprehensive quotation system for the dissemination of firm quotes; (2) market linkage and order routing systems to enable the best execution of orders; (3) nationwide limit order protection to ensure that agency orders receive auction-type trading protections; and (4) off-board trading restrictions.

[27] Currently, the options exchanges report their respective quotes and trades of OPRA, which operates pursuant to a national market system plan, approved by the Commission pursuant to Section 11A of the Exchange Act and Rule 11Aa3–2 thereunder. *See* Securities Exchange Act Release No. 17638 (March 18, 1981). Quote and trade reporting are integral components of a national market system. *See* Section 11A(a)(1)(C)(iii) of the Exchange Act. 15 U.S.C. 78k–1(a)(1)(C)(iii). *See also infra* Section III.B.1.

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

participants to develop access arrangements with each other.

III. Discussion of Proposed Rulemaking

A. Proposed Trade-Through Disclosure Rule

1. Background

In the 1975 Amendments, Congress declared that, ''[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure * * * the practicability of brokers executing investor's orders in the best market * * * ''[29]. In accordance with these principles, the Commission determined that trade-throughs—that is, the execution of orders at prices inferior to prices offered on other markets—are ''inconsistent with the goals of a national market system.''[30] Consequently, the Commission has consistently sought to protect orders displayed at a better price from being traded through at inferior prices by encouraging executions of customer orders at the best prices. Further, the Commission has repeatedly emphasized a broker-dealer's duty of best execution of customer orders, which includes seeking the best price reasonably available. In the equity markets, the Intermarket Trading System (''ITS'') Plan includes a trade-through rule protecting displayed bids and offers for ITS-eligible exchange-listed securities.[31] In conformance with the ITS Plan, each participating exchange and the National Association of Securities Dealers (''NASD'') has adopted rules that limit trade-throughs in exchange-listed securities.[32] In the options markets, the Commission has repeatedly encouraged the exchanges to implement mechanisms to limit trade-throughs from occurring.[33] For a variety of reasons over the years, however, none of these efforts has been wholly successful.

In 1980, at the time the Commission ended the voluntary moratorium on expansion of standardized options trading, it asked for comment on several approaches to more fully integrate the options markets into the national market system, including a market linkage system similar to ITS, requiring brokerage firms to route retail orders on an order-by-order basis to the market center showing the best quotation, and an order exposure system for options public limit orders.[34]

The Commission's adoption of Exchange Act Rule 19c–5 in 1989[35] created the need for some mechanism to ensure that customers' orders for multiply-traded options could be executed at the best available price. Accordingly, in 1990, the CBOE, New York Stock Exchange (''NYSE''),[36] Amex, and PCX filed with the Commission a proposed Joint Industry Plan providing for the creation and operation of an Options Intermarket Communications Linkage (''Linkage Plan'').[37] The Commission sought comment on the Linkage Plan,[38] but neither the Linkage Plan nor its Model Trade-Through Rule was adopted, in part, because the options exchanges could not reach a consensus on several critical elements.

During the comment period on the Linkage Plan, an alternative plan was considered that involved the gradual phase-in of multiple trading, along with the adoption of exchange rules and operational enhancements linking the markets non-electronically (''Phase-In Plan'').[39] Specifically, the Phase-In Plan would have provided for the re-routing of orders received through automated systems to other execution facilities, in conjunction with a trade-or-fade rule.[40] Again, however, the exchanges did not agree to the Phase-In Plan and it was not adopted.

In 1994, the markets adopted trade-or-fade rules, which require a market maker to revise its quote if it is unwilling to trade at its published quote with an order sent to it by a market maker from another exchange.[41] The trade-or-fade rules do not provide efficient means of access between the markets. They also provide little incentive to try to reach a better quote in another market, because that quote need not be firm when reached. Thus, the trade-or-fade rules have done little to promote price priority or discourage intermarket trade-throughs.

To provide investors with better information on the quality of the executions they are receiving and to provide incentives to market participants to develop means of access to the competing markets, without mandating a single linkage mechanism, the Commission today is proposing the Trade-Through Disclosure Rule, described below.

2. Proposed Trade-Through Disclosure Rule

a. Proposed Disclosure Requirement. Generally, proposed Exchange Act Rule 11Ac1–7 would require a broker-dealer to disclose to a customer when the customer's order is executed at a price inferior to a better published quote on another exchange and what that better published quote was.[42] A broker would

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[29] *See* Section 11A(a)(1)(C)(iv) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C)(iv). In fact, as early as 1973, the Commission had indicated that the facilities of a national market system should provide a broker-dealer with the ability to ensure that ''his customer's order is executed in the best market available.'' SEC, Policy Statement on the Structure of a Central Market System, at 17 (March 29, 1973), reprinted in [1973] Sec. Reg. & L Rep. (BNA) No. 196 at D–1, D–4.

[30] *See* Securities Exchange Act Release No. 22127 (June 21, 1985), 50 FR 26548 (June 27, 1985) (soliciting comment on issues relating to the designation of securities as national market system securities).

[31] *See* Securities Exchange Act Release No. 17703 (April 9, 1981), 22 S.E.C. Doc. 707.

[32] *See* Securities Exchange Act Release No. 17704 (April 9, 1981), 46 FR 22520 (April 17, 1981). The NASD submitted a proposed trade-through rule for exchange-listed stocks, which the Commission approved on May 6, 1982. *See* Securities Exchange Act Release No. 18714, 47 FR 20429 (May 12, 1982). On June 21, 1985, the Commission requested comment on, among other things, the extent to which securities listed on The Nasdaq Stock Market, Inc. (''Nasdaq'') should be subject to trade-through rules. *See* Securities Exchange Act Release No. 22127 (June 21, 1985), 50 FR 26584 (June 27, 1985). In addition, in recently adopting amendments to the ITS Plan to expand the linkage to all listed securities, the Commission concluded that the NASD should continue to consider modifications to its existing trade-through rule to cover non-ITS participants, but that such modifications were not a precondition to approval of the expanded linkage. *See* Securities Exchange Act Release No. 42212 (December 9, 1999), 64 FR 70297 (December 16, 1999).

[33] *See* supra note 28.

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

[35] 17 CFR 240.19c–5. *See* Securities Exchange Act Release No. 26870, *supra* note 28.

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

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

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

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

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

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

[42] Proposed Exchange Act Rule 11Ac1–7(b)(1). The Commission believes that a broker-dealer should be allowed to rely on the market of

be required to make this disclosure on the customer's confirmation delivered pursuant to Exchange Act Rule 10b–10.[43] To satisfy this disclosure requirement, the Commission would expect such disclosure to be as prominent as the transaction price disclosed to the customer under Exchange Act Rule 10b–10.

A broker-dealer would not be required to provide such disclosure to its customer if it effects a transaction for a customer on an exchange that participates in an approved linkage plan that includes provisions reasonably designed to limit customers' orders from being executed at prices that trade through a better published price.[44] Importantly, the proposed rule's disclosure requirement would not prohibit trade-throughs, but is intended to provide customers with important information about the quality of their executions. The Commission believes that the proposed rule would provide the individual customer with important information and facilitate an individual investor's ability to actively monitor whether his or her order routing firm is fulfilling its best execution obligations. It also would encourage broker-dealers to develop effective means of accessing better quotes published by other markets. The Commission notes, however, that the proposed Trade-Through Disclosure Rule would not replace the well-established duty that broker-dealers must provide best execution to their customers. To the contrary, broker-dealers remain obligated to seek the most favorable terms possible under the circumstances for their customers.[45]

The Commission solicits comment on whether there are any special considerations that should be taken into account in light of the fact that options trades are settled the day after the transaction.

b. Proposed Exception to Disclosure Requirement. As noted above, the proposed Trade-Through Disclosure Rule provides an exception from the customer disclosure requirements if the broker-dealer effects its customers' orders on an options exchange that participates in an effective national market system options linkage plan that includes provisions reasonably designed to limit intermarket trade-throughs. Preliminarily, the Commission believes that, at a minimum, to be reasonably designed to limit trade-throughs, a plan should contain provisions to: (1) Limit participants from trading through not only the quotes of other linkage plan participants, but also the markets of exchanges that are *not* participants in the plan; (2) require plan participants to actively surveil their markets for trades executed at prices inferior to those publicly quoted on other exchanges; and (3) make clear that the failure of a market with a better quote to complain within a specified period of time that its quote was traded-through may affect potential liability, but does not signify that a trade-through has not occurred.[46]

In addition, to comply with these standards, a participating exchange, generally, would have to adopt rules that would allow the exchange to sanction firms that repeatedly trade-through better prices of other exchanges, maintain policies and procedures that would limit the occurrence of trade-throughs, and maintain records that would identify trade-throughs and any review or remedial action taken by the exchange in response to such trade-throughs.

As stated above, to be reasonably designed to limit trade-throughs, the Commission preliminarily believes that a plan should limit trade-throughs of all markets displaying quotes in the consolidated quote system. The Commission recognizes that because of barriers to access and order routing obstacles, limiting trade-throughs of quotes on markets not participating in a linkage plan would be more difficult than limiting trade-throughs of quotes published by linked markets. The Commission seeks comment on potential approaches that could be employed in linkage plans to adequately limit trade-throughs of non-linked markets. The Commission also requests comment on whether instead of requiring the limitation of trade-throughs of non-linked markets, the exception from disclosure of trade-throughs should be limited only to trade-throughs of markets that participate in the linkage plan.

The Commission believes exchange linkage agreements are a straightforward method of removing barriers to access between exchanges. Because a linkage plan satisfying the proposed rule would provide for a mechanism to access superior quotes on another market and rules limiting such trade-throughs, the Commission believes there would be little value in requiring order routing firms to develop a disclosure process to deal with the unlikely event that there was a trade-through. Moreover, such an exception would provide an incentive for exchanges to enter into linkage agreements to limit trade-throughs, without mandating participation in a linkage or the method of linkage.

The Commission requests comment on the propriety of the proposed exception to the proposed Trade-Through Disclosure Rule for orders effected on exchanges that are participants in an effective national market system options linkage plan that includes provisions reasonably designed to limit customer orders from trading through better published prices. The Commission also seeks comment on what provisions such a linkage plan should be required to include and whether the minimum requirements identified by the Commission above are sufficient. Commenters are also invited to express their views as to whether an options exchange that is not a participant in an approved linkage plan should be required to provide to broker-dealers information about intermarket trade-throughs occurring on its market.

In response to the linkage plan proposals, several commenters suggested that the Commission require broker-dealers to route customers' orders on an order-by-order basis to the best quote.[47] The Commission does not currently believe that it is appropriate to mandate such a routing requirement, but would like commenters' views on whether it would be appropriate to except broker-dealers from the Commission's proposed disclosure requirements in new Rule 11Ac1–7[48] if broker-dealers systematically route customer orders on an order-by-order basis to the exchange with the best price at the time the order is routed.

c. Proposed Definition of Trade-Through. The proposed Trade-Through Disclosure Rule would define a trade-through as occurring when a customer

execution to notify the broker-dealer of when a trade-through has occurred and the best quote at that time.

[43] 17 CFR 240.10b–10. Exchange Act Rule 10b–10 requires information to be delivered in writing (including electronically) at or before completion of the transaction. It does not require that all information be included in a single document.

[44] Proposed Exchange Act Rule 11Ac1–7(b)(2).

[45] *See supra* note 1.

[46] The Commission, in a separate release, is approving a national market system options linkage plan that generally requires members of participating markets to avoid initiating trade-throughs. *See supra* note 8. The Commission notes, however, that if the proposed Trade-Through Disclosure Rule is adopted as proposed, the Amex/CBOE/ISE plan approved today would have to be amended before broker-dealers effecting transactions on exchanges participating in the plan would be excepted from the disclosure requirements of the proposed Trade-Through Disclosure Rule.

[47] *See e.g.,* letters to Jonathan G. Katz, Secretary, Commission, from Douglas J. Engmann, President and Chief Executive Officer, ABN–AMRO, dated March 24, 2000; and Thomas Petterffy, Chairman, and David M. Battan, Vice President and General Counsel, Interactive Brokers, the Timber Hill Group, dated April 3, 2000 and April 10, 2000.

[48] Proposed Exchange Act Rule 11Ac1–7.

order for listed options is executed at a worse price than the best quote published pursuant to a national market system plan for reporting quotations in listed options at the time of execution.[49] The proposal identifies seven circumstances in which a trade executed at a price inferior to a published price on another market would nevertheless not be considered a trade-through for purposes of the rule.[50] These circumstances are, in large part, the same as those exceptions proposed by the options exchanges in each of their linkage plan proposals.

In particular, because a broker-dealer should not be required to disclose to its customer that its order was executed at a price inferior to a ''stale'' quote, a trade would not be considered a trade-through if it occurs while OPRA is experiencing queuing. In the past, the aggregate message traffic generated by the options exchanges has, at times, surpassed OPRA's systems capacity,[51] which could result in the dissemination of quotes that are no longer accurate or accessible. Similarly, the definition of trade-through would exclude a trade executed at a price inferior to a price published by another exchange that has determined, for example, that as a result of unusual market conditions, it is incapable of accurately collecting and disseminating quotes, and thus would not require disclosure in such circumstances.[52]

In addition, a trade would not be considered a trade-through under the proposed rule when it occurs at a price inferior to a quote published by another market conducting a trading rotation for that options class, or when a customer order is executed as part of a trading rotation in that options class. During a trading rotation, each options series or class may not be open on all markets at the same time and may not be accessible. Moreover, two options exchanges have automated openings where their respective systems determine a single opening price and then automatically cross customer orders.[53] As a result, orders that are on the book prior to the opening do not have a chance to interact with better quotes or orders published by other markets.

The Commission also is proposing that it not be considered to be a trade-through in the event that an exchange member attempts to access a better published quote for a customer order, but the market publishing the better quote fails to respond to the order routed to it within 30 seconds of receiving the order, or the market publishing the better price experiences systems malfunctions that result in inaccessible quotes. In either case, the broker-dealer has attempted to access the superior published quote and has been unsuccessful. The Commission is proposing these exceptions because it does not believe that there is any value in requiring a broker-dealer to repeatedly attempt to access a clearly inaccessible quote.

Finally, the Commission is proposing to exclude transactions executed as part of a complex trade from the proposed Trade-Through Disclosure Rule. A complex trade involves two or more transactions that are contingent on each other, such as a spread[54] or a straddle.[55] The Commission is proposing to exclude such trades from the requirements to disclose trade-throughs because it believes that customers using these complex-trading strategies understand that inherent in executing the component parts of such strategies is the possibility that they may not receive the best-published price for each component part of the trade.

The Commission seeks comment on the propriety of the proposed exceptions to the proposed Trade-Through Disclosure Rule, and on whether there are any other circumstances in which a trade executed at a price inferior to a price offered on another market should nevertheless not be considered a trade-through for purposes of the proposed rule.

The Commission also seeks comment on whether a trade-through disclosure requirement should apply to all trade-throughs, or only to trade-throughs of a material price or amount. This question is particularly important in a decimals trading environment, where quotes may be for a smaller size, and trade-throughs for smaller amounts, and with respect to large orders, where the quote size may be small in relation to the order. One possible response would be to allow broker-dealers to include the size of the quote as part of the disclosure, so investors can better assess whether the size of the quote traded-through is meaningful compared to the size of their orders. Another response would be to exempt large block orders from the disclosure requirement because of their size in relation to the quote, their special handling need, and the awareness by customers with block orders of the quality of executions they receive.

d. *Rejection of Absolute Prohibition on Trade-Throughs.* The Commission considered whether to mandate a flat prohibition on trading at an inferior price. The Commission, however, was concerned, in part, that mandating a flat prohibition on trading at an inferior price would preclude investors from choosing to trade at an inferior price for reasons of better speed, size, or liquidity. The proposed rule would, instead, require that inferior executions be disclosed to investors, who would then be better informed and therefore better able to determine whether the quality of executions they receive are satisfactory.

B. Proposed Amendments to the Quote Rule

1. Background

One of the first national market system initiatives implemented by the Commission in the equity markets was the Quote Rule, Exchange Act Rule 11Ac1–1.[56] The Quote Rule requires all national securities exchanges and associations to establish procedures for collecting from their members bids, offers, and quotation sizes with respect to reported securities, and for making such bids, offers, and sizes available to quotation vendors. It also requires that quotation information made available to vendors be ''firm,'' subject to certain exceptions.

The reliability and availability of quotation information are basic components of a national market system[57] and are needed so that broker-dealers are able to make best execution decisions for their customers' orders, and customers are able to make order

[49] Proposed Exchange Act Rule 11Ac1–7(b)(3).

[50] Proposed Exchange Act Rule 11Ac1–7(b)(4).

[51] *See, e.g.,* Securities Exchange Act Release No. 42849 (May 26, 2000), 65 FR 36180 (June 7, 2000) (approving a temporary capacity allocation plan). There are a number of events, such as the conversion to decimal pricing, that may result in an increase of peak message traffic, which could result in delayed quotes.

[52] 17 CFR 240.11Ac1–1(b)(3). Currently, each options exchange has rules that allow the exchange to suspend its firm quote requirements, for example, if a systems malfunction or other circumstance impairs the exchange's ability to disseminate or update market quotes in a timely and accurate manner. *See* Amex Rule 958A; CBOE Rule 8.51(a); PCX Rule 6.86(d); Phlx Rule 1015(a)(ix); and ISE Rule 804(d). The options exchanges may have to amend these rules to conform to the Quote Rule's exception for unusual market conditions. *See supra* note 70 and accompanying text.

[53] *See* CBOE Rule 6.2A and PCX Rule 6.64.

[54] A spread is an investment strategy that generally involves the simultaneous purchase or sale of options on the same underlying stock with different strike prices or expiration dates or both.

[55] A straddle is an investment strategy that generally involves the simultaneous purchase and sale of an equal number of calls and puts on the same underlying security with identical strike prices and expiration dates.

[56] *See supra* note 11.

[57] *See* Securities Exchange Act Release No. 12670 (July 29, 1976), 41 FR 32856 (1976) (proposing Exchange Act Rule 11Ac1–1).

entry decisions. Quotation information has significant value to the marketplace as a whole because a quotation reflects the considered judgment of a market professional as to the various factors affecting the market, including current levels of buying and selling interest.[58] Both retail and institutional investors rely on quotation information to understand the market forces at work at any given time and to assist in the formulation of investment strategies.

By its terms, the Quote Rule currently does not apply to options. At the time the Quote Rule was adopted in 1978, standardized options had been listed and traded on the options exchanges for only a few years, and the Commission had imposed a moratorium that restricted the expansion of options trading.[59] However, while the Commission intentionally excluded options from the requirements of the Quote Rule at that time, the Commission always thought that firm quotes ultimately should be required in the options markets. In 1980, when the Commission lifted the moratorium on options listings, it also set forth its vision on the future of options multiple trading, including the feasibility of firm quotes.[60] Successful implementation of a linkage among the markets was thought to depend upon the quality and reliability of quotation information disseminated by each market center. At that time, however, the Commission believed that the imposition of a firm quote requirement was unworkable.[61]

In conjunction with the Commission's adoption in 1989 of Rule 19c–5 [62] on multiple trading of options, the Commission published a Staff concept release that discussed options market structure issues associated with multiple trading, and outlined suggestions for possible market structure enhancements. At that time, the release emphasized that the availability and reliability of comprehensive quotation information for options are important elements in considering the concerns traditionally associated with multiple trading.[63]

The release discussed whether the then-existing quote and trade reporting mechanism for options needed to be adapted for multiple trading by requiring that equity options quotes be firm. Market participants had, in the past, argued against a firm quote requirement in the options markets for a number of reasons.[64] These concerns, however, were recognized as largely moot due to the development of autoquote [65] and automatic execution [66] systems, which indicated that firm quotes were, at the very least, possible.[67]

Today, each options market requires its market makers to have firm quotes for some types of orders.[68] Therefore, the Commission believes that imposing a market-wide firm quote obligation on the options market participants should not be unduly burdensome. While the exchanges' firm quote rules and automatic execution systems provide their public customers with firm quote guarantees, these rules currently do not extend to other market participants. As described below, the Commission's proposal would modify the Quote Rule to require that options quotes be firm to both customers and other market participants.

The Commission is proposing a firm quote rule for options in conjunction with the proposed Trade-Through Disclosure Rule to ensure that the published quotes of options exchanges are accessible to orders from both customers and broker-dealers.[69] Currently, the options exchanges' quotes need not be firm for broker-dealer orders. Therefore, market markers on an exchange may not be able to trade with quotes on competing exchanges even when these market makers are representing customer orders. Yet market makers are expected to match the prices on competing exchanges or to trade with those quotes, before trading at an inferior price. The proposed Trade-Through Disclosure Rule is intended to reinforce efforts to honor the best-displayed price, and should encourage the development of improved methods to access better prices in other markets. A firm quote requirement for options is needed to ensure that these quotes will, in fact, be honored when orders are routed from other markets.

2. Proposed Amendments to the Quote Rule

The Quote Rule currently requires that the best bid, best offer, and size for each market quoting any security covered by the Quote Rule be collected and publicly disseminated.[70] These quotations must be firm, and a market maker, specialist, or other responsible broker or dealer generally is obligated to execute an order at a price at least as favorable as its published bid or offer up to the size of its published bid or offer.[71]

[58] *See* Securities Exchange Act Release No. 11288 (March 11, 1975), 40 FR 15015 (1975) (letter sent from the Commission to the registered national securities exchanges requesting that the exchanges eliminate rules that restrict their access to, or use of, quotation information that is provided by an exchange to a quotation vendor).

[59] *See supra* notes 24 and 25 and accompanying text.

[60] *See* Moratorium Termination Release, supra note 34.

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

[62] *See* Securities Exchange Act Release No. 26870, supra note 28.

[63] *See* Securities Exchange Act Release No. 26871, *supra* note 28.

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

[65] The autoquote systems enable options market professionals to update their quotes in numerous options series simultaneously.

[66] The automatic execution systems provide, in effect, firm quotes for public customer orders.

[67] *See* Securities Exchange Act Release No. 26871, *supra* note 28.

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

[69] Section 11A(c)(1) of the Exchange Act grants the Commission the authority to prescribe, among other matters, rules and regulations to assure accurate and reliable quotations ''with respect to any security other than an exempted security.'' 15 U.S.C. 78k–1(c)(1). The Commission believes that extending the requirements of the Quote Rule to listed options will further these interests.

[70] Exchange Act Rule 11Ac1–1(b) requires exchanges to establish and maintain procedures and mechanisms for collecting bids, offers, quotation sizes and aggregate quotation sizes from responsible brokers or dealers who are members of such exchange or association, processing such bids, offers and sizes, and making such bids, offers, and sizes available to quotation vendors. 17 CFR 240.11Ac1–1(b). An exchange is relieved of its obligations to collect and disseminate quotation data if it determines pursuant to rules approved by the Commission that the level of trading activities or the existence of unusual market conditions is such that the exchange is incapable of collecting and disseminating quotation data and it notifies specified persons of that determination. 17 CFR 240.11Ac1–1(b)(3)(i). The Commission expects that each exchange would submit to the Commission for its approval proposed rule changes necessary to comply with the requirements of paragraph (b)(3) of Exchange Act Rule 11Ac1–1.

[71] This is referred to as the broker-dealer's ''firm quote'' obligation. The firm quote obligation under Exchange Act Rule 11Ac1–1(c) requires a responsible broker-dealer to: (i) communicate to its exchange, pursuant to procedures established by that exchange, its best bids, offers and quotation sizes for any subject security; and (ii) execute any

Continued

In addition, the Quote Rule requires responsible broker-dealers to supply quotations to their exchange or association for dissemination to quotation vendors.[72] The Commission is proposing to expand the application of the Quote Rule to options traded on national securities exchanges.

a. *Proposed Amendments to Defined Terms.* Exchanges, associations, and responsible broker-dealers have obligations under the Quote Rule only with respect to subject securities. The Commission is proposing to expand application of the Quote Rule to include transactions in listed options by amending the definition of the term ''reported security.'' As proposed, the term ''reported security'' would be modified to include any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan[73] or an effective national market system plan for reporting transactions in listed options.[74] By proposing to broaden the definition of the term ''reported security'' to include listed options,[75] the proposal would also include listed options within the definitions of ''covered security,''[76] ''exchange-traded security,''[77] and ''subject security.''[78] Thus, options exchanges and market makers would be obligated to publish their quotes and, as importantly, be firm for those quotes.

In addition, the Commission is proposing to amend the definition of ''consolidated system'' under Rule 11Ac1–1(a)(5)[79] to include a transaction reporting system operating pursuant to an effective national market system plan. The effect of this proposed amendment is to make clear that listed options would only be ''subject securities'' with respect to an exchange or association if, during the most recent calendar quarter, the aggregate trading volume on such exchange or association is more than 1% of the aggregate trading volume as reported by OPRA.

b. Quotation Size. Under the Quote Rule, each responsible broker or dealer is required to communicate to its exchange quotation sizes for any subject security,[80] and exchanges are required to collect and make available to quotation vendors quotation sizes and aggregate quotation sizes for subject securities.[81] Broker-dealers responsible for the quote must be firm up to its published size.[82]

Because the options markets do not disseminate to quotation vendors the size associated with their bids and offers,[83] the Commission is proposing two alternative amendments to the Quote Rule so that, at this time, broker-dealers and options exchanges would not be required to publish on a quote-by-quote basis the size associated with each quotation in listed options. Exchanges would, however, be required to establish by rule and periodically publish the size for which its best bid or offer in each options series[84] that is listed on the exchange is firm. The Commission is proposing these exceptions to the Quote Rule because of the existing limitations of the options exchanges' systems and of the OPRA system. Instead, market participants would be furnished by the exchanges with information relating to the size associated with the quotes in a particular series, as they are today. While the proposal, as drafted, permits each exchange to determine the size associated with quotes on its market, the Commission seeks comment as to whether the Commission should establish a minimum number of contracts for which quotes must be firm.

Commenters should also address whether the Commission should mandate that size be disseminated with each quotation. Comment on this issue was solicited at the time the Commission published for comment linkage plans submitted by the options markets. In response, the majority of commenters that addressed this issue favored the development of a system to provide the dissemination of quotes with size.[85] Some of those commenters, however, stated that quotations with size should not be required as part of a linkage plan.[86] Two of these commenters noted the desirability of disseminating quotes with size, but questioned whether existing options quotation systems would be able to handle quotes with size in the near future.[87]

Under both alternatives being proposed, if the rules of the exchange do not require its members to communicate to it quotation sizes for listed options, a responsible broker or dealer that is a member of that exchange would be relieved of its obligations under the Quote Rule to communicate to such exchange its quotation sizes for any listed option that is a subject security. Instead, each responsible broker or dealer would satisfy its firm quote obligation by executing any order to buy or sell a listed option that is a subject

order to buy or sell a subject security presented to it by another broker-dealer at its published bid or offer in any amount up to its published quotation size, unless an exception applies. 17 CFR 240.11Ac1–1(c).

[72] *Id.*

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

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

[75] The Commission is proposing to define the term ''listed option'' in the Quote Rule by reference to Exchange Act Rule 15c3–1(c)(2)(x)(B)(*1*), which defines ''listed option'' as any option traded on a registered national securities exchange or automated facility of a registered national securities association. 17 CFR 240.15c3–1(c)(2)(x)(B)(1). *See* Proposed Exchange Act Rule 11Ac1–1(a)(27).

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

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

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

[79] 17 CFR 240.11Ac1–1(a)(5).

[80] *See supra* note 71.

[81] *See supra* note 70.

[82] Each responsible broker or dealer, subject to certain exceptions, must execute any order to buy or sell a subject security, other than an odd-lot order, presented to it by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker's or dealer's published bid or offer in any amount up to its published quotation size. *See* Exchange Act Rule 11Ac1–1(c)(2), 17 CFR 240.11Ac1–1(c)(2). This obligation is subject to certain exceptions. *See* Exchange Act Rule 11Ac1–1(c)(3), 17 CFR 240.11Ac1–1(c)(3). In addition to the existing exceptions, the Commission is proposing to except responsible brokers or dealers from the firm quote requirements of proposed paragraph (d)(3)(i) if the order for the purchase or sale of a listed options is presented during a trading rotation in that listed option. Alternatives A and B, Proposed Exchange Act Rule 11Ac1–1(d)(3)(ii)(B).

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

[84] The Commission is proposing to define the term ''option series'' in the Quote Rule. Under proposed Exchange Act Rule 11Ac1–1(a)(28), the term ''option series'' means contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions.

[85] Donahue Letter; Ianni Letter; Amex Letter; Susquehanna Letter; Pershing Letter; SIA Letter; CBOE Letter; and Charles Schwab Letter.

[86] Amex Letter; Susquehanna Letter; Pershing Letter; SIA Letter; and CBOE Letter.

[87] Susquehanna Letter and SIA Letter.

security, in an amount up to the size established by the exchange's rules.[88]

The two alternatives differ, however, in the flexibility that exchanges would have to establish the size for which its bid and offer is firm. Under proposed Alternative A, the size for which an exchange's best bid or offer is firm, as established by exchange rule, would have to be the same for orders received from customers as for orders received from broker-dealers.[89] Under proposed Alternative B, however, an exchange could establish different firm quote sizes for customer orders than for broker-dealer orders.[90]

The Commission is soliciting comment on the circumstances under which it is appropriate for exchanges to be permitted to establish rules that allow options market makers to be firm for broker-dealer orders in a size different than that for which they are firm for customer orders. In particular, should the Commission establish a minimum size for which options market makers' quotes must be firm for broker-dealer orders? The Commission would also like commenters views on whether the size for which options market makers' quotes are firm for customer orders should be the same, regardless of whether the orders are executed through an exchange's automatic execution system or otherwise.

c. Proposed Thirty Second Response Requirement. As discussed above, under the proposed Trade-Through Disclosure Rule, if a responsible broker or dealer fails to respond to an incoming order within the 30 seconds required pursuant to the Quote Rule, the routing broker or dealer may execute its customer's order at its own inferior quote and would not be required to disclose the unresponsive quote to its customer as a trade-through.[91] The Commission's 30-second proposal is based on the trade-through provisions of the Amex/CBOE/ISE plan, under which broker-dealers are excepted from trade-through liability when a receiving market fails to respond to an incoming linkage order within 30 seconds.[92]

As a complement to this provision, the Commission is proposing to require each responsible broker or dealer to respond to an order to buy or sell a listed option within 30 seconds by either: (i) Executing the entire order; or (ii) executing at least that portion of the order equal to the applicable firm quote size and revising its bid or offer.[93] A responsible broker's or dealer's applicable firm quote size would be its published quote size or, if a responsible broker or dealer has been relieved of the obligation to publish quote size, the minimum firm quote size established by its exchange's rules. If, as provided in Alternative B, an exchange is permitted to set different firm quote sizes for orders received from customers than for orders received from broker-dealers, a responsible broker's or dealer's applicable firm quote size could be different for customer orders than for broker-dealer orders.[94]

For example, if Market Maker A is not required to publish a quotation size but Market Maker A's exchange requires Market Maker A to be firm for customer orders up to 20 contracts, Market Maker A must respond within 30 seconds to a customer order for 30 contracts by filling the order for an amount equal to at least 20 contracts. If Market Maker A executes the entire order for 30 contracts, Market Maker A would not be obligated to move its quote. If Market Maker A executes only the part of the order representing its firm quote guarantee (*i.e.*, 20 contracts), Market Maker A would be required to move its quote to an inferior price.

The Commission preliminarily believes that it is appropriate to establish a time limit in which a broker-dealer that routes an order to another broker-dealer's quote must wait before being able to execute its customers' orders at its own inferior quote without being required to disclose the subsequent execution as a trade-through. If a market that is displaying a quote fails to respond to an incoming order that seeks execution at the displayed quote, the Commission believes it would be unreasonable to require a broker that executes its customer order at its own inferior quote to incur trade-through disclosure responsibility. Further, the Commission does not want to unduly delay the execution of orders by requiring a broker-dealer to wait an unreasonable amount of time for a response from an away market before it can execute the order without incurring disclosure responsibility. Thus, any time period that is established must balance the need for price priority against the need for efficient execution of orders.

Commenters should address the propriety of the proposed modification to the Quote Rule that would require a response within 30 seconds from a market that has published the best quote. Specifically, is it appropriate to have a specified time frame? If so, is 30 seconds appropriate, or is there another time frame, such as 15 seconds, or 45 seconds, that would be more appropriate?

IV. General Request for Comment

The Commission seeks comment on the proposals described in this release. In addition to the specific requests for comment throughout the release, the Commission asks commenters to address whether the proposed amendments to the Quote Rule and proposed Trade-Through Disclosure Rule would further the national market system goals set out in Section 11A of the Exchange Act,[95] and, in particular, the goals of assuring ''the practicability of brokers executing investors' orders in the best market.'' Commenters are also asked to address whether disclosure to customers about the execution of their orders at a price that trades through another market is an adequate substitute for requiring that all customers' orders receive trade-through protection by mandating a linkage among the options markets.

In addition, the Commission seeks comment on whether it should order the options exchanges to become participants in the Amex/CBOE/ISE plan or any other linkage plan.

Commenters may also wish to discuss whether there are any legal or policy reasons why the Commission should consider a different approach. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[96] the Commission is also requesting information regarding the potential impact of the proposed amendments and rules on the economy on an annual basis. If possible, commenters should provide empirical data to support their views.

V. Paperwork Reduction Act

Certain provisions of the proposed rules contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995,[97] and the Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 C.F.R. 1320.11. The Commission is proposing amendments

[88] Alternatives A and B, Proposed Exchange Act Rule 11Ac1–1(d)(2).

[89] Alternative A, Proposed Exchange Act Rule 11Ac1–1(d)(1).

[90] Alternative B, Proposed Exchange Act Rule 11Ac1–1(d)(1)(ii).

[91] Proposed Exchange Act Rule 11Ac1–7(b)(4)(vii).

[92] *See* Amex/CBOE/ISE plan Section 8(c)(iii)(B).

[93] Alternatives A and B, Proposed Exchange Act Rule 11Ac1–1(d)(3).

[94] Alternative B, Proposed Exchange Act Rule 11Ac1–1(d)(1)(ii).

[95] 15 U.S.C. 78k–1.

[96] Pub. L. No. 104–121, 110 Stat. 857.

[97] 44 U.S.C. 3501 *et seq.*

to the collection of information titled ''Rule 11Ac1–1, Dissemination of Quotations'' (OMB Control Number 3235–0461). The Commission is also proposing to create a new information collection entitled ''Rule 11Ac1–7, Trade-Through Disclosure Rule.'' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless it displays a currently valid OMB control number.

A. Summary of Collection of Information

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

The Quote Rule, Rule 11Ac1–1, was adopted pursuant to Exchange Act Sections 2, 3, 5, 6, 9, 10, 11A, 15, 15A, 17, and 23. The proposed amendment to Exchange Act Rule 11Ac1–1 would require markets to establish procedures for collecting their members' bids, offers, and quotation sizes for options traded on a national securities exchange or an automated facility of a registered national securities association. The proposed amendment also would require that the quotation information made available to vendors be firm, subject to certain exceptions.

B. Proposed Use of Information

The proposed Trade-Through Disclosure Rule information would be used by customers to evaluate the quality of the trade executions they receive. It would also be used by broker-dealers to evaluate and make determinations related to their best execution obligations. The Commission and options markets would use the information collected pursuant to the proposed rule for enforcement inquiries or investigations and trading reconstructions, as well as for inspections and examinations.

Customers of broker-dealers, as well as other market participants, would use the firm quote information to determine the best prices available for, and level of trading interest in, listed options trading. The Commission and options markets would use the firm quote information for enforcement inquiries or investigations and trading reconstructions, as well as for inspections and examinations of broker-dealers.

C. Respondents

While the proposed Trade-Through Disclosure Rule generally would apply to all of the approximately 7,500 broker-dealers that were registered with the Commission as of December 31, 1999, of which approximately 3,800 broker-dealers conduct business with the general public, most provisions would apply only to the less than 330 broker-dealers that clear customer accounts pursuant to Exchange Act Rule 15c3–3.[98] The proposed amendments to the Quote Rule would apply to the approximately 1,044 broker-dealers registered with the Commission that function as options market makers or specialists.[99]

D. Total Annual Reporting and Recordkeeping Burden

1. Proposed Trade-Through Disclosure Rule

a. *Capital Costs.* If a broker-dealer effects trades on a market that participates in a linkage plan with provisions reasonably designed to limit trade-throughs, including trade-throughs of prices on unlinked markets, the broker-dealer has no paperwork capital costs under the proposed Trade-Through Disclosure Rule.

However, the proposed Trade-Through Disclosure Rule would require broker-dealers to make certain disclosures to customers if the broker-dealer effects trades on markets that do not participate in a linkage plan. Broker-dealers would incur paperwork costs to modify systems to permit them to receive information about when a trade-through has occurred and the price that was traded through. Further, broker-dealer systems would have to be modified to ensure that information about trade-throughs is matched with correct customer accounts, thus permitting broker-dealers to disclose to customers when trade-throughs occur.

Because broker-dealer processes, systems capability, and customer bases vary so widely, it is difficult to provide an estimated cost with which all parties will agree. Nevertheless, the Commission estimates that it would take a computer programmer at an hourly rate of approximately $50[100] between 500 and 1,000 hours[101] to modify the average broker-dealer's systems to receive trade-through information, at a cost of between $25,000 and $50,000 for each broker-dealer. There are approximately 7,500 broker-dealers that were registered with the Commission as of December 31, 1999. Of those, approximately 3,800 broker-dealers conduct business with the general public. Most introducing firms, however, rely on their clearing firms to generate confirmation statements for customers.[102] As a result, fewer than 330 broker-dealers would actually have to modify their systems, should any systems modifications be necessary. However, if all 330 registered broker-dealers that clear customer accounts pursuant to Exchange Act Rule 15c3–3[103] were required to make these systems modifications, the one-time paperwork cost is estimated to be between $8,250,000 and $16,500,000.

The Commission notes, however, that it is quite possible that the participants in the approved linkage plan would amend the plan to adequately limit trade-throughs, and that the Phlx and PCX would choose to join the linkage plan or submit their own linkage plan for Commission approval. If all options markets participate in a linkage plan that includes provisions reasonably designed to limit trade-throughs, no systems modifications would be necessary and broker-dealers would incur no paperwork costs.

b. *Burden Hours.* If a broker-dealer effects trades on a market that participates in a linkage with provisions reasonably designed to limit trade-throughs, including trade-throughs of prices on non-linked markets, the broker-dealer would have no paperwork burden under the proposed Trade-Through Disclosure Rule.

However, the proposed Trade-Through Disclosure Rule would require broker-dealers to make certain disclosures to customers if the broker-dealer effects trades on markets that do not participate in a linkage that has provisions reasonably designed to limit

[98] 17 CFR 240.15c3–3.

[99] The number of specialist and market makers was determined by counting the number of registered broker-dealers that report non-zero market making profits or losses in their FOCUS reports.

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

[101] The Commission estimates that it would take each broker-dealer that provides confirmation statements to customers between 500 and 1,000 hours to complete the required systems modifications.

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

[103] 17 CFR 240.15c3–3.

trade-throughs. Specifically, if a customer order was traded-through, a broker-dealer would be required to disclose the trade-through to the customer. Currently, approximately 21,000,000 trades in multiply-listed options classes occur each year.

If the Amex, CBOE, and ISE amend their linkage plan to comply with the proposed Trade-Through Disclosure Rule's alternative to disclosure of trade-throughs, and the Phlx and PCX choose not to join the Amex/CBOE/ISE plan and also choose not to submit for Commission approval another linkage plan, the Commission estimates that approximately one-third of all trades annually, or 7,000,000 trades, in multiply-listed options classes would be subject to the disclosure requirement of the proposed Trade-Through Disclosure Rule. Of those 7,000,000 trades, the Commission estimates that as many as 5%, or 350,000 trades, would involve intermarket trade-throughs. For each trade-through, it is assumed that broker-dealers' systems would have already been reprogrammed to receive information about trade-throughs and to appropriately disclose such trade-throughs to their customers on the customer confirmation statements. Therefore, the Commission estimates that the paperwork burden of the disclosure for broker-dealers would be nominal because it would merely require a small amount of additional information on customer confirmation statements.

The Commission notes, however, that it is quite possible that the participants in the approved linkage plan would amend the plan to adequately limit trade-throughs, and that the Phlx and PCX will choose to join the linkage plan or submit their own linkage plan for Commission approval. If all options markets participate in a linkage plan that is reasonably designed to limit trade-throughs, there may ultimately be no paperwork burden associated with the proposed Trade-Through Disclosure Rule.

2. Proposed Amendments to the Quote Rule

a. *Capital Costs.* Applying the Quote Rule to options trading would require options self-regulatory organizations (''SROs'') to collect bids and offers from their members. However, SROs generally are obligated already, pursuant to their participation in the OPRA plan, to collect bids and offers, and send them to OPRA for dissemination. To comply with the amended Quote Rule, SROs would be required to periodically publish the size (or sizes, if different categories are used) for which a quote must be firm. In addition, under the amended Quote Rule, SROs would be required to file proposed rule changes to identify unusual market conditions. The options markets would incur one-time costs to file and obtain approval of these rule changes, as well as other related rules. The Commission estimates that the five options SROs would need to file two rule changes initially to comply with the proposed amendments to the Quote Rule, for a total of 10 rule changes. The Commission estimates that a routine rule change requires approximately 25 hours of legal review at an hourly cost of $98.25,[104] plus one hour of secretarial time at an hourly cost of $30.40,[105] for a total cost of $2,487 per proposed rule change submitted for Commission approval. Therefore, the Commission estimates that the aggregate cost of two proposed rule changes filed by each of the five options SROs would total approximately $24,867.

Broker-dealers that are market-makers or specialists have existing obligations under SRO rules to communicate their bids and offers to their SROs, and already do so. Therefore, broker-dealers would incur no additional paperwork costs from the amended Quote Rule beyond those related to systems changes, discussed below, to comply with the amended Quote Rule. Specifically, market makers and specialists may, to comply with the amended Quote Rule, change their quote-setting practices by changing the factors used to establish quotes through automated quoting systems (*i.e.,* resetting the parameters). The Commission notes that almost all option quotes are currently set by automated quoting systems. The Commission estimates broker-dealer systems changes made to comply with the amended Quote Rule would require changes estimated to take approximately three to five minutes per options class. As there are approximately 3,000 options classes eligible for multiple listing, the Commission estimates that the total burden for one market could range from 180 to 250 hours. For all five markets, the total burden could range from 900 to 1,255 hours. The hourly rate of an exchange clerk that would make the required system changes is $32.50;[106] therefore, the total cost for these changes could range from $29,250 to $40,787.

b. Burden Hours. SROs may amend their rules to comply with the Quote Rule from time to time. The Commission estimates that the five options SROs would amend their respective rules at most once per year, for a total of five proposed rule changes. The Commission estimates that a routine proposed rule change takes 25 hours of legal review at an hourly cost of $98.25[107] plus one hour of secretarial time at an hourly cost of $30.40,[108] for a total cost of $2,487 per proposed rule change. Therefore, the total annual cost of five SRO proposed rule changes would impose a burden of $12,433.

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

E. General Information about the Collection of Information

Any collection of information pursuant to the proposed rules would be mandatory. Market centers that are national securities exchanges or national securities associations would be required to retain the collections of information required under the proposed Trade-Through Disclosure Rule and the amended Quote Rule for a period of not less than five years, the first two years in an easily accessible place. Broker-dealers would be required to retain the collections of information for a period of not less than three years, the first two years in an easily accessible place.

The information collected pursuant to the Quote Rule would be held by the broker-dealers and markets. The Commission and other securities regulatory authorities would obtain possession of the information only upon request. The information collected pursuant to the proposed Trade-Through Disclosure Rule would be sent

[104] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 100.

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

[106] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 100.

[107] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 100.

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

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

F. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (1) Evaluate whether the proposed collection of information is necessary for the proposed performance of the functions of the agency, including whether the information shall have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (3) enhance the quality, utility, and the clarity of the information to be collected; and (4) minimize the burden of collection on those who are to respond, including through the use of electronic or automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, D.C. 20503; and (2) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549–0609, with reference to File No. S7–17–00.

The Commission has submitted the proposed collection of information to OMB for approval. Members of the public should direct any general comments to both the Commission and OMB within 30 days. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication in the **Federal Register**, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication of this release. Requests for the materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–17–00, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, N.W., Washington, D.C. 20549–0609.

VI. Costs and Benefits of Proposed Rules

As discussed above, the Commission is proposing a new rule—the Trade-Through Disclosure Rule—and amendments to the Quote Rule to provide customers with more information with which to evaluate the quality of executions achieved by their broker-dealers and to require that quotes for listed options be firm. Together, these rules would provide incentives for the options exchanges and their members to develop mechanisms to reduce the frequency of intermarket trade-throughs, but would not mandate the form of mechanism employed.

The Commission has identified below certain costs and benefits to the proposed Trade-Through Disclosure Rule and the proposed amendments to the Quote Rule. The Commission requests comment on all aspects of this cost-benefit analysis, including identification of additional costs or benefits of the proposed changes. The Commission encourages commenters to identify or supply any relevant data concerning the costs or benefits of the proposed amendments.

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

The proposed Trade-Through Disclosure Rule would require a broker-dealer to disclose to its customer (on the confirmation statement) when a trade-through has occurred. A broker-dealer would not be required to make this disclosure if the trade was effected on a market that is a participant in a Commission-approved intermarket linkage plan that contains provisions reasonably designed to limit trade-throughs.

1. Benefits

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

The staff estimates that approximately 5% of all trades (or 7,964 trades for a total of 156,403 contracts) in the 50 most active multiply-listed option classes took place at prices inferior to the best price quoted on a competing exchange during the week of June 26, 2000.[109] To better describe the execution quality of small customer orders, the staff also estimates that 1% of all automatic execution trades (or 464 automatic execution trades for a total of 2,336 contracts) in the 50 most active multiply-listed option classes took place at prices inferior to the best price quoted on a competing exchange during the week of June 26, 2000.[110]

Investors would benefit from the proposed Trade-Through Disclosure Rule because they would be informed of whether their orders were executed at a price inferior to the best available price. With that information, investors would have the opportunity to reduce the likelihood that their orders would be executed at a price inferior to a price displayed by another market, by selecting broker-dealers that effect their transactions on markets that are participants in a linkage plan with provisions reasonably designed to limit trade-throughs. If all orders executed through automatic execution systems were executed at the best-published quote (*i.e.*, trade-throughs of automatic execution trades were eliminated), the estimated annual savings to investors trading through exchanges' automatic execution systems would be approximately $11,000,000 each year.[111] If all trades were considered, the elimination of trade-throughs would result in substantially higher annual savings to investors.[112]

The Commission requests comment on whether there is a better measure for

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

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

[111] The annual benefit estimate is obtained by applying the staff's trade-through findings for automatic execution trades in the 50 most active multiply-traded options classes to all multiply-listed classes and extending the results from one week to a full year.

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

determining the benefits of the proposed rule than the evaluation of the trades currently executed at a price inferior to the best published quote. Commenters are also invited to express their views on the estimate of the number of trades executed at inferior prices. Would options exchanges' audit trail data, rather than OPRA data, provide a better estimate of the number and cost of trade-through executions? Is it possible to estimate the price and number of contracts that an order would have received had it been routed to an exchange showing a superior price? Is the week of June 26, 2000 representative of general trading patterns? Finally, the Commission would like commenters' views on investors' likely response to order confirmation statements disclosing that their orders were executed at prices inferior to the best prices available in the market, and the impact of such response.

2. Costs

The proposed rule may require broker-dealers and markets to incur capital costs, such as one-time costs to modify existing systems. For example, the proposal could impose one-time costs on markets and broker-dealers that must modify systems to determine when trade-throughs have occurred and to issue notifications to customers of trade-throughs. Further, to identify when an order trades through a posted quote, information systems would need to be developed that could identify the displayed quotes at the time of execution. Because the Commission would allow broker-dealers to rely on notifications from the markets when trade-throughs occur and the quote at that time, the costs of such information systems may be borne by the options markets. The Commission seeks comment on the costs of implementing such systems. The Commission requests commenters' views on whether the current OPRA feed is adequate to identify quotes from options markets. Would information in addition to the quote need to be made available to broker-dealers by the options markets? If so, the Commission requests comment on the anticipated costs of providing such information.

In addition, implementing the proposed rule could require broker-dealers to change the content of customer confirmation statements, issued in either electronic or paper form. The Commission requests estimates of the costs of changing customer confirmation statements. An alternative to changing confirmation statements would be for broker-dealers to route orders to exchanges participating in an approved linkage plan. Although the proposed rule does not require the implementation of such a plan, it does envision that an approved plan could be implemented.

Thus, one possible cost to the options markets of the Trade-Through Disclosure Rule could be a one-time cost to establish a linkage. In addition to the capital costs of establishing the linkage, costs could include regulatory costs, such as obtaining Commission approval of a linkage and of SRO rule changes necessary to implement a linkage. Further, there may be economic implications if a market chooses to participate in an approved linkage plan, because members may then be more likely to route orders to other exchanges that are quoting a better price.

The Commission estimates that capital costs for a linkage plan range from $1,000,000 to $1,500,000 initially, and yearly costs could range from $300,000 to $1,000,000. The Commission requests comment on the costs of developing a linkage between the markets, as well as the costs for individual markets to integrate their systems into such a plan.

B. Costs and Benefits of Proposed Amendments to the Quote Rule

The Commission proposes to amend the Quote Rule so that it applies to trading in listed options. The proposal makes certain accommodations for the fact that options markets do not currently disseminate to quotation vendors the size of their quotes. The Commission also proposes an alternative that would allow broker-dealers to be firm in different sizes for customer and broker-dealer orders. Finally, the proposal would require a broker-dealer to respond to an incoming order within 30 seconds by either: (1) Executing the order in full; or (2) partially executing the order up to the firm quote size and updating its quote.

1. Benefits

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

The Commission believes that applying the Quote Rule to options trading would provide a number of benefits. Firm quotes reduce uncertainty surrounding order routing decisions for broker-dealers that are seeking to fill customer orders at the best available price. If broker-dealers are confident that quotes are firm, investor orders may be routed to the market with the best price and receive an execution at that price. Under current practices, because broker-dealers cannot be confident that a price on another market is firm (due to existing market rules, including trade-or-fade rules), orders do not always receive the best available price. As discussed above, the staff estimates that 5% of all trades in the 50 most active multiply-listed classes took place at prices inferior to the best price quoted on a competing market during a one-week period in June 2000. Broker-dealers often state that such trade-throughs occur when market makers trade at inferior prices because they believe the better price on the other market may not be firm and the quote may ''fade'' if the broker-dealer were to attempt to execute against it. By requiring that posted prices be firm, a great deal of uncertainty about order execution quality could be reduced. This would be true even if the quote were permitted to be firm for different sizes for customer orders than for broker-dealer orders. The Commission is unable to quantify these benefits, and therefore requests comment and estimates.

In addition to providing certainty to broker-dealers making order routing decisions and seeking to fill orders at the best available price, extending the Quote Rule to the options markets may benefit broker-dealers by enhancing their ability to satisfy their regulatory obligations, including best execution. The Commission is unable to quantify these benefits, and therefore requests comment and estimates.

The Commission also believes that the proposed amendments to the Quote Rule would bolster investor confidence in the options markets by ensuring that quotes made by market participants are available for a specified number of options contracts, thus providing greater certainty for investors. In addition, by requiring the quotations in listed options to be firm, the proposed amendments may also lead to better informed investors, also increasing investor confidence in the market. The Commission requests comment and estimates on any other benefits that would result from applying the Quote Rule to options trading.

Specifically, the Commission requests comment on whether investors (including broker-dealers) have

experienced problems with the execution of their orders because options quotes have not proven to be firm. If so, how widespread are these problems and to what extent do they presently occur? Do these problems encourage broker-dealers to route orders to markets displaying inferior prices? The Commission also requests any data or information on the number of trades executed at inferior prices. Is it possible to estimate the price and quantity that a trade would have received had it been routed to a market showing a superior price?

Another benefit of applying the Quote Rule to options trading is that it would likely increase competition between markets. Because all quotes would be firm, a market participant would know that a posted quote that is superior to the best-published quote would be recognized as firm. Therefore, the posted quote may attract order flow. The ability to attract order flow with a market-improving quote encourages intermarket price competition, which benefits investors. The Commission requests comment on whether firm quotes would affect order routing decisions, including information and data about the impact, if any.

Currently, options markets do not disseminate quotes with size. Options markets determine the size for which their market makers or specialists must be firm. The proposed amendment to the Quote Rule would require each market to establish and periodically publish the sizes for which market makers or specialists must be firm. The Commission requests comment on the costs and benefits of permitting options markets to require different minimum sizes for customer orders than for broker-dealer orders. Would this help avoid market makers widening their spreads to protect themselves from other market professionals? Is it possible to quantify the benefits of having different minimum size requirements for customer and broker-dealer orders? What is the current experience with differential treatment for customer and broker-dealer orders, with particular regard to the markets' minimum size and auto-execution eligibility rules?

The Commission believes the proposed amendments to the Quote Rule will benefit investors whose orders, upon arrival at the options market, are either: (1) delayed, but then executed, or (2) delayed and never executed. The Commission further believes that its proposal would result in (1) fewer unexecuted investor orders due to quote changes after order arrival, or (2) fewer orders executed at prices less favorable to the investor than those prevailing at the time of order arrival. The Commission requests comment on the extent to which order execution is delayed following order arrival at a market, particularly for orders requiring manual execution. What execution prices do delayed orders receive relative to the quotes at order arrival? How many orders are cancelled due to delays incurred prior to exposure to the market?

Finally, the proposed rule would provide a similar standard for firm quotes in both equity and option markets. Does the current regulatory environment create confusion for investors experiencing different firm quote rules in different markets? If such confusion exists, what are the benefits that would be achieved by eliminating the confusion? Do investors have incorrect expectations about the nature of quotes in options markets? If so, do these incorrect expectations have a cost?

2. Costs

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

Amendment of the Quote Rule to include options may require markets to incur one-time costs. For example, options markets will need to enhance surveillance and enforcement mechanisms to ensure that SRO members are complying with the Quote Rule. Further, options market makers and specialists may need to reevaluate and change their quotes in light of the obligation to be firm that would be imposed by the proposed amendment to the Quote Rule. As the Commission is unable to quantify these costs, comment and estimates on the costs described above is requested.

Commenters are invited to express their views about the costs associated with the proposed 30-second response time for orders larger than the firm quote size. What are the costs, including opportunity costs, to investors in waiting 30 seconds for a report on such orders? What are the costs related to enabling the markets to respond to such an order within 30 seconds? Will options markets be able to respond within 30 seconds if both markets involved are not participants in the same linkage plan? The Commission seeks estimates for the costs to market makers of executing orders that they currently decline to fill at their displayed quote. If firm quotes were extended to broker-dealers as well as customers, would there be an increase in the risk to market makers from executing orders against other market professionals? What costs are currently incurred by SROs and other regulators in investigating market maker complaints that broker-dealers are misidentifying their trades as those of public customers? Would these costs be reduced if the amended Quote Rule were adopted? How would a difference in firm quote size between customer orders and broker-dealer orders affect the costs incurred by market makers and specialists?

In order to minimize costs, the Commission is proposing to amend the Quote Rule to conform as closely as possible to existing options market requirements and practices. The Commission seeks comment and supporting data on these and any other costs of the proposed amendments to the Quote Rule.

VII. Consideration of the Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation

Exchange Act Section 23(a) [113] requires the Commission, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. Because both the proposed amendments to the Quote Rule and the proposed Trade-Through Disclosure Rule would apply equally to all relevant market participants, the Commission does not believe that the proposals would have any anti-competitive effects. The Commission requests comment on any anti-competitive effects of the proposals.

In addition, Exchange Act Section 3(f) [114] requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. The Commission believes that the proposed

[113] 15 U.S.C. 78w(a).

[114] 15 U.S.C. 78c(f).

Trade-Through Disclosure Rule would bolster investor confidence in the options markets by better informing customers about the quality of their executions and the implications of their broker-dealers' execution decisions. This increased investor confidence should promote market efficiency and capital formation. The proposed disclosure requirement likely would help minimize the number of customer orders that do not receive an execution at the best available published quote. Further, the proposed Trade-Through Disclosure Rule would assist broker-dealers in evaluating and complying with their best execution obligations. Finally, it would provide an incentive for securities markets to develop an effective means to access quotes on other markets to avoid trade-throughs. This should increase the efficiency of the markets.

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

Finally, the Commission anticipates that any impact of these proposals on competition would be to promote competition. The Commission requests comment on all of these matters.

VIII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis (''IRFA'') has been prepared in accordance with the Regulatory Flexibility Act.[115] It relates to proposed Exchange Act Rule 11Ac1–7 and proposed amendment to Exchange Act Rule 11Ac1–1.

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

The Quote Rule, Rule 11Ac1–1, currently requires markets to establish procedures for collecting from their members bids, offers, and quotation sizes for certain equity securities available to quotation venders. It also requires that the quotation information made available to vendors be firm, subject to certain exceptions. The proposed amendments to the Quote Rule would apply the Quote Rule to options trading on a national securities exchange or an automated facility of a national securities association.

A. Reasons for the Proposed Action

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

Therefore, the Commission is proposing the Trade-Through Disclosure Rule and the proposed amendments to the Quote Rule to help address this situation. The proposed Trade-Through Disclosure Rule would require a broker-dealer to disclose to its customer when the customer's order was executed at a price inferior to the best published quote. A broker-dealer would not be required to make this disclosure when the broker-dealer transacts the customer order on a market that participates in a Commission-approved linkage plan that has rules reasonably designed to limit trade-throughs, even when the better price is displayed by a non-linked market. Amending the Quote Rule to apply to the options markets would provide greater certainty about both options quotes and pricing generally in the options markets. The proposed amendments to the Quote Rule, along with the proposed Trade-Through Disclosure Rule, would assist broker-dealers in making their best execution evaluations.

B. Objectives and Legal Basis

As noted above, the proposed Trade-Through Disclosure Rule and the proposed amendments to the Quote Rule are intended to bolster investor confidence in the options markets by better informing customers about the quality of their executions and the implications of their broker-dealers' execution decisions. The proposed Trade-Through Disclosure Rule likely would help minimize the number of customer orders that do not receive an execution at the best available published quote. Further, the proposed Trade-Through Disclosure Rule would assist broker-dealers in evaluating and complying with their best execution obligations. Finally, it would provide an incentive for options markets to develop effective means to access quotes on other markets to avoid trade-throughs.

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

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

C. Small Entities Subject to the Rules

Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person) that is not a small

[115] 5 U.S.C. 601. Pursuant to 5 U.S.C. 603 when an agency is engaged in a proposed rulemaking, ''the agency shall prepare and make available for public comment an initial regulatory flexibility analysis.''

entity.[116] The Commission estimates that as of December 31, 1999, approximately 41 Commission-registered broker-dealers were small entities that would be subject to the proposed Trade-Through Disclosure Rule.[117] However, the Commission estimates that none of the 41 registered broker-dealers that would be considered small entities for purposes of the statute regularly represent options orders on behalf of their customers. In addition, the Commission notes that only those broker-dealers that are also options specialists or market markers would be required to comply with the proposed amendments to the Quote Rule. As of December 31, 1999, our data indicates that only one broker-dealer that was a small entity was an options specialist or market maker.

The proposed amendments to the Quote Rule also would directly affect the national securities exchanges that trade listed options, none of which is a small entity as defined by Commission rules. Paragraph (e) of Exchange Act Rule 0–10 [118] states that the term ''small business,'' when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Exchange Act Rule 11Aa3–1. The proposed amendments to the Quote Rule also would directly affect national securities associations. There is one national securities association, which is not a small entity as defined by 13 CFR 121.201.

D. Reporting, Recordkeeping, and other Compliance Requirements

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

The proposed amendments to the Quote Rule would require a broker-dealer that is either a specialist or market maker to honor its quote for a size determined and disseminated by the options market where the specialist or market maker is quoting. The proposal also would require national securities exchanges and national securities associations to collect quote information from their members and disseminate that information to quotation venders.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes there are no rules that duplicate, overlap, or conflict with the proposed rules.

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entity issuers. In connection with the proposed rules, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rules, or any part thereof, for small entities.

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

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

Further, the Commission believes that none of the above alternatives is applicable to the proposed amendment with regard to national securities exchanges or national securities associations. The markets are directly subject to the requirements of the rules and are not ''small entities'' because they are all national securities exchanges or national securities associations that do not meet the definition of small entity. Therefore, the Commission does not believe the alternatives to the proposed rules are applicable to the markets.

G. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. In particular, the Commission requests comments regarding: (1) The number of small entities that may be affected by the proposed rules; (2) the existence or nature of the potential impact of the proposed rules on small entities discussed in the analysis; and (3) how to quantify the impact of the proposed rules. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed Regulation and Rules themselves.

IX. Statutory Authority

We are proposing the rules pursuant to our authority under Exchange Act Sections 3(b), 5, 6, 15, 11A, 17(a) and (b), 19, and 23(a).

[116] 17 CFR 240.0–10(c).

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

[118] 17 CFR 240.0–10(e).

List of Subjects in 17 CFR Part 240

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

Text of the Proposed Rules

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

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

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

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

* * * * *

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

§ 240.11Ac1–1 Dissemination of quotations.

(a) *Definitions.* * * *

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

* * * * *

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

* * * * *

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

(27) The term *listed option* shall have the meaning provided in § 240.15c3–1(c)(2)(x)(B)(*1*).

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

* * * * *

[Alternative A for paragraph (d)]

(d) *Transactions in listed options.*

(1) An exchange or association that establishes by rule and periodically publishes the size associated with its best bid or offer in each options series that is a subject security listed on such exchange or association shall not be required, under paragraph (b) of this section, to collect and make available to quotation vendors the quotation size and aggregate quotation sizes from responsible brokers or dealers who are members of such exchange or association.

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

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

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

(3) *Thirty second response.*

(i) Each responsible broker or dealer, within thirty seconds of receiving an order to buy or sell a listed option must:

(A) Execute the entire order; or

(B)(*1*) Execute that portion of the order equal to at least:

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

(*ii*) The size of the exchange's or association's quotation made available to quotation vendors by such exchange or association under paragraph (b) of this section; and

(*2*) Revise its bid or offer.

(ii) Notwithstanding paragraph (d)(3)(i) of this section, no responsible broker or dealer shall be obligated to execute a transaction for any subject security if:

(A) Any of the circumstances in paragraphs (c)(3) of this section exist; or

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

[Alternative B for paragraph (d)]

(d) *Transactions in listed options.*

(1)(i) An exchange or association that establishes by rule and periodically publishes the size associated with its best bid or offer in each options series that is a subject security listed on such exchange or association:

(A) Shall not be required, under paragraph (b) of this section, to collect and make available to quotation vendors the quotation size and aggregate quotation sizes from responsible brokers or dealers who are members of such exchange or association; and

(B) May allow, pursuant to such exchange rules, responsible brokers or dealers obligated under paragraph (c)(2) of this section to execute an order to buy or sell a listed option that is a subject security for the account of a broker or dealer that is different from the quotation size for which it is obligated to execute such an order for the account of a customer.

(ii) An exchange or association that establishes and maintains procedures and mechanisms for collecting bids, offers, quotation sizes and aggregate quotation sizes from responsible brokers and dealers for listed options that are subject securities listed on such exchange or association may allow, pursuant to exchange rules, responsible brokers or dealers to publish a quotation size for which it will be obligated under paragraph (c)(2) of this section to execute an order to buy or sell a listed option that is a subject security for the account of a broker or dealer that is different from its published quotation size for which it is obligated to execute such an order for the account of a customer.

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

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

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

(3) *Thirty second response.*

(i) Each responsible broker or dealer, within thirty seconds of receiving an order to buy or sell a listed option must:

(A) Execute the entire order; or

(B)(*1*) Execute that portion of the order equal to at least:

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

(*ii*) The size of the exchange's or association's quotation made available to quotation vendors by such exchange or association under paragraph (b) of this section; and

(*2*) Revise its bid or offer.

(ii) Notwithstanding paragraph (d)(3)(i) of this section, no responsible broker or dealer shall be obligated to execute a transaction for any subject security if:

(A) Any of the circumstances in paragraphs (c)(3) of this section exist; or

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

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

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

§ 240.11Ac1–7. Trade-through disclosure rule.

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

(1) The term *complex trade* means a transaction in an options series that is executed in conjunction with a related transaction occurring at or near the same time for the purpose of executing a particular investment strategy.

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

(3) The term *effective national market system plan* shall have the meaning provided in § 240.11Aa3–2 (Rule 11Aa3–2 under the Act).

(4) The term *listed option* shall have the meaning provided in § 240.15c3–1(c)(2)(x)(B)(*1*).

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

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

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

(8) The term *trading rotation* means, with respect to a specified options class at a given exchange, the time period during which opening transactions in individual options series are being completed and continuous trading has not yet commenced in such options class.

(b) *Broker-dealer disclosure requirements.* (1) Any broker or dealer that effects a transaction in a listed option for the account of its customer must disclose to such customer, in conformance with the procedures set forth in § 240.10b–10:

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

(ii) That better published price at the time of execution;

(2) A broker-dealer shall not be required to provide the disclosure set forth in paragraph (b)(1) of this section if it effects such transaction on a market that is a participant in an effective national market system options linkage plan that includes provisions reasonably designed to limit the incidence of customer orders being executed at prices that trade through a better published price, including prices published other than by a linkage plan participant.

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

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

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

(4) Notwithstanding paragraph (b)(2) of this section, a customer order is not considered to be executed at a price that trades through a better published price if:

(i) Such better published price cannot be accessed due to a failure, material delay, or malfunction of the systems of the market publishing the better price;

(ii) The quotation price reporting system provided for by the national market system plan for reporting quotations indicates that it is experiencing queuing;

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

(iv) The market publishing such better price is in a trading rotation for that option class;

(v) The customer order is executed during a trading rotation in that options class;

(vi) The customer order is executed as part of a complex trade; or

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

Dated: July 28, 2000.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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DEPARTMENT OF TRANSPORTATION

Coast Guard

33 CFR Parts 84 and 183

46 CFR Part 25

[USCG 1999–6580]

RIN 2115–AF70

Certification of Navigation Lights for Uninspected Commercial Vessels and Recreational Vessels

AGENCY: Coast Guard, DOT.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Coast Guard proposes to require that domestic manufacturers of vessels install only certified navigation lights on all uninspected commercial vessels and recreational vessels. This change would align the standards for these lights with those for inspected commercial vessels and with those for all other mandatory safety equipment carried on board all vessels. The Coast Guard expects the resulting reduction in the use of noncompliant lights to improve safety on the water.

DATES: Comments and related material must reach the Docket Management Facility on or before October 3, 2000.

ADDRESSES: To make sure your comments and related material (referred