

thereunder,<sup>8</sup> because it involves a member due, fee, or other charge. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to file number SR-CSE-00-07, and should be submitted by November 17, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34 43462; File No. SR-ISE-00-10]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the International Securities Exchange, LLC Relating to Payment for Order Flow

October 19, 2000

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

(“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on September 12, 2000, the International Securities Exchange, LLC (the “Exchange” or “ISE”) filed with the Securities and Exchange Commission the proposed rule change as described in Items I, II, and III below, which items have been prepared by the ISE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange is proposing to establish a payment for order flow program as follows:

*Authorization To Impose a Payment-for-Order-Flow Fee.* The ISE will impose fees on Primary Market Makers (“PMMs”) and Competitive Market Makers (“CMMs”). There will be up to three separate fees on a per-contract basis:

- Fees on transactions with Public Customer;<sup>3</sup>
- Fees on transactions with Non-Customers<sup>4</sup> other than market makers on another options exchange (“away market makers”); and
- Fees on transactions with away market makers.

There will not be any fees on transactions in which all parties are PMMs and CMMs. The Exchange will establish the specific fees in a separate rule filing submitted pursuant to Section 19(b)(3)(A) of the Act.<sup>5</sup> The three fees may be the same, or may differ from each other; one or more fees may be set at \$0 per contract. The fees on transactions with Non-Customers and away market makers may not be higher than the fee on Customer transactions, however. In addition, the fee on transactions with away market makers will not be higher than the fee on transactions with other Non-Customers.

The Exchange also will have the flexibility to establish multi-tiered fees. These tiers can be based on such factors as the overall trading activity of an option, the Exchange's market share in an option, or any other objective factor. If the Exchange establishes multi-tiered fees, the Exchange's fee filing will specify each of those fees.

*Use of the Funds Generated by the Fee to Pay for Order Flow.* The Exchange

will separately account for the funds this fee generates on a per-group basis. That is, the Exchange will segregate these funds according to each of the groups of “bins” of options the Exchange trades. The PMMs will use the funds generated by the fee to pay Electronic Access Members (“EAMs”) for their order flow. The PMMs will have full discretion regarding payments, including which EAMs will be paid, the amount of the payments, and the type of order flow subject to the payment. The Exchange also will establish “bin advisory committees” (“BACs”) consisting of the PMM and CMMs in a bin. The Exchange will provide to all bin members information regarding payments made and the BACs will provide a forum for the discussion of, among other things, payment issues. These committees will be advisory in nature only, however, and the PMM will retain full discretion over all payment decisions.

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

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

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

###### 1. Purpose

The purpose of the proposed rule change is to establish the structure for an ISE payment-for-order-flow program. This is a competitive response by the Exchange to similar programs of the other options exchanges. The proposal has two parts: establishing the structure of a fee to fund a payment-for-order-flow program; and establishing how the funds the fees generate will be used to pay for order flow.

*Establishing a Fee Structure.* The Exchange is proposing the flexibility of having up to three separate fees. The highest level of market maker fees will be on transactions between market makers and Public Customers. Because the funds generated will primarily be used to pay for customer order flow, the ISE believes that it is reasonable that market makers be “taxed” primarily on

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

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

<sup>3</sup> The ISE defines “Public Customer” in ISE Rule 100(29).

<sup>4</sup> The ISE defines “Non-Customer” in ISE Rule 100(19).

<sup>5</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>8</sup> 17 CFR 240.19b-4(f)(2).

<sup>9</sup> 17 CFR 200.30-3(a)(12).

their transactions with customers to fund these payments. The structure allows for lower fees on Non-Customer transactions and away market makers, and there are no fees on transactions executed between ISE market makers.

The ISE states that the possible lower fees on Non-Customers reflect a balancing of the competitive interests that currently exist in the options markets. The Exchange seeks to encourage market makers to provide significant size for Non-Customer orders. If the payment-for-order flow fee is set at too high a level, however, PMMs and CMMs may not provide sufficient size to attract these orders to the Exchange. Thus, the Exchange believes that it is important to establish a structure that will allow it to establish a balance between generating revenue to pay for order flow and attracting Non-Customer order flow.

In addition, the Exchange is proposing a structure that could distinguish between orders of away market makers and other Non-Customers. While the fee could be lower on transactions with away market makers than with other Non-Customers, it could not be higher. This distinction recognizes certain unique aspects of away market maker order flow. In particular, pursuant to the intermarket options linkage plan<sup>6</sup> that the Commission has approved, ISE market makers will have certain obligations to trade against the orders of away market makers. Thus, the Exchange believes that it may be appropriate to "tax" these transactions less than other Non-Customer transactions, recognizing that these transactions could be in fulfillment of regulatory and market obligations and are important in promoting price discovery in the market place. This proposal establishes a structure that would allow, but not require, the fee to be set in a manner than reflects these competitive and market place factors.

The proposed rule change also provides that there will not be a fee on transactions in which all parties are PMMs and CMMs. Transactions between market makers are an important aspect of the ISE's price-discovery model. These trades often occur when market makers have different views on an options price and their quotes interact until a "price equilibrium" is established. In addition, these trades could occur as market makers hedge or rebalance their positions. The Exchange believes that it would be inappropriate to "tax" these

trades. Such a "tax" could create incentives to avoid this type of trading, which could harm the overall depth, liquidity, and pricing efficiency of the ISE's market.

Finally, the proposal would permit the Exchange to establish multiple tiers of fees. The Exchange would define the tiers pursuant to objective criteria, including but not limited to the overall activity in an option and the Exchange's market share in an option. This is intended to provide the ISE with as much flexibility as possible in collecting funds to pay for order flow in a manner consistent with the Exchange's overall goal of creating incentives for market makers to provide deep and liquid markets.

*Payment for Order Flow.* The only use of funds generated will be to pay for order flow. The Exchange will segregate the funds proportionately to the bins that generated the funds, and the PMM in each bin generally will have full discretion on how to use those funds to pay for order flow. The Exchange will make the payments to the EAMs based on the PMM's directives. While the Exchange will establish BACs as a forum for CMMs to discuss payment issues with PMMs, CMMs will not have any formal role in making payment decisions.

With respect to members who receive payments for their order flow, the Exchange will be issuing appropriate circulars to its members emphasizing their disclosure and best execution obligations. The Exchange also will be providing to members various reports and other information demonstrating the quality of executions that they receive on the Exchange.

## 2. Basis

The basis for this proposed rule change is the requirement under Section 6(b)(5) of the Act<sup>7</sup> that an exchange have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

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

The ISE believes that payment-for-order-flow raises significant competitive issues. In the ISE's view, when market makers pay broker-dealers for their order flow, the true cost of executing orders is obscured, imposing a burden on price competition in the market. Specifically, the ISE believes that it is difficult to compete for order flow when

undisclosed payments are influencing order routing decisions.

Furthermore, the ISE believes that these competitive issues are compounded when exchanges establish payment-for-order-flow programs. In the ISE's view, not only do the payment programs impede price discovery and competition on an intermarket basis, but these programs also can raise intramarket competitive issues. In this regard, the ISE believes that market makers on an exchange should be encouraged to compete vigorously within their markets for order flow. Exchange-mandated payment-for-order-flow programs require these competitors to act jointly in paying broker-dealers for their orders, however. The ISE believes that this mandated "tax" on transactions may well adversely affect the ability of individual market makers to compete as vigorously as possible for order flow through aggressive quotations, thus harming intra market price competition. Moreover, in the ISE's view, to the extent that market makers do "compete" by paying for order flow, such payments may or may not flow through to the ultimate investor. In contrast, aggressive quotation competition clearly would flow through to investors.

Notwithstanding these concerns, the ISE believes that it must establish a level playing field on which it can compete with the other options exchanges, all of which have developed their own payment for order flow programs. Accordingly, the Exchange believes that this proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

As noted below, the Commission has permitted payment-for-order-flow programs on all four competing options exchanges to take effect pursuant to effective-on-filing rule changes. While the Commission has the authority to abrogate those filings, it has not exercised that authority.<sup>8</sup> In the ISE's view, the burden on competition resulting from payment-for-order-flow already is present in the market, and therefore any incremental effects of the ISE's program will be minimal. The ISE believes, moreover, that it will be at a competitive disadvantage, at least in the short term, if it is not permitted to offer a competitive program. Accordingly, the ISE believes that there is no basis under

<sup>6</sup> See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

<sup>8</sup> The ISE urged the Commission to abrogate the first of these filings, which was submitted by the Chicago Board Options Exchange. See letter dated July 14, 2000 from Michael Simon, Senior Vice President and Secretary, ISE, to Jonathan G. Katz, Secretary, SEC.

the Act to impose such an anticompetitive burden upon it.

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

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

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

Within 35 days of the date of publication of this notice in the **Federal Register** (or within such longer period as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or as to which the ISE consents), the Commission shall by order approve this proposed rule change or institute proceedings to determine whether the proposed rule change should be disapproved.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of the filing will also be available for inspection and copying at the principal office of the ISE. All submissions should refer to File No. SR-ISE-00-10 and should be submitted by November 17, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>1</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-43469; File No. SR-NASD-00-60]

**Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. To Delay the Implementation Date of Changes to Riskless Principal Trade Reporting Rules**

October 20, 2000.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 18, 2000, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, The Nasdaq Stock Markets, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Item I, II, and III below, which Items have been prepared by Nasdaq. Nasdaq filed the proposal pursuant to Section 19(b)(3)(A)(i) of the Act,<sup>3</sup> and Rule 19b-4(f)(1)<sup>4</sup> thereunder, which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

Nasdaq proposes to delay until February 1, 2001, the implementation date of the riskless principal trade reporting rule changes announced in SR-NASD-98-59,<sup>5</sup> SR-NASD-98-08,<sup>6</sup> SR-NASD-00-52,<sup>7</sup> and the interpretations thereto filed in SR-

NASD-99-39,<sup>8</sup> SR-NASD-99-52,<sup>9</sup> SR-NASD-00-06,<sup>10</sup> and SR-NASD-00-44.<sup>11</sup>

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

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

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

On March 24, 1999 and July 8, 1999, the Commission approved proposals to amend the NASD trade reporting rules relating to riskless principal transactions in Nasdaq National Market, Nasdaq SmallCap Market, Nasdaq convertible debt, and non-Nasdaq over-the-counter ("OTC") equity securities, and exchange-listed securities traded in the Nasdaq InterMarket ("Riskless Principal Trade Reporting Rules").<sup>12</sup> Under the new Riskless Principal Trade Reporting Rules, a "riskless" principal transaction is one where an NASD member, after having received an order to buy (sell) a security, purchases (sells) the security as principal at the same price to satisfy the order to buy (sell). The Rules require a firm to report a riskless principal trade as one transaction.

In the Order approving SR-NASD-98-59, the Commission asked Nasdaq to submit an interpretation providing examples of how mark-ups, mark-downs, and other fees would be excluded for purposes of the amended riskless principal rules.<sup>13</sup> As requested, on August 5, 1999, Nasdaq filed with the Commission SR-NASD-99-39,<sup>14</sup> attached to which was *Notice to Members 99-65*, which gave examples of how mark-ups and other fees will be

<sup>1</sup> 17 CFR 200.30-3(a)(12).

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> 17 CFR 240.19b-4.

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A)(i).

<sup>5</sup> 17 CFR 240.19b-4(f)(1).

<sup>6</sup> Securities Exchange Act Release No. 41208 (March 24, 1999), 64 FR 15386 (March 31, 1999).

<sup>7</sup> Securities Exchange Act Release No. 41606 (July 8, 1999), 64 FR 38226 (July 15, 1999).

<sup>8</sup> Securities Exchange Act Release No. 43303 (September 19, 2000), 65 FR 57853 (September 26, 2000).

<sup>9</sup> Securities Exchange Act Release No. 41731 (August 11, 1999), 64 FR 44983 (August 18, 1999).

<sup>10</sup> Securities Exchange Act Release No. 41974 (October 4, 1999), 64 FR 55508 (October 13, 1999).

<sup>11</sup> Securities Exchange Act Release No. 41494 (March 3, 2000), 65 FR 13069 (March 10, 2000).

<sup>12</sup> Securities Exchange Act Release No. 43103 (August 1, 2000), 65 FR 48774 (August 9, 2000).

<sup>13</sup> See footnotes 5 and 6, *supra*.

<sup>14</sup> Securities Exchange Act Release No. 41208 (March 24, 1999), 64 FR 15386 (March 31, 1999) at footnote 15.

<sup>15</sup> See footnote 8, *supra*.