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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44482; File No. 4-429]

### Joint Industry Plan; Order Approving Amendment to the Options Intermarket Linkage Plan to Conform the Options Intermarket Linkage Plan to the Requirements of Securities Exchange Act Rule 11Ac1-7

June 27, 2001.

#### I. Introduction

On March 13, 2001, the American Stock Exchange LLC ("Amex"), Chicago Board Options Exchange, Inc. ("CBOE"), International Securities Exchange LLC ("ISE"), Pacific Exchange, Inc. ("PCX"), and Philadelphia Stock Exchange, Inc. ("Phlx") (collectively, the "Participants") submitted to the Securities and Exchange Commission ("SEC" or "Commission") in accordance with Section 11A(a)930 of the Securities Exchange Act of 1934 ("Exchange Act" or "Act")<sup>1</sup> and Rule 11Aa3-2 thereunder,<sup>2</sup> a proposed amendment to the options intermarket linkage plan ("Linkage Plan").<sup>3</sup> The amendment proposes to conform the Linkage Plan to the requirements of recently adopted Exchange Act Rule 11Ac1-7, the Trade-

Through Disclosure Rule.<sup>4</sup> The proposed amendment to the Linkage Plan was published in the **Federal Register** on April 4, 2001.<sup>5</sup> Three comment letters were received in response to the notice.<sup>6</sup> This order approves the proposed amendment to the Linkage Plan.

#### II. Description of the Proposed Amendment

On November 17, 2000, the Commission adopted Exchange Act Rule 11Ac1-7 to require a broker-dealer to disclose to its customer when the customer's order for listed options is executed at a price interior to a better quote displayed by another market ("intermarket trade-through"), and to disclose the better published quote available at that time. Under the rules, however, a broker-dealer is not required to disclose to its customer an intermarket trade-through if the broker-dealer effects the transaction on an exchange that participates in an approved linkage plan that includes provisions reasonably designed to limit intermarket trade-throughs.

In the Adopting Release, the Commission noted that to conform to the requirements of the Trade Through Disclosure Rule, a linkage plan must, at a minimum, contain provisions to: (1) Limit participants from trading through, not only the quotes of other linkage plan participants, but also, the quotes of exchanges that are not participants in an approved linkage 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.<sup>7</sup> The proposed amendment to the Linkage Plan was intended to add such provisions to the Linkage Plan.

<sup>4</sup> 17 CFR 240.11Ac1-7. See Securities Exchange Act Release No. 43591 (November 17, 2000), 65 FR 75439 (December 1, 2000) ("Adopting Release").

<sup>5</sup> See Securities Exchange Act Release No. 44106 (March 27, 2001), 66 FR 17977 (April 4, 2001) ("Notice").

<sup>6</sup> See Letter to Jonathan G. Katz, Secretary, Commission, from Joseph B. Stefanelli, Executive Vice president, Derivative Securities, Amex, dated May 7, 2001 ("Amex letter"); Letter to Jonathan G. Katz, Secretary, Commission, from Charles Rogers, Executive Vice President, Phlx, dated May 1, 2001 ("Phlx Letter"); and Letter to Jonathan G. Katz, Secretary, Commission, from Edward J. Joyce, President and Chief Operating Officer, CBOE, dated April 26, 2001 ("CBOE Letter").

<sup>7</sup> See Adopting Release, *supra* note 4, at n.2 and accompanying text.

First, the proposed Amendment would change the definitions of "National Best Bid or Offer" ("NBBO") and "Trade-Throughs" so that the terms would apply to unlinked, as well as linked, exchanges. Second, the proposed amendment would require Participants to establish procedures for conducting surveillance for trade-throughs, both respect to trading through linked and unlinked markets. Third, it would require that Participants adopt uniform rules that make it a violation of a participant's rules for a member to engage in a pattern or practice of trading through bids and offers in other linked markets, unless one of the enumerated exceptions to the Linkage Plan's Trade-Through provisions applies and, in the case of a Block Trade, where the initiating member has satisfied aggrieved parties at the block price. Lastly, the proposed amendment would add a provision to the Linkage Plan that states that a failure to lodge a Trade-Through complaint will not signify that a Trade-Through has not occurred, but instead, affects only liability.

#### III. Summary of Comments

The Commission received comment letters from three participants in response to the notice published in the **Federal Register**.<sup>8</sup> In these letters, the Participants expressed concerns regarding the reference in the Notice to footnote 62 of the Adopting Release. The Notice states "[n]otwithstanding the more limited language in the proposed amendment to the Linkage Plan, each exchange's rules must address trade-throughs of better quotes displayed by both linked and unlinked markets."<sup>9</sup>

The commenters stated that they believe that the proposed amendment to the Linkage Plan fully complies with the requirements of the Trade-Through Disclosure Rule, and that it is not necessary for the exchanges to adopt rules to address trade-throughs in addition to complying with the requirements of the Linkage Plan, as amended.<sup>10</sup> The commenters argued that the proposed amendment clearly provides that members should not effect trade-throughs, and that participants to the Linkage Plan should conduct surveillance to detect any violations of this mandate.<sup>11</sup> One commenter further noted that Section 4(b) of the Linkage Plan specifically requires that all

<sup>8</sup> See Amex Letter; CBOE Letter; and Phlx Letter, *supra* note 6.

<sup>9</sup> See Notice, *supra* note 5, at n.5.

<sup>10</sup> See Amex Letter; CBOE Letter; and Phlx Letter, *supra* note 6.

<sup>11</sup> *Id.*

<sup>1</sup> 15 U.S.C. 78k-1(a)(3).

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

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

participants enforce the provisions of the Linkage Plan.<sup>12</sup>

Another commenter questioned how else the participants could address trade-throughs beyond the requirements contained in the proposed amendment.<sup>13</sup> The commenter disagreed that the participants must adopt rules to mandate disciplinary action against members for trading through unlinked markets in order to comply with the Trade-Through Disclosure Rule, expressing frustration that this view was not expressed by the Commission before the proposed amendment was submitted.<sup>14</sup>

One commenter expressed concern regarding a requirement that the exchanges impose sanctions on their members for trading through unlinked markets.<sup>15</sup> This commenter stated that while it agreed that members who trade through quotes from unlinked markets without justification or due diligence should be subject to investigation and possible sanction, it would be unfair for the exchanges to adopt rules under which members would be sanctioned if they traded through an unlinked market when investigation revealed that such market was inaccessible to members, or information concerning the validity of that market unreliable.<sup>16</sup> This commenter also stated that upon submitting the proposed amendment to the Commission it did not understand that it also would be required to adopt specific exchange rules providing for sanctions on members that trade through unlinked markets.

Finally, one commenter argued that the Commission's position that the proposed Linkage Plan does not satisfy the rule may severely impact broker-dealers due to the additional cost and potential liability associated with detecting and disclosing possible trade-throughs resulting from a failure to have in place a Commission-approved linkage.<sup>17</sup> This commenter suggested that the compliance date of the rule should be coordinated with the implementation date of the proposed Linkage Plan.

#### IV. Discussion

The Commission finds that the proposed amendment to the Linkage Plan satisfies the three minimal requirements set out in the Adopting Release to conform the Linkage Plan to the requirements of the Trade-Through

Disclosure Rule. Specifically, the Commission finds that by amending the definitions of "NBBO" and "Trade-Throughs" so that the terms apply to unlinked, as well as linked, exchanges, the proposed amendment would add to the Linkage Plan a provision to limit participants from trading through, not only the quotes of other linkage plan participants, but also, the quotes of exchanges that are not participants in an approved linkage plan. The Commission also finds that the proposed amendment would add to the Linkage Plan a requirement that each participant establish procedures for conducting surveillance for trade-throughs of both linked and unlinked markets. In addition, the Commission finds that the proposed amendment to the Linkage Plan clarifies 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.

Further, the Commission has carefully considered the comment letters submitted by the CBOE, Phlx, and Amex. The Commission reiterates its statement made in the Adopting Release that, in addition to the minimal provisions that must be included in an intermarket linkage plan to allow broker-dealers effecting transactions on exchanges participating in the plan to be excepted from the disclosure requirements of the Trade-Through Disclosure Rule, each exchange participating in a linkage plan would have to adopt certain rules. The Adopting Release stated that an exchange participating in the Linkage Plan:

Would have to adopt rules to allow the exchange to sanction specialists or market makers that trade through better prices of other exchanges, maintain policies and procedures that would limit the occurrence of intermarket trade-throughs, and maintain records that would identify intermarket trade-throughs and any review or remedial action taken by the exchange in response to such intermarket trade-throughs.<sup>18</sup>

The Commission believes that the requirement set forth in the Adopting Release, detailed above, that the Linkage Plan participants adopt rules regarding trade-throughs of better prices of other exchanges, not only linked markets, provided adequate notice to the participants in the Linkage Plan that such rules were expected to be filed for Commission approval. The Commission

again restates here that the Commission fully expects the Linkage Plan participants to satisfy this requirement. Moreover, the Commission notes that the concerns raised by commenters are, at this time, purely academic because all of the options exchanges currently are participants in the Linkage Plan.

Finally, the Commission strongly believes that each exchange must have rules to allow it to sanction any member who has the ability to execute a transaction in its market at a price inferior to a price displayed by another exchange. In connection with the requirement set forth in the Adopting Release that each exchange adopt rules to allow it to sanction "specialists or market makers that trade through better prices of other exchanges," the Commission believes that this language cannot be read as limiting the reach of the exchanges' rules to only specialists or market makers in each market. Rather, this provision must be read in conjunction with the other requirements set forth in the Adopting Release and consistent with a plain reading of the Linkage Plan. Specifically, the Commission believes that the requirement in the Adopting Release that, in addition to provisions that the Linkage Plan must contain to conform to the requirements of the Trade-Through Disclosure Rule, each exchange participating in the Linkage Plan has to "maintain policies and procedures that would limit the occurrence of intermarket trade-throughs,"<sup>19</sup> can only be read to require that such policies and procedures limit the occurrence of intermarket trade-throughs for all trades, other than those trades expressly excluded from the Trade-Through Disclosure Rule, regardless of the member affecting such trade. Moreover, Section 8(c) of the Linkage Plan states that "the Participants agree that absent reasonable justification and during normal market conditions, *members* in their markets should not effect trade-throughs (emphasis added)."

Finally, after careful review, the Commission finds that the proposed amendment to the Linkage Plan to consistent with the requirement of the Act and the rules and regulations thereunder, Specifically, the Commission believes that the proposed amendment is consistent with Section 11A of the Act,<sup>20</sup> and Rule 11Aa3-2 thereunder,<sup>21</sup> in that it is appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove

<sup>12</sup> See Amex Letter, *supra* note 6.

<sup>13</sup> See CBOE Letter, *supra* note 6.

<sup>14</sup> See CBOE Letter, *see also* Amex Letter, *supra* note 6.

<sup>15</sup> See Phlx Letter, *supra* note 6.

<sup>16</sup> *Id.*

<sup>17</sup> See Amex Letter, *supra* note 6.

<sup>18</sup> See Adopting Release, *supra* note 4, at n.62.

<sup>19</sup> See Adopting Release, *supra* note 4, at n.62.

<sup>20</sup> 15 U.S.C. 78k-1.

<sup>21</sup> 17 CFR 240.11Aa3-2.

impediments to, and perfect the mechanisms of, a national market system. Moreover, the Commission believes that the Linkage Plan, as amended, satisfies the minimal requirements of the Trade-Through Disclosure rule to except broker-dealers who effect transactions on one of the linked markets from making the required disclosures under the Trade-Through Disclosure Rule, so long as each of the linked markets has adopted the required rules, discussed above.

## V. Conclusion

*It is Therefore Ordered*, pursuant to Section 11A of the Act<sup>22</sup> and Rule 11Aa3-2 thereunder,<sup>23</sup> that the proposed Linkage Plan amendment is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>24</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44491; File No. SR-DTC-00-17]

### Self-Regulatory Organizations; The Depository Trust Company; Order Granting Approval of a Proposed Rule Change To Eliminate DTC's Option To Resell to Deliverers the Securities They Had Previously Delivered by Book Entry to the Account of a Participant That Has Failed To Settle Its Debit Obligation to DTC

June 28, 2001.

#### I. Introduction

On November 14, 2000, the Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-DTC-00-17) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on April 17, 2001.<sup>2</sup> The Commission received two comment letters in support of the proposal.<sup>3</sup> For the reasons

discussed below, the Commission is granting approval of the proposed rule change.

#### II. Description

If a participant fails to pay its settlement obligation to DTC at the end of the day, DTC will use its liquidity resources (all-cash participants fund and bank line of credit) to complete settlement. Currently, DTC's rules provide that if the participant is insolvent and use of the participant's participants fund deposit does not eliminate its net debit obligation, DTC may on the business day following the failure-to-settle either: (1) Resell to deliverers the securities they had delivered to the insolvent participant on the day of the failure ("resale procedure") or (2) sell in the open market those securities and other collateral in the insolvent participant's account. Under the proposed rule change, DTC would amend its Rule 9(B) to eliminate DTC's option to resell to deliverers the securities they had previously delivered by book-entry to the account of a participant that has failed to settle its debit obligation to DTC.

The resale procedure was included in DTC's rules prior to the industry's conversion to same-day funds settlement and DTC's adoption of associated risk management controls, including the collateral monitor and the imposition of net debit caps.<sup>4</sup> The collateral monitor systematically prevents a participant from accruing a net debit that exceeds the value of the collateral in its account by blocking any transaction that would have that effect. For this purpose, collateral includes: (1) The participant's deposit to the participants fund, (2) the value of securities in the participant's account that it has designated as collateral, and

(3) the value of securities that are the subject of deliveries from other participants. The collateral value attributed to securities is equal to their market value minus a "haircut" determined by DTC. DTC believes that its risk management controls adequately limit DTC's risk exposure in the event of a participant insolvency and that there is no need to rely upon the resale procedure.

#### III. Discussion

Section 17A(b)(3)(F)<sup>5</sup> of the Act requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The Commission believes that DTC's risk management controls such as collateral monitoring and the use of net debit caps adequately limit DTC's exposure in the event of a participant failure to settle an insolvency situation. The Commission further believes that DTC's right to sell the insolvent's collateral in the open market give DTC a sufficient means to eliminate any unsatisfied net debit obligation of the insolvent participant. Therefore, the Commission finds DTC's decision to eliminate its right to resell securities to deliverers and to rely upon its risk management controls and its right to resell collateral into the open market is consistent with DTC's obligations to assure the safeguarding of securities and funds which are in the custody or control of DTC or for which it is responsible because use of the risk management controls and open market sales should provide DTC with the means to meet its financial obligations in the event of a participant's failure to settle.

#### IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.

*It Is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-DTC-00-17) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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<sup>5</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>6</sup> 17 CFR 200.30-3(a)(12).

<sup>22</sup> 15 U.S.C. 78k-1.

<sup>23</sup> 17 CFR 240.1Aa3-2.

<sup>24</sup> 17 CFR 200.30-3(a)(29).

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

<sup>2</sup> Securities Exchange Act Release No. 44172, (April 10, 2001), 66 FR 19820.

<sup>3</sup> Letters from Diane L. Schueneman, First Vice President, Merrill Lynch Investment Managers Operations and Arthur L. Thomas, Chief Operating Officer, Merrill Lynch Securities Services Division,

to Dennis Dirks, President, Depository Trust Company (June 7, 2000) ("Merrill Lynch") and from Jeffrey P. Neubert, President and Chief Executive Officer, New York Clearing House, to John Mancuso, Senior Systems Director, The Depository Trust & Clearing Corporation (September 22, 2000) ("NYCH").

<sup>4</sup> For a description of same day funds settlement and DTC's adoption of associated risk management controls, refer to Securities Exchange Act Release Nos. 24689 (July 9, 1987), 52 FR 26613 [File No. SR-DTC-87-04] (order granting temporary approval to DTC's same-day fund settlement service), 26051 (August 31, 1988), 53 FR 34853 [File No. SR-DTC-88-06] (order granting permanent approval to DTC's same-day fund settlement service), 27360 (May 16, 1995), 60 FR 27360 [File No. SR-DTC-95-06] (order modifying DTC's same-day funds settlement system to accommodate the overall conversion to same-day settlement for securities transactions), and 36843 (February 14, 1996), 61 FR 6672 [File No. SR-DTC-96-03] (order granting modifications to certain DTC procedures in order to facilitate conversion to entirely same-day funds settlement system).