

POMA;<sup>8</sup> and (4) liquidation amount. The liquidation computation, which is the subject of this rule filing, is a floor amount designed to ensure that if the margin offsets ordinarily allowed in calculating the receive/deliver settlement component do not reflect actual market conditions during a liquidation period, GSCC nonetheless will have a sufficient level of collateral protection. In other words, this minimum requirement protects against the risk that during a liquidation period the yield curve will be aberrational. In such a situation, collection of a minimum amount of margin based on gross calculation should ensure that GSCC will have sufficient collateral to cover liquidation losses.

The proposed rule change lowers the percentage calculated on the net long and net short positions in the liquidation amount calculation from 25 percent to 10 percent. GSCC believes that this more appropriately balances the level of margin it collects against the liquidity needs of its members.

GSCC believes that 25 percent was overly conservative for several reasons. First, GSCC's experience has demonstrated that its POMA and average POMA calculations provide adequate protection against potential settlement risks. By calculating an average POMA (based on a member's twenty highest POMA amounts occurring in the most recent 75 business days), GSCC ensures that it calculates a historically sufficient receive/deliver settlement component for a member even when current activity results in a relatively low requirement. Also, periodic studies conducted by GSCC assessing the risks presented to it from the potential default by a member on its obligations to GSCC have concluded that GSCC's methodologies for identifying and computing its risks provide it with a high level of protection on an individual and aggregate basis.

Second, the liquidation amount ignores and negates much of the protection afforded by a hedging strategy. The more a member engages in a hedging strategy with respect to its trading, the more it protects itself and in turn its clearing corporation from the risk of its failure. However, GSCC believes that the current 25 percent requirement effectively disregards the protection afforded to GSCC by a

<sup>8</sup> The adjusted POMA computation is the same as the POMA with the exception that it excludes all trades that are scheduled to settle on the current day. This is done based on the assumption that those trades will in fact settle on the current day and that calculating POMA in this manner will more accurately reflect GSCC's settlement exposure during the current day.

member that engages in trading activity on a fully hedged basis.

## II. Discussion

Section 17A(b)(3)(F)<sup>9</sup> of the Act requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds that are in its custody or control or for which it is responsible. Because the Commission believes that even with the liquidation component of the clearing fund formula reduced from 25 percent to 10 percent, GSCC's clearing fund formula will give GSCC sufficient resources to protect it in a situation where a member is insolvent and fails to settle with GSCC. As such, the Commission believes GSCC's proposal is consistent with its obligation to assure the safeguarding of securities and funds that are in its custody or control or for which it is responsible.

## III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A(b)(3)(F) 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-GSCC-00-02) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44508; File No. SR-ISE-2001-17]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the International Securities Exchange LLC Relating to Permanent Approval of its Allocation Algorithm Pilot

July 3, 2001.

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 May 23, 2001, the International Securities Exchange LLC (the "Exchange" or the

<sup>9</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>10</sup> 17 CFR 200.30-3(a)(12).

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

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

"ISE") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by 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 amend Supplementary Material .01 to Rule 713 to adopt the Exchange's current allocation algorithm pilot program on a permanent basis. The Exchange's allocation algorithm pilot was approved by the Commission on May 22, 2000,<sup>3</sup> and recently was extended until August 1, 2001.<sup>4</sup> The text of the proposed rule change is available at the ISE and the Commission.

### 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 III below. The ISE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

##### 1. Purpose

ISE Rule 713 provides that, at a given price, customer orders have priority, based on the time priority of such orders. ISE Rule 713(e) provides that if there are two or more non-customer orders or market maker quotations at the Exchange's inside market, after filling all customers at that price, executions will be allocated between the non-customer orders and market maker quotations "pursuant to an allocation procedure to be determined by the Exchange from time to time \* \* \*." ISE Rule 713(e) also states that, if the primary market maker ("PMM") is quoting at the Exchange's inside market, it will have precedence over non-

<sup>3</sup> See Securities Exchange Act Release No. 42808 (May 22, 2000), 65 FR 34515 (May 30, 2000) ("Release No. 42808").

<sup>4</sup> See Securities Exchange Act Release No. 44340 (May 22, 2001), 66 FR 29373 (May 30, 2001) ("Release No. 44340").

customer orders and competitive market maker ("CMM") quotes for execution of orders that are up to a specified number of contracts. Supplementary Material .01 to ISE Rule 713 specifies the ISE's allocation procedure for non-customer orders and market maker quotations and defines the size of orders for which the PMM has priority to be those of five contracts or fewer.

The allocation procedure is a trading algorithm programmed in the ISE's electronic auction market system (the "System") that determines how to split the execution of incoming orders among professional trading interests at the same price. All public customer orders at a given price are always executed fully before the trading algorithm is applied. Moreover, because the algorithm is applied automatically by the System upon the receipt of an executable order, only those non-customer orders and market maker quotes that are in the System participate in the algorithm. Thus, there is no opportunity for a market participant to receive an allocation unless it had an order or quote in the System at the execution price at the time the incoming order was received by the System.

Subject to the PMM's participation rights discussed below, allocation of executions to non-customer orders and market maker quotes is based on the size associated with the order or quote relative to the total size available at the execution price. According to the Exchange, because PMMs have unique obligations to the ISE market,<sup>5</sup> they are provided with certain participation rights. If the PMM is one of the participants with a quote at the best price,<sup>6</sup> it has participation rights equal to the greater of (1) the proportion of the total size at the best price represented

<sup>5</sup> For example, PMMs are responsible for ensuring that all ISE disseminated quotations are for at least 10 contracts, addressing customer orders that cannot be automatically executed when another market is disseminating a better quotation, and opening the market. See ISE Rule 803(c).

<sup>6</sup> The participation rights are programmed into the trading algorithm, so that they are applied automatically by the System when splitting executions among non-customer orders and market maker quotes after public customer orders at the same price are fully executed as described above. Consequently, like any other market participant, the PMM cannot receive any portion of an allocation, regardless of its participation rights, unless it is quoting at the best price at the time the executable order is received by the System. Moreover, the size associated with the PMMs quote must be sufficient to fill the portion of the order that would be allocated to it according to the participation rights, but the size of its quote is only 20 contracts, the PMM would receive an allocation of only 20 contracts. If the size associated with a PMM's quote is only three contracts when an executable order for five contracts is received (assuming there are no public customer orders), the PMM would execute only three contracts.

by the size of its quote, or (2) 60 percent of the contracts to be allocated if there is only one other non-customer order or market maker quotation at the best price, 40 percent if there are two other non-customer orders and/or market maker quotes at the best price, and 30 percent if there are more than two other non-customer orders and/or market maker quotes at the best price.<sup>7</sup> This allocation procedure has been approved by the Commission on a permanent basis, and the Exchange is not proposing any changes to the procedure at this time.<sup>8</sup>

In addition, to the above preference, the allocation procedure provides that the PMM has precedence to execute orders of five contracts or fewer. This means that such orders will be executed first by the primary market maker if it is quoting at the best price. This aspect of the allocation procedure was approved by the Commission on a one-year pilot basis.<sup>9</sup> In its temporary approval of this PMM preference, the Commission stated its intent to monitor the rule's impact on competition during the pilot period and the ISE agreed to provide four types of specific confidential data to the Commission on a quarterly basis. The Commission stated that these statistics would enable it to adequately assess the operation of the small-order preference and determine the merit of the competitive issues raised by commenters at the time the pilot was adopted. The ISE also committed to lowering the size of the orders to which the PMM is given a preference if the execution of orders for five contracts or fewer by PMMs exceeded 40 percent of total exchange volume (excluding volume from the execution facilitation orders).

During the pilot period, the Exchange has provided the statistics required under the pilot and has carefully monitored the percentage of total ISE volume resulting from execution of orders of five contracts or fewer by the

<sup>7</sup> According to the participation rights, a PMM quoting at the inside market generally is allocated the plurality of an order. For example, if both a PMM and CMM are quoting at the inside market for 50 contracts each, an incoming order for 10 contracts will be allocated between the two for six and four contracts respectively (a 60% allocation to the PMM). If the PMM is quoting for 50 contracts and there are two CMMs each quoting for 50 contracts, the PMM is allocated four contracts and the two CMMs are allocated three each (40 percent for the PMM, and the remaining 60 percent split equally between the CMMs because they are quoting an equal size). At a minimum, a PMM will be allocated 30 percent of an order, regardless of the number of other quotes or orders at that price.

<sup>8</sup> See Release No. 42808, *supra* note 3.

<sup>9</sup> *Id.* The pilot has been extended to August 1, 2001 while the Commission considers this proposed rule change requesting permanent approval. See Release No. 44340, *supra* note 4.

PMMs. The Exchange notes that the 40% threshold was not reached during the pilot program, and in fact, that the total percentage was substantially lower than 40%. Moreover, the statistics indicated that the five contract precedence for PMMs did not result in reduced incentives for other market makers to quote aggressively. Large percentages of orders of five contracts or fewer were executed by participants other than the PMM, and large percentages of all the volume on the Exchange were executed by participants other than the PMM. Overall, the Exchange believes the confidential statistics showed that there is very active quote competition on the ISE for all orders, both large and small.

Going forward, the Exchange believes that the small order participation right for PMMs will not necessarily result in a significant portion of the Exchange's volume being executed by the PMM. As stated above, the PMM executed against such orders only if it is quoting at the best price, and only for the number of contracts associated with its quotation. Nevertheless, on a semi-annual basis, the Exchange will continue to evaluate what percentage of the volume executed on the Exchange is comprised of orders for five contracts or fewer executed by primary market makers, and will reduce the size of the orders included in this provision if such percentage is over 40 percent.

The small order participation rights for PMMs described above is part of the ISE's careful balancing of the rewards and obligations that pertain to each of the Exchange's classes of memberships. This balancing is part of the overall market structure that is designed to encourage vigorous price competition between market makers on the Exchange, as well as maximize the benefits of price competition resulting from the entry of customer and non-customer orders, while encouraging participants to provide market depth.<sup>10</sup>

The ISE is the first exchange in the United States to attempt to combine all of the elements of an auction market in an electronic environment. The Exchange believes the proposed trading algorithm, which includes participation rights for PMMs only when they are quoting at the best price, strikes the appropriate balance within its market and maximizes the benefits of an electronic auction market for all participants. The ISE's experience to

<sup>10</sup> The other options exchanges also have participation rights for their specialists, designated primary market makers and lead market makers. See Amex Rules 950(d) and 126(e); CBOE Rule 8.80(c)(7); PCX Rule 6.82(d)(2); and Phlx Rule 1014(g).

date has been consistent with this belief and the Exchange has provided the Commission with execution data to this effect. Accordingly, the Exchange requests that the Commission now approve the pilot on a permanent basis.

## 2. Statutory Basis

The ISE believes that the proposed rule change is consistent with the provisions of Section 6(b)(5) of the Act,<sup>11</sup> which requires that an exchange have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

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

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

Written comments on the proposed rule change were neither solicited nor received.

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

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

(A) By order approve the proposed rule change, as amended, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions

should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such 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-2001-17 and should be submitted by August 1, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44505; File No. SR-Phlx-2001-54]

### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. To Eliminate the Requirement That the Three Core Members of the Equity and Options Allocation, Evaluation, and Securities Committees Who Conduct a Public Securities Business Be the Same People for Both Committees**

July 3, 2001.

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 May 16, 2001, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

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

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

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

The Phlx proposes to amend Phlx rule 500(a)(iii), Equity Allocation, Evaluation and Securities Committee and Options Allocation, Evaluation and Securities Committee (the "Committee" or "Committees"), which establishes the composition of the Committees, to eliminate the requirement that the three core members of the Committees who conduct a public securities business be the same people for both Committees.<sup>3</sup> The following is the text of the proposed rule change. Proposed additions are *italicized* and proposed deletions are in brackets.

\* \* \* \* \*

Rule 500. Equity Allocation, Evaluation and Securities Committee and Options Allocation, Evaluation and Securities Committee.

The Equity Allocation, Evaluation and Securities Committee and the Options Allocation, Evaluation and Securities Committee, respectively, shall administer Rules 500 through 599, where applicable, and unless indicated otherwise, these rules shall apply to both option and equity specialist evaluations and allocations. For the purpose of Rules 500 through 599, the term "Committee" shall mean either the Equity Allocation, Evaluation and Securities Committee or the Options Allocation, Evaluation and Securities Committee, where applicable.

(a) Composition.

(i) The core members of the Equity Allocation, Evaluation and Securities Committee shall be three persons who conduct a public securities business, and two persons who are active on the equity trading floor as a specialist or floor broker. The annual members of the Equity Allocation, Evaluation and Securities Committee shall be two persons who are active on the equity trading floor as a specialist or floor broker, one public Governor and one non-industry Governor.

(ii) The core members of the Options Allocation, Evaluation and Securities Committee shall be three persons who conduct a public securities business, one person who is active on the options trading floor as a floor broker, and one person who is active on the options trading floor as a specialist, registered options trader, or floor broker. The

<sup>3</sup> On July 5, 2000, the Commission approved a proposed rule change, which divided the Phlx Allocation, Evaluation and Securities Committee into two separate committees, one for equities and one for options. See Securities Exchange Act Release No. 43011 (July 5, 2000), 65 FR 34521 (May 30, 2000).

<sup>11</sup> 15 U.S.C. 78f(b)(5).