

### 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 CHX consents, the Commission will:

(A) By order approve the proposed rule change, 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 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 at the Commission's Public Reference Room. Copies of such filings will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CHX-2002-06 and should be submitted by April 12, 2002.

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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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45584; File No. SR-CHX-2002-05]

#### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Requesting Permanent Approval of Pilot Rules Relating to the Securities Industry Transition to Decimal Pricing

March 18, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 1, 2002, the Chicago Stock Exchange, Incorporated ("CHX" 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 CHX. 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 requests permanent approval of pilot rule changes amending certain CHX rules that were impacted by the securities industry transition to a decimal pricing environment, including the Exchange's crossing rule. The two pilots containing these rule changes are due to expire on April 15, 2002. The text of the proposed rule change is available at the Commission and at the CHX.

#### 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 CHX included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received regarding the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CHX 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

The Exchange requests permanent approval of pilot rule changes amending certain CHX rules that were impacted by the securities industry transition to a decimal pricing environment, including the Exchange's crossing rule. The two pilots containing these rule changes are due to expire on April 15, 2002. The CHX is not proposing any substantive changes to the pilots.

On August 24, 2000, the Commission approved, on a pilot basis through February 28, 2001, changes proposed by the Exchange to amend certain CHX rules that would be impacted by the securities industry transition to a decimal pricing environment.<sup>3</sup> By a series of subsequent submissions, each pilot was extended to April 15, 2002.<sup>4</sup> The Exchange now requests permanent approval of the current pilots, effective as of April 15, 2002.

*The Omnibus Decimal Pilot:* The Omnibus Decimal Pilot for which the Exchange seeks permanent approval amended certain provisions of Article XX, Rule 37 of the Exchange's rules, which were impacted by the securities industry transition to a decimal pricing environment. Specifically, the Exchange proposes permanent approval of changes to Article XX, Rule 37 which (1) Allow specialists to elect, on an issue by issue basis, to either manually

<sup>3</sup> These changes were proposed in two separate CHX submissions, the second of which dealt solely with decimal-related changes to the Exchange's crossing rule, Article XX, Rule 23, *See* Securities Exchange Act Release No. 43204 (August 24, 2000), 64 FR 53065 (August 31, 2000) (SR-CHX-00-22) (approving changes to various CHX rules on a pilot basis ("Omnibus Decimal Pilot")); *see also* Securities Exchange Act Release No. 43203 (August 24, 2000), 65 FR 53067 (August 31, 2000) (SR-CHX-00-13) approving changes to the CHX crossing rule on a pilot basis ("Crossing Rule Decimal Pilot").

<sup>4</sup> *See* Securities Exchange Act Release No. 42964 (February 16, 2000) 66 FR 11621 (February 26, 2001) (File No. SR-CHX-2001-03) (extending Omnibus Decimal Pilot through July 9, 2001); 44488 (June 28, 2001), 66 FR 35684 (July 6, 2001) (SR-CHX-2001-13) (extending Omnibus Decimal Pilot through November 5, 2001); 45059 (November 15, 2001), 66 FR 58453 (November 21, 2001) (SR-CHX-2001-20) (extending Omnibus Decimal Pilot through January 14, 2002), and 45481 (February 27, 2002), 67 FR 10244 (March 6, 2002) (SR-CHX-2002-01) (extending Omnibus Decimal Pilot through April 15, 2002; *see also*, Securities Exchange Act Release Nos. 44000 (February 23, 2001) (66 FR 13361 (March 5, 2001) (extending Crossing Rule Decimal Pilot through July 9, 2001), 45010 (November 1, 2001), 66 FR 56585 (November 8, 2001) (SR-CHX-2001-22) (extending Crossing Rule Decimal Pilot through January 14, 2002), and 45482 (February 27, 2002), 67 FR 10243 (March 6, 2002) (SR-CHX-2002-03) (extending Crossing Rule Decimal Pilot through April 15, 2002).

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

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

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

or automatically execute limit orders when a trade-through occurs in the primary market; (2) remove the "pending auto-stop" functionality from the Exchange's systems; and (3) allow a specialist, on an issue by issue basis, to establish an auto execution guarantee that is not dependent on the ITS Best Bid or Offer ("ITS BBO") or National Best Bid or Offer ("NBBO") size. The Exchange believes that decimal pricing is likely to continue to affect the CHX trading environment, and the interaction between the CHX and the national market system, in a manner that necessitates permanent approval of these pilot rule changes, which are designed to minimize the adverse impact of decimalization on trading operations.<sup>5</sup>

*Manual or Automatic Execution of Limit Orders When a Trade-Through Occurs.* The Exchange proposes to amend permanently Article XX, Rule 37(b)(6) to allow a specialist to elect, on an issue by issue basis, to either manually or automatically execute limit orders when a trade-through occurs in the primary market. The pre-pilot version of the rule provided that agency limit orders (that were not marketable when entered into the Exchange's MAX automatic execution system) would automatically be filled at the limit price when there was a price penetration of the limit price in the primary market for the subject security. Under the pilot rule, automatic execution of such limit orders is no longer mandated. A CHX specialist may elect to provide for automatic execution of agency limit orders at the limit price when there is a price penetration of the limit price in the primary market for the subject security or securities. The obligation to fill the order at the limit price remains the same under either election. The Exchange believes that this pilot rule reasonably addresses the impact that the decimal pricing environment has had on the national market system, where the number of small orders executed at multiple price levels has increased the number of inadvertent trade throughs that would otherwise lead to unwarranted automated executions of large orders in a CHX specialist's limit order book, exposing the specialist to

substantially increased liability in the decimal pricing environment.

*Removal of the Pending Auto-Stop Functionality.* For similar reasons, the Exchange proposes to amend permanently Article XX, Rule 37(b)(10) to eliminate the Exchange's "pending auto-stop" function. Under the pre-pilot rule, all agency market orders from 100 to 599 shares that were not automatically executed, because, among other things, the order size exceeded the quantity at the ITS BBO, were designated as "pending auto-stop orders." Such orders were stopped, and due an execution at the ITS BBO thirty seconds after entry into the Exchange's MAX system, unless the order had been canceled, executed, manually stopped, or put on hold during such thirty second period. Once an order was stopped, a text message to that effect was automatically sent to the order-sending firm.

The Exchange believes that this feature is not practicable in the decimal pricing environment, given the dramatic increases in quote traffic and the systems issues associated with generating administrative notifications regarding pending auto-stop. Additionally, quoting in decimals has significantly increased stock price points and, as a result, decreased the quantities associated with the ITS BBO price point and increased the rate of change in the ITS BBO price point. Both of these factors reduce a specialist's ability to offset the pending auto-stop guarantee. Under these circumstances, the Exchange believes it would be imprudent to continue to provide such a guarantee.

*Changes Relating to Relationship Between Automatic Execution Guarantee and BBO Size.* The rationale set forth above relating to the decrease in the quantities associated with the BBO price point also supports permanent approval of the Exchange's pilot rule change permitting CHX specialists to designate automatic execution guarantee levels that are not dependent on the BBO. Under the pre-pilot version of the CHX rule,<sup>6</sup> an order was not eligible for automatic execution on the Exchange if the order was larger than the then-current BBO size. Given the post-decimalization decreased quantities at each price point, the pre-pilot version of the rule would effect a corresponding decrease in the number of orders eligible for automatic execution on the Exchange. To accommodate customer demand for automatic execution, the Exchange believes that permanent approval of the

pilot rule is necessary. The pilot rule permits a CHX specialist to designate, on an issue-by-issue basis, automatic execution guarantees that exceed the BBO size. Such an election is strictly voluntary and thus does not operate to increase the exposure of any specialist who desires to maintain the protections of the existing rule.

*The Crossing Rule Decimal Pilot: The Exchange also proposes permanent approval of the pilot rule change to Article XX, Rule 23 of the Exchange's rules, which governs participation in crossing transactions in Nasdaq/NM securities effected on the floor of the Exchange Crossing transactions represent a significant component of Exchange volume. Under the pre-pilot rule, if a floor broker presents a crossing transaction, another member was able to participate, or "break up," the transaction, by offering (after presentation of the proposed crossing transaction) to better one side of the transaction by the minimum price variation. The floor broker was then effectively prevented from consummating the transaction as a "clean cross," which often operated to the detriment of the floor broker's customer(s).<sup>7</sup> In instances where the minimum price variation is relatively small, it is very inexpensive for a member to break up crossing transactions in this manner.*

Given the post-decimalization transition to a minimum price variation of only \$.01, the floor broker community, and other CHX members, remain concerned that much of the crossing business (and corresponding Exchange volume) will evaporate if the pilot rule is not amended on a permanent basis to preclude breaking up crossing transactions in the manner described above.

Under the pilot rule (which was developed by the Exchange's Decimalization Subcommittee and Floor Broker Tech Subcommittee to strike a balance of interests of those members who are impacted by crossing transactions), a floor broker is permitted to consummate crossing transactions without interference by any specialist or market maker if, prior to presenting the cross transaction, the floor broker first requests a quote for the subject

<sup>7</sup> According to the Exchange, some institutional customers prefer executing large crossing transactions at a single price and are willing to forego the opportunity to achieve the piecemeal price improvement that might result from the breakup of the cross transaction by another Exchange member. Of course, the floor broker will still retain the ability to present both sides of the order at the post if the customers so desire.

<sup>5</sup> This submission does not concern "typographical" amendments to CHX rules, where the sole change that was proposed by the Exchange was the substitution of a decimal price increment for the fractional price increment set forth in certain CHX rules. The proposed "typographical" amendments were the subject of a separate submission previously approved by the Commission on a permanent basis. See Securities Exchange Act Release No. 43256 (September 6, 2000), 65 FR 55659 (September 14, 2000) (SR-CHX-00-25).

<sup>6</sup> Art. XX, Rule 37(b)(11).

security.<sup>8</sup> These requests will place the specialist and other market makers on notice that the floor broker is intending to “cross” within the bid-offer spread. This arrangement is intended to ensure that a specialist or market maker retains the opportunity to better the cross price by updating their quote, but will preclude them from breaking up a cross transaction after the cross transaction is presented.

## 2. Statutory Basis

The CHX believes the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of section 6(b).<sup>9</sup> The CHX believes the proposal is consistent with section 6(b)(5) of the Act<sup>10</sup> in that it is designed to promote just and equitable principles of trade, to remove impediments to, and to 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 Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

No written comments were either solicited or 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 CHX consents, the Commission will:

(A) by order approve the proposed rule change; 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 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 CHX. All submissions should refer to File No. SR-CHX-2002-05 and should be submitted by April 12, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-45568; File No. SR-ISE-2001-32]

### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the International Securities Exchange LLC To Increase the Minimum Quote Size for Certain Option Classes**

March 15, 2002.

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 November 16, 2001, the International Securities Exchange LLC (“ISE” 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 ISE amended its proposal on February 13, 2002<sup>3</sup> and on March 13,

2002.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The ISE proposes to adopt a three-month pilot program establishing greater size requirements for certain quotations in specified options. The text of the proposed rule change is available at the ISE and at 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, as amended, 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 such statements.

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

##### 1. Purpose

Currently, ISE market makers must establish and maintain quotations that are firm for at least 10 contracts for customers and 1 contract for non-customers. The ISE now wishes to adopt a three-month pilot program in which ISE market makers would be required to establish and maintain quotations of a larger minimum size in a limited number of option classes. Specifically, the details of the three-month pilot program are as follows:

- The pilot would apply to the following options:<sup>5</sup> Nasdaq 100 Trust; Sun Microsystems; EMC Corp.; Qualcomm; Wells Fargo & Co.; Oracle; Lucent; Juniper Networks; Intel; AOL

February 12, 2002 (“Amendment No. 1”). In Amendment No. 1, the ISE proposes to replace the original rule filing in its entirety and specifies the options to be included in the pilot program rather than allowing Primary Market Makers (“PMMs”) to choose the options to be included in the pilot.

<sup>4</sup> See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division, Commission, dated March 12, 2002 (“Amendment No. 2”). In Amendment No. 2, the ISE proposes to clarify that, in the pilot program, new enhanced size levels would apply to customer and broker-dealer orders, but not to the orders of market makers on either the ISE or other exchanges.

<sup>5</sup> For the purpose of the three-month pilot program, an “option” refers to all put and call options on the same underlying security.

<sup>8</sup> These updated quotes are not directed solely to the floor broker. Anyone at the post may respond to the updated quotes.

<sup>9</sup> 15 U.S.C. 78f(b).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

<sup>11</sup> 17 CFR 200.30-3(a)(912).

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

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

<sup>3</sup> See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated