

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50562; SR-BSE-2004-14; SR-CBOE-2004-41; SR-ISE-2004-01; SR-PCX-2004-84; SR-Phlx-2004-16)

October 19, 2004

Self-Regulatory Organizations; Order Approving a Proposed Rule Change and Amendment No. 1 by the Boston Stock Exchange, Inc.; a Proposed Rule Change by the Chicago Board Options Exchange, Inc.; a Proposed Rule Change and Amendments No. 1 and 2 by the International Securities Exchange, Inc.; a Proposed Rule Change by the Pacific Exchange, Inc.; and a Proposed Rule Change and Amendment No. 1 by the Philadelphia Stock Exchange, Inc. Relating to Minimum Size Guarantees for Linkage Orders

I. Introduction

On January 13, 2004, February 13, 2004, April 6, 2004, July 7, 2004, and September 1, 2004, the International Securities Exchange, Inc. (“ISE”), the Philadelphia Stock Exchange, Inc. (“Phlx”), the Boston Stock Exchange, Inc. (“BSE”), the Chicago Board Options Exchange, Inc. (“CBOE”), and the Pacific Exchange, Inc. (“PCX”) (collectively, the “options exchanges”), respectively, filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² proposed rule changes to modify the definitions of Firm Customer Quote Size (“FCQS”) and Firm Principal Quote Size (“FPQS”) contained in their Exchange rules by changing certain minimum size guarantees for Linkage Orders to accommodate the “natural size” of quotations.³

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The options exchanges have also filed an amendment to the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage (“Linkage Plan”) that corresponds to the proposed rule changes, described herein. (“Joint Amendment No. 13”). See Securities Exchange Act Release No. 50211 (August 18, 2004), 69 FR 52050 (August 26, 2004) (File No. 4-429).

BSE submitted BSE Amendment No. 1 to its proposed rule change on June 9, 2004.⁴ ISE submitted ISE Amendment No. 1 to its proposed rule change on May 10, 2004,⁵ and ISE Amendment No. 2 to its proposed rule change on July 30, 2004.⁶ Phlx submitted Phlx Amendment No. 1 to its proposed rule change on August 11, 2004.⁷

Notice of BSE's proposed rule change, as amended, was published in the Federal Register on September 16, 2004.⁸ Notice of CBOE's proposed rule change was published in the Federal Register on September 16, 2004.⁹ Notice of ISE's proposed rule

⁴ See Letter from John Boese, BSE, to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated June 8, 2004 ("BSE Amendment No. 1"). In BSE Amendment No. 1, the BSE amended the proposed rule text to clarify that the general requirement that the BSE's FCQS and FPQS be at least 10 contracts would not apply if the BSE were disseminating a quotation of fewer than 10 contracts. In that case, the BSE explained that it may establish a FCQS or FPQS equal to its disseminated size.

⁵ See Letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division, Commission, dated May 7, 2004 ("ISE Amendment No. 1"). In ISE Amendment No. 1, the ISE amended the proposed rule text to clarify that the general requirement that the ISE's FCQS and FPQS be at least 10 contracts would not apply if the ISE were disseminating a quotation of fewer than 10 contracts. In that case, the ISE explained that it may establish a FCQS or FPQS equal to its disseminated size.

⁶ See Letter from Michael J. Simon, Senior Vice President and General Counsel, ISE, to Nancy Sanow, Assistant Director, Division, Commission, dated July 28, 2004 ("ISE Amendment No. 2"). In ISE Amendment No. 2, the ISE submitted a new Form 19b-4, which replaced and superseded the original filing in its entirety.

⁷ See Letter from Richard S. Rudolph, Director and Counsel, Phlx, to Deborah Lassman Flynn, Assistant Director, Division, Commission, dated August 10, 2004 ("Phlx Amendment No. 1"). In Phlx Amendment No. 1, the Phlx amended the proposed rule text to clarify that the general requirement that the Phlx's FCQS and FPQS be at least 10 contracts would not apply if the Phlx were disseminating a quotation of fewer than 10 contracts. In that case, the Phlx explained that it may establish a FCQS or FPQS equal to its disseminated size.

⁸ Securities Exchange Act Release No. 50341 (September 9, 2004), 69 FR 55850 (September 16, 2004) (SR-BSE-2004-14).

⁹ Securities Exchange Act Release No. 50340 (September 9, 2004), 69 FR 55852 (September 16, 2004) (SR-CBOE-2004-41).

change, as amended, was published in the Federal Register on September 16, 2004.¹⁰ Notice of PCX's proposed rule change was published in the Federal Register on September 16, 2004.¹¹ Notice of Phlx's proposed rule change, as amended, was published in the Federal Register on September 16, 2004.¹² No comments were received on the proposed rule changes. This order approves the proposed rule changes, as amended.¹³

II. Description of the Proposals

The purpose of the proposed rule changes is to amend the definitions of FCQS and FPQS provided in each of the options exchange's rules¹⁴ to conform them to the definitions provided in the Linkage Plan, as amended by Joint Amendment No. 13.¹⁵

¹⁰ Securities Exchange Act Release No. 50339 (September 9, 2004), 69 FR 55853 (September 16, 2004) (SR-ISE-2004-01).

¹¹ Securities Exchange Act Release No. 50346 (September 10, 2004), 69 FR 55857 (September 16, 2004) (SR-PCX-2004-84).

¹² Securities Exchange Act Release No. 50342 (September 9, 2004), 69 FR 55864 (September 16, 2004) (SR-Phlx-2004-16).

¹³ The Commission notes that the American Stock Exchange LLC ("Amex"), filed a comparable proposed rule change with the Commission on August 3, 2004, and Amendment No. 1 thereto on September 10, 2004. Notice of Amex's proposed rule change, as amended, was published in the Federal Register on September 23, 2004. See Securities Exchange Act Release No. 50394 (September 16, 2004), 69 FR 57110 (SR-Amex-2004-63). Section 19(b)(2) of the Act provides that the Commission may not approve any proposed rule change prior to the thirtieth day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission has determined to wait until the requisite thirty days has passed before acting on the Amex's filing.

¹⁴ See Chapter XII, Sections 1(g) & (h) of the Rules of the BSE's Boston Options Exchange Facility; CBOE Rules 6.80(9) & (10); ISE Rules 1900(7) & (8); PCX Rules 6.92(a)(9) & (10); and Phlx Rules 1083(g) & (h).

¹⁵ See Notice of Joint Amendment No. 13 supra note 3.

While the proposed rule changes would maintain a general requirement, in each of the options exchange's rules, that the FCQS and FPQS be at least 10 contracts, that requirement would not apply if, pursuant to its rules, an options exchange were disseminating a quotation of fewer than 10 contracts. In that case, the options exchange could establish a FCQS or FPQS equal to its disseminated size, or "natural size."

Under the proposed rule changes, as with Linkage orders today, if an order is of a size eligible for automatic execution, the receiving options exchange must provide an automatic execution of the Linkage order. If this is not the case (for example, the receiving options exchange's automatic execution system is not engaged), the receiving exchange may allow the order to drop to manual handling. However, the receiving options exchange still must provide a manual execution for at least the FCQS or FPQS, as appropriate (in this case, the size of its disseminated quotation of less than 10 contracts).

III. Discussion

After careful review, the Commission finds that the proposed rule changes, as amended, are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁶ In particular, the Commission finds that the proposals, as amended, are consistent with the provisions of Section 6(b)(5) of the Act,¹⁷ which requires, among other things, that a national securities exchange's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and to perfect the

¹⁶ In approving these proposals, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁷ 15 U.S.C. 78f(b)(5).

mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.

The Commission notes that the options exchanges adopted the current definitions of FCQS and FPQS, which impose a "10-up" requirement, at a time when all the options exchanges had rules requiring that their minimum quotation size be for at least 10 contracts. Consequently, an exchange receiving a customer limit order for fewer than 10 contracts would disseminate the price of the customer limit order with a size of 10 contracts and the specialist or the trading crowd would be responsible to make up the difference. Since implementation of the Linkage Plan, several of the options exchanges have modified their rules to permit them to disseminate the "natural size" of customer limit orders that are of a size of less than 10 contracts.¹⁸ The Commission believes that approval of the proposed rule changes, which will permit options exchanges to conform their Linkage rules to other Exchange rules allowing them to disseminate a customer limit order's "natural size," should provide greater transparency to investors and the marketplace and better reflect the true state of liquidity in the marketplace.

¹⁸ See Securities Exchange Act Release Nos. 46325 (August 8, 2002), 67 FR 53376 (August 15, 2002) (SR-Phlx-2002-15); 46029 (June 4, 2002), 67 FR 40363 (June 12, 2002) (SR-PCX-2002-30); 45067 (November 16, 2001), 66 FR 58766 (November 23, 2001) (SR-CBOE-2001-56); 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003) (SR-CBOE-2002-05); and 48957 (December 18, 2003), 68 FR 75294 (December 30, 2003) (SR-Amex-2003-24).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁹ that the proposed rule changes (SR-BSE-2004-14; SR-CBOE-2004-41; SR-ISE-2004-01; SR-PCX-2004-84; SR-Phlx-2004-16), as amended, are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁰

Margaret H. McFarland
Deputy Secretary

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ 17 CFR 200.30-3(a)(12).