

MEMO# 12541

August 29, 2000

SEC APPROVES JOINT OPTIONS INTERMARKET LINKAGE PLAN

[12541] August 29, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 46-00 RE: SEC APPROVES JOINT OPTIONS INTERMARKET LINKAGE PLAN The Securities and Exchange Commission has issued an order authorizing the American Stock Exchange, the Chicago Board Options Exchange, and the International Securities Exchange to act jointly to implement an intermarket linkage plan (the "Amex/CBOE/ISE plan").¹ The Amex/CBOE/ISE plan was originally filed by the three exchanges pursuant to an SEC order, which directed all the options exchanges to file a national market system plan that would link the options markets.² The most significant aspects of the Amex/CBOE/ISE plan are summarized below. Price/Time Priority. The Amex/CBOE/ISE plan does not provide for price/time priority and instead allows the exchange initially receiving an order to step up to match the better price being disseminated by another market. The Release states that the SEC believes that given many of the concerns expressed by market participants regarding price/time priority and the uncertainty of how impending changes to the structure of the securities markets, particularly the implementation of decimalization, will impact the options markets, it is not practicable at this time to require a price/time priority rule in the options markets. Access to the Linkage. The Amex/CBOE/ISE plan provides access to the linkage to eligible market makers on behalf of customer orders and to market makers and specialists on behalf of their principal accounts. Non-market maker broker-dealers, however, would not have access to the linkage. The Release states that by limiting who has access to the linkage, the Amex/CBOE/ISE plan reasonably attempts to address the concern that allowing broader access to the linkage could dilute the value of exchange memberships. The Amex/CBOE/ISE plan also limits eligible market maker access to the linkage for sending principal orders to less than twenty percent of each market maker's total volume. A market maker effecting more than twenty percent of its volume in a calendar quarter through the linkage would be prohibited from sending principal orders through the linkage in the subsequent quarter. 1 Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) ("Release"). 2 The Pacific Exchange ("PCX") and the Philadelphia Stock Exchange ("Phlx") filed separate proposals with the SEC for alternative linkage plans. Although the three plans were identical with respect to a majority of the issues pertaining to a linkage, the exchanges were unable to reach agreement on whether the linkage should require that orders be routed to exchanges based on price/time priority, who should have access to the linkage, and the appropriate remedy owed when a trade-through occurs. 2Trade-Through Provisions. The Amex/CBOE/ISE plan provides that exchange members should, absent reasonable justification and during normal market conditions, avoid initiating trade-throughs, subject to certain exceptions. The plan, however, does not flatly prohibit trade-throughs and does not provide a remedy to the quotes or orders traded through unless the aggrieved party complains. The Release states that the SEC recognizes that the plan may

not eliminate trade-throughs in all instances but believes that the plan is beneficial nevertheless because it provides an efficient means, and some incentive, for exchanges to avoid trade-throughs. Governance and Voting Requirements. The Amex/CBOE/ISE plan will be administered by an Operating Committee, composed of one representative of each participating exchange, which will have discretion to develop and implement the linkage, and advise participants regarding deficiencies, problems, or recommendations. The plan also will require a unanimous vote for plan amendments. Trade-or-Fade Provisions. The Amex/CBOE/ISE plan will continue to apply the exchanges' "trade-or-fade rules"³ in limited circumstances. The Release notes that several market participants expressed concern that without the repeal of trade-or-fade rules by the options exchanges, the exchanges do not have to provide firm quotes. The SEC, however, believes that although no exchange should be permitted to "back away" from its displayed quote, it recognizes there should be a mechanism that requires a market to change its quote if it refuses to trade at its published quote with an order for a size that exceeds its firm quote requirement. The SEC therefore supports the retention of the trade-or-fade rules to the extent that they prevent markets from refusing to trade at their disseminated prices and then continuing to disseminate the same quotes. Ari Burstein Assistant Counsel Attachment Attachment (in .pdf format) 3 Generally, under trade-or-fade rules, an order must be executed at the currently disseminated bid or offer, either by satisfying the full size of the order or by updating the disseminated quote to reflect that the previously disseminated quote is no longer available.