

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**In the Matter of the Petition of:**

**CHICAGO BOARD OPTIONS EXCHANGE,  
INCORPORATED**

**File No. SR-ISE-2009-35**

**REPLY IN SUPPORT OF INTERNATIONAL SECURITIES EXCHANGE, LLC'S  
MOTION TO LIFT THE COMMISSION RULE 431(e) AUTOMATIC STAY OF  
DELEGATED ACTION TRIGGERED BY CHICAGO BOARD OPTIONS  
EXCHANGE'S NOTICE OF INTENTION TO PETITION FOR REVIEW**

Pursuant to Commission Rule of Practice 154, International Securities Exchange, LLC respectfully files this Reply in support of its Motion to Lift the Commission Rule 431(e) Automatic Stay of Delegated Action Triggered by Chicago Board Options Exchange, Incorporated's Notice of Intention to Petition for Review.

**INTRODUCTION**

Following the Commission's August 28, 2009 approval of ISE's rule filing SR-ISE-2009-35 (the "Filing")<sup>1</sup>, CBOE filed a Notice of Intention to Petition for Review under Commission Rule of Practice 430(b)(1) regarding the Filing. On September 11, 2009, ISE moved pursuant to Commission Rule of Practice 154 to lift the automatic stay of Rule 431(e). On September 14, 2009, CBOE filed its Petition for Review. The Commission has not considered CBOE's Petition, and ISE will formally oppose that Petition if the Commission reviews it.

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<sup>1</sup> All capitalized and defined terms herein have the same meaning as in the Brief in Support of International Securities Exchange, LLC's Motion to Lift the Commission Rule 431(e) Automatic Stay of Delegated Action Triggered by Chicago Board Options Exchange, Incorporated's Notice of Intention to Petition for Review (the "Opening Brief").

On September 17, 2009, CBOE filed its Response to Motion of International Securities Exchange, LLC to Lift Automatic Stay (“Response Brief”). CBOE’s arguments opposing ISE’s motion to lift the stay are without merit. In particular, CBOE fails to refute ISE’s arguments that: (1) there is a strong likelihood that the Filing will be approved by the full Commission, as it was earlier approved after comprehensive proceedings before the Commission’s Division of Trading and Markets (and that CBOE cannot show (as it must) that it has a strong likelihood of success on the merits); (2) that CBOE will *not* suffer irreparable injury if the Commission lifts the stay; (3) that there will be a benefit, not harm, to other parties if the Commission lifts the stay; and (4) the stay does not serve the public interest.<sup>2</sup>

Every day the stay remains in effect, ISE is suffering substantial harm.

### ARGUMENT

**I. Rule 431(e) Expressly Provides the Commission Discretion to Lift the Automatic Stay and Does Not, as CBOE Argues, “Evidence a Policy Preference for the Commission to Review the Decision [Made Pursuant to Delegated Authority] Before It Goes Into Effect”**

Rule 431(e) is, at best for CBOE, neutral as to whether there is a preference for the Commission to stay a challenged action taken pursuant to delegated authority while the action is reviewed. That Rule (1) expressly gives the Commission discretion to lift an automatic stay, (2) does not suggest a particular duration for the stay, and (3) certainly does not indicate any “policy preference” for delaying the effect of a challenged action made pursuant to delegated authority:

*(e) Automatic stay of delegated action. An action made pursuant to delegated authority shall have immediate effect and be deemed the action of the*

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<sup>2</sup> As explained in ISE’s motion papers, the Commissioner should consider a request for a stay in light of four criteria: (A) whether the petitioner has shown a strong likelihood that he will prevail on the merits of the appeal; (B) whether the petitioner has shown that, without a stay, it will suffer irreparable injury; (C) whether there would be substantial harm to other parties if a stay were granted; and (D) whether the issuance of a stay would likely serve the public interest. Opening Brief at 2-4.

**Commission.** Upon filing with the Commission of a notice of intention to petition for review, ... *an action made pursuant to delegated authority shall be stayed until the Commission orders otherwise....*

17 C.F.R. § 201.431(e) (emphasis added). For CBOE's suggestion that "whenever the Division takes action pursuant to delegated authority and that action is challenged, the Commission's Rules of Practice evidence a policy preference for the Commission to review the decision *before* it goes into effect" (Response Brief at 2-3) to be correct, the Rule would have to provide for an automatic stay during the entirety of the review process. But Rule 431(e) states just the opposite; the Commission may lift the automatic stay at any time. To the extent Rule 431(e) evidences any "policy preference," it is a preference for involving the Commission in determining whether or not a stay is appropriate in the (historically atypical) event that an automatic stay is triggered.

**II. There Is a Strong Likelihood that CBOE's Petition for Review Will *Not* Succeed in Reversing the Commission's Action Made Pursuant to Delegated Authority**

CBOE cannot establish that there is a strong likelihood it will prevail on the merits of its Petition. Rather, CBOE simply states an unsupportable conclusion that the policy impacts of ISE's filing are "significant" and "represent potentially profound changes to market quality and customer protection." Response Brief at 3. CBOE's conclusory statements in this regard are irrelevant in determining whether to lift the stay. They are also wrong.

CBOE correctly notes that the Division, in approving the filing pursuant to delegated authority, acknowledged that ISE's filing would represent a change in certain long-held principles in the options market. CBOE fails to note, however, that the Approval Order then went to great lengths to explain why such a change is appropriate. Specifically, the Approval Order stated that QCCs "can benefit the market as a whole and contribute to the efficient

functioning of the securities and markets and the price discovery process.”<sup>3</sup> The Approval Order then explained how ISE’s proposal is carefully crafted to provide those benefits without the harm that CBOE alleges will occur.<sup>4</sup> Due to the careful and thorough analysis in the Approval Order, there is a strong likelihood that ISE will prevail on the merits.

CBOE provides no basis at all to conclude that its Petition may prevail. Rather, CBOE argues that the changes brought about by QCCs are “profound” because (1) public customers supposedly will be harmed because they will lose priority and will not receive executions of their resting orders (Response Brief at 3-4); and (2) it is the first time crosses will be permitted without an exposure period (*id.*). Neither point is true.

With regard to the first one, there is nothing novel about granting/not granting customer priority. There are numerous examples where the Commission has approved exchange rules that do not provide customer priority and there is no statutory requirement that customer orders receive priority. *See, e.g.*, Release No. 34-59287 under the Exchange Act (January 23, 2009); 74 F.R. 5694 (January 30, 2009) at 5696 (“... the customer priority rule under discussion was not a matter of public customer entitlement derived from the Act, but rather a matter of convention to accommodate public customer orders, or an auction principle applied as a matter of longstanding practice by exchanges”) (attached as Exhibit A hereto). In fact, entire options markets exist without the premise of customer priority (i.e., the price-time markets, including NYSE Arca Options, Boston Options Exchange, and Nasdaq Options Market). Options markets that do offer customer priority (CBOE, ISE, NYSE Amex Options, and Nasdaq OMX PHLX) have rules that offer exceptions to customer priority in certain situations (e.g., CBOE allows complex orders to

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<sup>3</sup> Release No. 60584 under the Securities Exchange Act of 1943 (“Exchange Act”) (August 28, 2009); 47 F.R. 45663 (September 3, 2009) (the “Approval Order”).

<sup>4</sup> *Id.*

trade ahead of customer orders on its book pursuant to CBOE Rule 6.53C (Complex Orders on the Hybrid System) (Exhibit B). Thus, if the Commission were to take a different approach to customer priority principles under the Exchange Act, it would have wide-ranging impact. The Commission should not prevent ISE from competing with CBOE should it decide to review its longstanding interpretation of the Exchange Act in this respect.

For its second point, CBOE suggests that the QCC poses a significant risk of harm to customers whose orders would be crossed without exposure. Response Brief at 4. There is no statutory requirement, however, that orders have an opportunity for price improvement – the *majority* of orders executed in the options marketplace are automatically executed *without* an opportunity for price improvement and there is nothing special about orders presented as crosses. In this respect, CBOE itself allows customer-to-customer crosses without any exposure. CBOE Rule 6.74A.09 (Exhibit C). Therefore, ISE fails to see how QCC could be in violation of the Exchange Act for the fact that it lacks an opportunity for price improvement.

Moreover, QCC concerns a narrow subset of transactions that are difficult to execute because they have a contingency that crosses the options and equities market. It does not affect all orders or all crosses, and simply is not the “profound” sea change that will broadly impact the overall market quality in the options industry that CBOE suggests. Rather, ISE anticipates that QCC will make ISE more competitive for stock-option transactions, a subset of the options industry in which CBOE currently enjoys a significant competitive advantage by virtue of floor-based trading practices that allow these types of crosses to be executed with little or no intervention on the floor.

### III. CBOE Will Not Suffer Irreparable Harm If the Commission Lifts the Stay

CBOE's response does not even attempt to allege that it will suffer irreparable harm without a stay of the Commission's action. Instead, CBOE simply states that the stay harms it in the marketplace, and then argues an irrelevant point: that *ISE* will not suffer irreparable harm if the stay remains in effect. CBOE cites no authority for the proposition that ISE must suffer irreparable harm to show that the stay should be lifted.

The central focus of CBOE's entire response is that it will be harmed in the marketplace if the Commission lifts the stay. Of course, CBOE will suffer "harm" due to competition if ISE can implement an innovative order type that allows ISE to continue to effect large stock/option combination orders. But this is not the type of harm the Commission should consider when determining a stay. See *In re Board of Trade of the City of Chicago*, File Nos. SR-Amex-81-1 & SR-CBOE-81-27, Release No. 34-18523, 1982 WL 523516, \*2-5 (March 3, 1982) (denying request for stay under Section 25(c)(2) of the Exchange Act in part because stay "would have certain anti-competitive consequences" and "would penalize the initiative" of Amex and CBOE, whose rule changes had been approved but were subject to judicial review at CBOT's insistence) (Exhibit D). With the stay in place thus far, CBOE has enjoyed a competitive windfall. ISE has effectively been forced to exit the market for these types of orders. In this regard, ISE agrees with CBOE that lifting the stay may result in it losing order flow to ISE. ISE further agrees that CBOE, and other exchanges, may have to consider competitive responses to our filing. That is the nature of competition, and ISE's attempts to compete with CBOE should be encouraged. CBOE as much as admits that it seeks the continuation of Rule 431's automatic stay simply to avoid having to compete with ISE.

Importantly, at no point does CBOE argue that any harm to it would be *irreparable*. As stated in ISE's Opening Brief, in the unlikely event the Commission ultimately decides to

reverse the earlier approval of the QCC, ISE will cease offering that order type. In the interim, CBOE will simply have to compete with a new order type that permits ISE to attract stock/option business similar to the business ISE attracted before the implementation of the new linkage plan. CBOE not only fails to counter ISE's argument that CBOE's "harm" is limited to effects of the marketplace, but effectively agrees with ISE by stating that if the Commission lifts the stay it will have to innovate to compete.

ISE will suffer harm if the stay remains in effect. As discussed in ISE's Opening Brief, under the Centralized Plan there was an exemption from the trade-through rule to permit ISE to effect large stock/option trades. That "block exemption" applied to all options trades of 500 or more contracts, and it provided the flexibility for ISE's members to effect large stock/option crosses. The distributive linkage plan<sup>5</sup> does not contain a similar exemption. Thus, without the ability to provide an alternative crossing mechanism, ISE cannot offer its members any opportunity to cross stock/option orders that are not presented as a package. Floor-based exchanges like CBOE offer alternative procedures to effect such trades on the floor. Maintaining the stay thus gives CBOE (and other exchanges that operate floors) an effective monopoly in this area, since exchanges that do not operate floors cannot otherwise compete.

With the demise of the Centralized Plan, ISE proposed the QCC as a limited alternative to the block exemption that would permit it to continue to offer members a vehicle to execute large stock/option orders. While the QCC does not provide a trade-through exemption for the options leg of the trade, it does permit the options leg to be effected in an efficient manner within the NBBO when coupled with a stock trade that relies on the Commission Qualified Contingent

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<sup>5</sup> Options Order Protection and Locked/Crossed Market Plan. See Exchange Act Release No. 60405 (July 30, 2009), 74 F.R. 39362 (August 6, 2009).

Trade (“QCT”) exception from the trade-through rule.<sup>6</sup> The Approval Order specifically states that the QCC “will allow [ISE] members to *retain* the flexibility needed to utilize the Commission’s NMS QCT Exemption for qualified stock-option transactions that are not presented as a package on an options exchange, but instead where the options and stock components are executed in separate markets.”<sup>7</sup> Thus, the Approval Order specifically recognizes that the QCC simply permits ISE to retain the ability it had under the Centralized Plan. The elimination of this flexibility under the new distributive linkage plan and implementing rules has caused, and continues to cause, ISE significant harm.<sup>8</sup>

#### IV. Lifting the Stay Will Benefit Other Parties

Lifting the stay will benefit ISE’s members, most of whom are also CBOE members, by providing an alternative and efficient method of effecting large stock/option combination orders. CBOE’s Response Brief does not address this point at all. CBOE simply argues that it will be harmed by the lifting of the stay because it “may lose significant order flow” from dual members that “may be attracted” to ISE’s market, “even though CBOE strongly believes that the QCC Rule Filing is inconsistent with the policies underlying the Exchange Act.” Response Brief at 4-5. This is a remarkable statement. Effectively, CBOE is arguing that the benefit other parties

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<sup>6</sup> See Approval Order at note 11.

<sup>7</sup> *Id.*, 74 F.R. at 45665.

<sup>8</sup> ISE’s Opening Brief cited *Instinet* as an example of the Commission lifting a Rule 431 stay. CBOE dismisses that case by arguing that because *Instinet* dealt with the continuation of a pilot program, not lifting the stay would have resulted in disruption to the market. But *Instinet* does not hold that continuing a pilot program is the sole reason why the Commission would lift an automatic stay. And, in any event, the present situation is similar to *Instinet*’s facts in an important way: ISE has already been able to offer members the ability to effect large stock/option orders in an efficient manner pursuant to the block exception, and ISE now seeks only to continue that ability through use of the QCC. The automatic stay has disrupted that continuity and causes significant harm to ISE, much as a stay of ongoing activity would have caused harm in *Instinet*.

may receive from being provided a potentially more attractive alternative execution venue for stock-option orders in competition to CBOE harms CBOE, and thus the Commission should not lift the stay.

**V. Lifting the Stay Will Serve the Public Interest**

A secondary focus of CBOE's arguments against lifting the stay is that doing so would harm the public. To the contrary, lifting the stay will serve the public interest. The crux of CBOE's claim of public harm is that customers on the limit order book would "lose priority" if a QCC is effected at the price of their orders, which appears to assume that there is some statutory right to customer priority. CBOE also appears to assume that there is an inherent right to exposure of an order prior to execution. Both of CBOE's assumptions are incorrect.

The ISE Letter submitted during the Commission's review of the Filing discussed numerous examples of customers not always having priority at a specific price. Indeed, CBOE's own rules permit it to bypass customer priority if it so chooses in any options class.<sup>9</sup> CBOE's rules also allow it to effect a cross without exposure.<sup>10</sup> Thus, without any legal basis for its claims, CBOE is reduced to arguing that the public is harmed due to the violation of some alleged amorphous (and unstated) Commission "policies."

CBOE further argues that not providing customers priority when members cross orders raises special concerns. There is no basis for that argument. There is no difference whether a customer receives priority when an order is crossed, or when a one-sided incoming order trades ahead of a customer order on the book, as long as an exchange's priority rules meet the statutory requirements. While CBOE again argues that the QCC violates "policies," the Approval Order

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<sup>9</sup> See ISE Letter at note 8.

<sup>10</sup> See CBOE Rule 6.74A.09.

specifically finds that priority and exposure aspects of the QCC do not violate any law or policy:

The Commission believes that the Exchange's proposal to establish a limited exception to priority and exposure principles is consistent with the [Exchange] Act because it is limited solely to options legs of stock-option orders that: (1) satisfy the requirements of the NMS QCT Exemption; (2) are for a size of at least 500 contracts; and (3) are executed at or better than the NBBO.<sup>11</sup>

Contrary to CBOE's argument, continuation of the stay harms the public. With ISE unable to offer a competing crossing mechanism to effect large stock/option trades, members of the public seeking an alternative to floor-based trades not presented as a package are denied the efficiencies of ISE's competitive offering. This harms the public and ISE. The only beneficiary of the stay is CBOE.

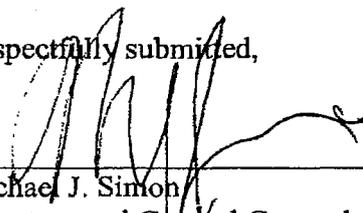
### CONCLUSION

CBOE's concern that its competitive position will be eroded if the automatic stay is lifted is an insufficient basis to continue the Rule 431(e) stay that has now been in place (to CBOE's competitive benefit; ISE's detriment) since September 4, 2009. The Commission should promptly lift the automatic stay and permit ISE to implement its approved QCC while the Commission considers the merits (or lack thereof) of CBOE's Petition. For the reasons in this reply brief, and those in ISE's Opening Brief, ISE respectfully petitions the Commission to use its authority under Rule 431(e) to lift the stay preventing ISE from implementing the QCC.

DATED: New York, New York  
September 22, 2009

Respectfully submitted,

By: \_\_\_\_\_

  
Michael J. Simon  
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<sup>11</sup> Approval Order, 74 F.R. at 45665.

**CERTIFICATE OF SERVICE**

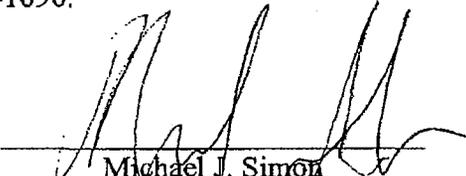
I, Michael J. Simon, counsel for International Securities Exchange, LLC, do hereby certify that on September 22, 2009 I caused to be served a true and correct copy of the

**REPLY IN SUPPORT OF INTERNATIONAL SECURITIES EXCHANGE, LLC'S  
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to be served on

**PAUL E. DENGEL**, counsel for Chicago Board Options Exchange, Incorporated, by way of facsimile telephone number (312) 258-5600 and Federal Express to Schiff Hardin LLP, 233 S. Wacker Drive, Suite 6600, Chicago, IL 60606, and

**ELIZABETH M. MURPHY**, Secretary, Securities and Exchange Commission, by way of facsimile telephone number (202) 772-9324. Contemporaneously, a non-facsimile original with a manual signature was sent by Federal Express to 100 F Street, NE, Washington, DC 20549-1090.

  
\_\_\_\_\_  
Michael J. Simon  
*International Securities Exchange, LLC*

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# **EXHIBIT A**

## Paper Comments

• Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-DTC-2008-15. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Section, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of DTC and on DTC's Web site at [http://www.dtcc.com/downloads/legal/rule\\_filings/2008/dtc/2008-15.pdf](http://www.dtcc.com/downloads/legal/rule_filings/2008/dtc/2008-15.pdf). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-DTC-2008-15 and should be submitted on or before February 20, 2009.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,<sup>12</sup> that the proposed rule change (File No. SR-DTC-2008-15) be and hereby is approved.<sup>13</sup>

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.<sup>14</sup>

Florence E. Harmon,  
Deputy Secretary.

[FR Doc. E9-1983 Filed 1-29-09; 8:45 am]

BILLING CODE 8011-01-P

<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>14</sup> 17 CFR 200.30-3(a)(12).

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-59287; File No. SR-ISE-2006-26]

**Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of the Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, Relating to Professional Account Holders**

January 23, 2009.

## I. Introduction

On May 5, 2006, the International Securities Exchange, LLC ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") a proposed rule change 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> to amend ISE rules to give certain non-broker-dealer orders, identified as "professional orders," the priority given broker-dealer orders and market maker quotes rather than the priority currently given all public customer orders and to charge the same transaction fees for professional orders as charged for the orders of broker-dealers and market makers. On January 25, 2008, the Exchange filed Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1, was published for comment in the *Federal Register* on February 7, 2008.<sup>3</sup> The Commission received ten comment letters on the proposal.<sup>4</sup> The Exchange filed Amendment No. 2 to the proposed rule change on June 17, 2008,<sup>5</sup> and submitted a response to the SIFMA

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

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

<sup>3</sup> See Securities Exchange Act Release No. 57254 (February 1, 2008), 73 FR 7345 (February 7, 2008) ("Notice").

<sup>4</sup> See letters from Abe Lampert, dated May 25, 2006 ("Lampert Letter"); Charles B. Cox III, dated May 26, 2006 ("Cox Letter I"); B. Thomas Rule, dated May 28, 2006 ("Rule Letter"); Bryan Weisberg, dated May 31, 2006 ("Weisberg Letter"); Andrea Schneider, dated June 18, 2006 ("A. Schneider Letter"); Gerald Schneider, dated February 6, 2008 ("G. Schneider Letter"); Andrew Carr, dated March 4, 2008 ("Carr Letter"); Charles B. Cox III, dated March 4, 2008 ("Cox Letter II"); Charles B. Cox III, dated April 16, 2008 ("Cox Letter III"); and Securities Industry and Financial Markets Association ("SIFMA"), dated July 23, 2008 ("SIFMA Letter").

<sup>5</sup> In Amendment No. 2, ISE deleted proposed changes to ISE Rules 715 and 723 (d)(2). These revisions clarify that the proposed rule change would not limit a Public Customer's access to the Exchange's Price Improvement Mechanism ("PIM"). See *infra* note 75.

Letter on January 12, 2009.<sup>6</sup> This order provides notice of Amendment No. 2 and approves the proposal, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

## II. Description of ISE's Proposal

Currently, ISE grants certain advantages to Public Customer Orders<sup>7</sup> over Non-Customer Orders.<sup>8</sup> In particular, Public Customer Orders receive priority over Non-Customer Orders and market maker quotes at the same price. In addition, subject to certain exceptions, Public Customer Orders do not incur transaction charges.<sup>9</sup> The ISE states that the purpose, generally, of providing these marketplace advantages to Public Customer Orders is to attract retail investor order flow to the Exchange by leveling the playing field for retail investors over market professionals and providing competitive pricing.<sup>10</sup> According to the Exchange, market professionals have access to sophisticated trading systems that contain functionality not available to a retail customer, including things such as continuously updated pricing models based upon real-time streaming data, access to multiple markets simultaneously, and order and risk management tools.<sup>11</sup>

With respect to the marketplace advantages of priority in trading and waiver of fees, the Exchange does not believe at this time that the definitions of Public Customer and Non-Customer properly distinguish between the kind of non-professional retail investors for whom these advantages were intended and certain professionals. The Exchange believes that distinguishing solely between registered broker-dealers and non-broker-dealers with respect to these

<sup>6</sup> See letter from Michael J. Simon, Secretary, ISE, to Florence Harmon, Acting Secretary, Commission, dated January 12, 2009 ("ISE Response Letter").

<sup>7</sup> A "Public Customer" is defined in ISE's rules as "a person that is not a broker or dealer in securities." A "Public Customer Order" is defined as "an order for the account of a Public Customer." ISE Rules 100(a)(38) and (39).

<sup>8</sup> A "Non-Customer" is defined in ISE's rules as "a person or entity that is a broker or dealer in securities." A "Non-Customer Order" is defined as "any order that is not a Public Customer Order." ISE Rules 100(a)(27) and (28).

<sup>9</sup> For example, Public Customer Orders currently incur fees for certain transactions in "Premium Products" (defined in the ISE Schedule of Fees) and Complex Orders that take liquidity on the Exchange's complex order book. In addition, transaction fees are charged for Public Customer Orders entered in response to special order broadcasts, such as Facilitation orders, Solicitation orders, Block orders, and orders entered in the Exchange's PIM. Public Customer Orders also are subject to fees for order cancellations. See ISE Schedule of Fees.

<sup>10</sup> See Notice, *supra* note 3, at 73 FR 7346.

<sup>11</sup> See Notice, *supra* note 3, at 73 FR 7346 n.7.

advantages is no longer appropriate in today's marketplace, because some non-broker-dealer individuals and entities have access to information and technology that enables them to trade listed options in the same manner as a broker or dealer in securities. The Exchange maintains that these individual traders and entities (collectively, "professional account holders") have the same technological and informational advantages as broker-dealers trading for their own accounts, which enables professional account holders to compete effectively with broker-dealer orders and market maker quotes for execution opportunities in the ISE marketplace.<sup>12</sup> The Exchange therefore does not believe that it is consistent with fair competition for these professional account holders to continue to receive the same marketplace advantages that retail investors have over broker-dealers trading on the ISE.<sup>13</sup>

ISE thus proposes to create two new order types: Priority Customer Orders and Professional Orders. Priority Customer Orders would be orders for the account of a Priority Customer, which would be defined as a person or entity that is not a broker-dealer in securities and that does not place more than 390 orders<sup>14</sup> in listed options per day on average during a calendar month for its own beneficial account(s). Professional Orders would be defined as orders for the account of a person or entity that is not a Priority Customer,

<sup>12</sup> The Exchange also maintains that, under its current rules, retail investors are prevented from fully benefiting from the priority advantage when professional account holders are afforded the same Public Customer Order priority that retail investors enjoy. See Notice, *supra* note 3, at 73 FR 7346.

<sup>13</sup> *Id.*

<sup>14</sup> The Exchange states that 390 orders is equal to the total number of orders that a person would place in a day if that person entered one order every minute from market open to market close. According to ISE, a study of one of the largest retail-oriented options brokerage firms indicated that on a typical trading day, options orders were entered with respect to each of 5,922 different customer accounts. There was only one order entered with respect to 3,765 of the 5,922 different customer accounts on this day, and there were only 17 customer accounts with respect to which more than 10 orders were entered. The highest number of orders entered with respect to any one account over the course of an entire week was 27. In addition, many of the largest retail-oriented electronic brokers offer lower commission rates to customers they define as "active traders." The Exchange reviewed the publicly available information from the Web sites for Charles Schwab & Co., Inc.; Fidelity Investments; TD Ameritrade, Inc.; and optionsXpress, Inc., and found all of them define an "active trader" as someone who executes only a relatively small number of options trades per month. The highest required trading activity to qualify as an active trader among these four firms was 35 trades per quarter. See Notice, *supra* note 3, at 73 FR 7347 n.10-11.

and would include proprietary orders of ISE members and non-member broker-dealers.<sup>15</sup> Priority Customer Orders would have priority over Professional Orders at the same price. Thus, Public Customers who now have priority over market makers and broker-dealers at the same price would be on parity with market makers and broker-dealers at the same price, if those Public Customers placed more than 390 orders in listed options per day on average during a calendar month. These Professional Orders also would be assessed the same fees that ISE charges for broker-dealer transactions.

The Exchange believes that the use of these new terms in the execution rules and fee schedule would result in professional account holders participating in the ISE's allocation process on equal terms with broker-dealer orders and market maker quotes. It would also result in members paying the same transaction fees for the execution of orders for a professional account as they do for broker-dealer orders. The Exchange believes that identifying professional account holders as participants who place more than one order per minute on average per day during a calendar month is an appropriately objective approach that would reasonably distinguish such persons and entities from retail investors. The Exchange proposes the threshold of 390 orders per day on average over a calendar month because it believes this amount far exceeds the number of orders that are entered by retail investors in a single day, while being a sufficiently low number of orders to cover the professional account holders that are competing with broker-dealers in the ISE marketplace. ISE further notes that basing the standard on the number of orders that are entered in listed options for a beneficial account(s) assures that professional account holders could not inappropriately avoid the purpose of the rule by spreading their trading activity over multiple exchanges, and using an average number over a calendar month would prevent gaming of the 390 order threshold.<sup>16</sup>

ISE's proposal would require Electronic Access Members ("EAMs") to indicate whether Public Customer Orders are Priority Customer Orders or Professional Orders. EAMs would be

<sup>15</sup> Members would be required to represent as Professional Orders for the next calendar quarter the orders for any customer that had an average of more than 390 orders per day during any month of a calendar quarter. See proposed Text of Regulatory Circular filed by ISE as part of the proposed rule change ("Proposed Regulatory Circular").

<sup>16</sup> See Notice, *supra* note 3, at 73 FR 7346-47.

required to review their customers' activity on at least a quarterly basis to determine whether orders that are not for the account of a broker or dealer should be represented as Priority Customer Orders or Professional Orders. Members would be required to make any appropriate changes to the way in which they are representing orders within five days after the end of each calendar quarter. If during a calendar quarter the Exchange identified a customer for which orders are being represented as Priority Customer Orders, but that customer has averaged more than 390 orders per day during a month, the Exchange would notify the member and the member would be required to change the manner in which it is representing the customer's orders within five days.<sup>17</sup>

All Public Customers would continue to be treated in the same manner under all ISE rules, other than those rules for priority and transaction fees. For example, ISE rules relating to the Intermarket Linkage affecting Public Customers<sup>18</sup> would continue to apply to all customers who are not broker-dealers—even those customers whose orders are identified as Professional Orders. Similarly, rules regarding customer suitability and other protections for customers would continue to apply with respect to all customers who are not broker-dealers.<sup>19</sup>

### III. Commission Findings and Order Granting Accelerated Approval to the Proposed Rule Change as Modified by Amendment Nos. 1 and 2

After careful consideration of the proposed rule change, as well as the comment letters and the ISE Response Letter, the Commission finds that the proposed rule change is consistent with the Act. As the options markets have become more electronic and more competitive over the last several years, the Commission believes that the distinction between a professional who is registered as a broker-dealer and a public customer who is not so registered, but who may trade to the same extent as a broker-dealer, has become blurred.<sup>20</sup> Moreover, the

<sup>17</sup> See Proposed Regulatory Circular, *supra* note 15.

<sup>18</sup> See Chapter 19 of the ISE Rules.

<sup>19</sup> See Chapter 6 of the ISE Rules. Telephone conversation between Nancy Burke-Sassow, Assistant Director, Division of Trading and Markets ("Division"), Commission, et al., and Katherine Simmons, Deputy General Counsel, ISE, on March 3, 2008.

<sup>20</sup> See, e.g., Nina Mehta, Options Maker-Taker Markets Gain Steam, *TRADER'S Magazine.com*, October 2007, <http://www.tradersmagazine.com/issues/20071004/2933-1.html>.

category of public customer today includes sophisticated algorithmic traders including former market makers and hedge funds that trade with a frequency resembling that of broker-dealers.<sup>21</sup> The Commission believes that the Act does not require the ISE to treat those customers who meet the high level of trading activity established in the proposal identically to customers who do not meet that threshold.<sup>22</sup>

Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)<sup>23</sup> of the Act and the rules thereunder,<sup>24</sup> and in particular with:

Section 6(b)(4) of the Act, which requires exchanges to provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities;<sup>25</sup>

Section 6(b)(5) of the Act, which requires that the rules of a national securities exchange, among other things, be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest; and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers;<sup>26</sup> and

Section 6(b)(8) of the Act, which requires the rules of an exchange not to impose any burden on competition not necessary or appropriate in furtherance of the Act.<sup>27</sup>

In addition, the Commission finds that the proposed rule change is consistent with Section 11(a) of the Act.<sup>28</sup>

#### A. Customer Priority on the Options Exchanges

Currently, the ISE accords priority to all Public Customer Orders at the best bid or offer on the basis of price-time

priority before allocating any remaining contracts among Non-Customer Orders and market maker quotes at the same best price. ISE now proposes that only Priority Customer Orders, as defined above, would receive such priority.

In considering this aspect of the proposal, the Commission examined the basis upon which exchanges have granted priority to public customers in the past. The Commission further considered the threshold question of when and whether the orders of public customers must be entitled to priority over the orders of broker-dealers.

In certain contexts, the Commission has characterized an exchange's practice of according priority to public customers' orders as a matter of "tradition."<sup>29</sup> Alternatively, the Commission has referred to public customer priority as "the generally accepted auction trading principle of priority of public limit orders over member proprietary orders at the same price."<sup>30</sup>

These references in Commission releases support the Commission's view that the customer priority rule under discussion was not a matter of public customer entitlement derived from the Act, but rather a matter of convention to accommodate public customer orders, or an auction principle applied as a matter of longstanding practice by exchanges. In addition, public customer orders are a source of liquidity in the market, and exchanges have sought to attract such orders by providing public customers certain guarantees that their orders would be executed even in the face of competition from broker-dealers.

The Commission previously has approved exchange rules that apply this "traditional priority" as consistent with

the Act but, as discussed below, has approved exchange rules that do not accord priority to public customer orders.<sup>31</sup> In analyzing the concept of public customer priority, the Commission has considered whether public customer priority, or the absence of such priority, is consistent with Section 11(a) of the Act, the agency obligations of the specialist, the protection of investors and the public interest, and the Act, in general.

#### 1. Section 11(a) of the Act

Section 11(a) of the Act prohibits any member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion unless an exception applies.<sup>32</sup> Thus, in some contexts, the Commission has cited Section 11(a) of the Act as a basis for exchange rules that accord customer orders priority, referring to "the traditional auction market concepts of customer priority embodied in Section 11(a) of the Act."<sup>33</sup>

Section 11(a)(1) contains a number of exceptions for principal transactions by members and their associated persons. One such exception, set forth in subparagraph (G) of Section 11(a)(1) and in Rule 11a1-1(T), permits any transaction for a member's own account provided, among other things, that the transaction yields priority, parity, and precedence to orders for the account of persons who are not members or associated with members of the exchange. Exchange rules, therefore, may require members to yield priority to the orders of public customers to satisfy this exception to Section 11(a). Another exception permits market makers to effect transactions on exchanges in which they are members.<sup>34</sup>

In addition to the exceptions noted above, Rule 11a2-2(T) under the Act<sup>35</sup> provides exchange members with an exception from the prohibitions in Section 11(a). Rule 11a2-2(T), known as the "effect versus execute" rule, permits an exchange member, subject to certain

<sup>28</sup> See, e.g., Securities Exchange Act Release Nos. 21695 (January 28, 1985), 50 FR 4823 (February 1, 1985) (in considering Chicago Board Options Exchange's ("CBOE") proposal to implement a retail automatic execution system ("RAES") pilot program, the Commission referred to "the traditional priority accorded to public customer orders"); and 22610 (November 8, 1985), 50 FR 47480 (November 18, 1985) (in considering a proposal by the American Stock Exchange ("Amex") to implement an automatic execution feature of its AUTOAMOS system on a pilot basis, the Commission stated that the pilot "ensures the traditional priority accorded public customer orders"). In each of these instances, the Commission was referring specifically to public customer orders that are placed on the book. Such placements may affect the application of priority principles. See, e.g., *infra* Section III.A.3.

<sup>29</sup> See, e.g., Securities Exchange Act Release No. 22817 (January 21, 1986), 51 FR 3547 (January 28, 1986) (notice of CBOE's proposal to implement RAES on a permanent basis for options on the Standard and Poor's 100 Index ("OEX") (SR-CBOE-85-32) and to extend RAES to selected classes of individual stock options on a six-month pilot basis (SR-CBOE-85-16) ("January 1986 Release"). See also *infra* note 40.

<sup>31</sup> See *infra* notes 41-44 and accompanying text.  
<sup>32</sup> 15 U.S.C. 78k(a).

<sup>33</sup> See, e.g., Securities Exchange Act Release No. 27205 (August 31, 1989), 54 FR 37180 (September 7, 1989) (Commission order approving a proposal of the Philadelphia Stock Exchange ("Phlx") relating to the crossing of agency orders). See also, e.g., Securities Exchange Act Release No. 33708 (March 3, 1994), 59 FR 11339 (March 10, 1994) (Commission order approving a proposal of the Midwest Stock Exchange, Inc. relating to agency crosses between the disseminated exchange market).

<sup>34</sup> Section 11(a)(1)(A).  
<sup>35</sup> 17 CFR 240.11a2-2(T).

<sup>21</sup> *Id.*

<sup>22</sup> The Commission notes that one of the commenters, discussing the proposed rule change before the Exchange filed Amendment No. 1, stated that she placed an average of 170 orders per day. See A. Schneider Letter *supra* note 4. Under the proposed rule change, as amended, a Public Customer that places this number of orders would be substantially short of the proposed threshold of more than 390 orders per day and thus would not be affected by the rule.

<sup>23</sup> 15 U.S.C. 78f(b).

<sup>24</sup> In approving the proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f). See also *infra* notes 50-71 and accompanying text.

<sup>25</sup> 15 U.S.C. 78f(b)(4).

<sup>26</sup> 15 U.S.C. 78f(b)(5).

<sup>27</sup> 15 U.S.C. 78f(b)(8).

<sup>28</sup> 15 U.S.C. 78k(a). See *infra* Section III.A.1.

conditions, to effect transactions for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion (collectively, "covered accounts") by arranging for an unaffiliated member to execute the transactions on the exchange.

To comply with the "effect versus execute" rule's conditions, a member: (i) Must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>36</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the rule.<sup>37</sup>

The Commission previously has found that the manner of operation of ISE's Facilitation Mechanism enables Exchange members to meet the conditions of the effect versus execute rule and thereby avail themselves of the exception that the rule provides from the prohibitions of Section 11(a).<sup>38</sup> Similarly, the Commission believes that the manner of operation of ISE's overall electronic trading system, not only the Facilitation Mechanism, enables members to meet the four conditions of the effect versus execute rule and would continue to do so under the proposal.<sup>39</sup>

<sup>36</sup> The member, however, may participate in clearing and settling the transaction. See Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978).

<sup>37</sup> 17 CFR 240.11a2-2(T). See, e.g., Securities Exchange Act Release No. 51666 (May 9, 2005), 70 FR 25631 (May 13, 2005).

<sup>38</sup> The Commission notes that, first, all orders are electronically submitted to the ISE through remote terminals. Second, because a member relinquishes control of its order after it is submitted to the system, the member does not receive special or unique trading advantages. Third, although the effect-versus-execute rule contemplates having an order executed by an exchange member who is not affiliated with the member initiating the order, the Commission recognizes that this requirement is satisfied when automated exchange facilities are used. (In considering the operation of automated execution systems operated by an exchange, the Commission has noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See Securities Exchange Act Release No. 15533 (January 29, 1979).) Finally, to the extent that ISE members rely on Rule 11a2-2(T) for a managed account transaction, they must comply with the limitations on compensation set forth in the rule. See *id.*, at note 20.

For this reason, the Commission believes that the proposed rule change, which would permit orders of ISE members to be executed under certain circumstances even if a Professional Order is on the ISE's book, is consistent with the requirements of Section 11(a) of the Act and Rule 11a2-2(T) thereunder.

## 2. Protecting Investors and the Public Interest

In analyzing the merits of exchange proposals affecting public customer order priority, the Commission has considered whether the proposed rule change is consistent with Section 6(b)(5) of the Act, which requires that the rules of an exchange, among other things, be designed "to protect investors and the public interest."<sup>40</sup>

The Commission does not believe that this provision of Section 6(b)(5) requires that ISE give priority to Public Customers whose orders would be considered Professional Orders under the proposal. The Commission has indicated in the past that it does not believe that priority for public customer orders is an essential attribute of an exchange. In particular, the Commission has approved options exchanges' trading rules that do not give priority to orders of public customers that are priced no better than the orders of other market participants.

<sup>40</sup> For example, in January 1986, in publishing for public comment two proposed rule changes relating to the operation of RAES, *see supra* note 30, the Commission raised the question of whether the proposals were inconsistent with the provision in Section 6(b)(5) of the Act relating to the protection of investors and the public interest. The Commission also asked whether RAES was inconsistent with Section 11A of the Act, which states that it is in the public interest and appropriate for the protection of investors to assure "economically efficient execution of securities transactions," "the practicability of brokers executing investors' orders in the best market," and "an opportunity \* \* \* for investors' orders to be executed without the participation of a dealer." 15 U.S.C. 78k-1(a)(1)(C)(i), (iv) and (v). On August 1, 1986, the Commission approved the proposal to make the RAES pilot program in OEX options permanent and a modified version of the pilot proposal for RAES in equity options, concluding that the proposed rule changes were consistent with the requirements of the Act, and, in particular, with Sections 6 and 11A of the Act. See Securities Exchange Act Release No. 23490 (August 1, 1986), 51 FR 28788 (August 11, 1986). In its approval order, the Commission stated that it was "cognizant of the substantial benefits provided by RAES to public customers of OEX and firms using the system" and noted that RAES had increased the efficiencies of the OEX market and added to the confidence of public customers. The Commission indicated that it expected CBOE to modify RAES for OEX options in the future, although it stated that its approval of the rule change was not tied to this expectation. Noting the technical impediments to modifying the system for such options, the Commission expressed its belief that "on balance, the benefits of RAES for the market in OEX weigh in favor of permanent approval."

For example, in approving proposed rules governing CBOE's *direct*, CBOE's electronic screen-based trading system ("SBT"), the Commission concluded that it was consistent with the Act for the CBOE's rules not to provide priority to public customer orders over market maker quotes and orders in all instances.<sup>41</sup> Significantly, the Commission noted in its approval order for the SBT rules that, in the rules governing trades on CBOE's floor, customer orders displayed on the limit order book are given priority over broker-dealer orders and market maker quotes, but distinguished the operation of CBOE's *direct*. On the floor, the Commission noted, the priority of booked customer limit orders was essential because (at the time) the DPM was the agent for orders resting in the limit order book and, therefore, consistent with general agency law principles, CBOE's rules accorded priority to those resting limit orders.<sup>42</sup> In contrast, an SBT market maker was not required to act as agent with respect to a limit order entered into CBOE's *direct*.

Furthermore, on the Boston Options Exchange ("BOX"), the options facility of the Boston Stock Exchange, Inc., orders generally are executed according to price-time priority, with no distinctions made with regard to account designation (Public Customer, Broker/Dealer or Market Maker).<sup>43</sup> On the options facility of NYSE Arca, Inc. ("NYSE Arca"), all non-marketable limit orders and quotes also are ranked in an electronic limit order file and matched for execution according to price-time priority.<sup>44</sup> On these exchanges, all options orders at the best price are executed based on the time the order was entered. In approving these

<sup>41</sup> CBOE had proposed alternative priority methodologies for its SBT system including public customer priority, market maker priority, and trade participation rights for Designated Primary Market Makers ("DPMs") and Lead Market Makers. See Securities Exchange Act Release No. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (Commission order approving rules for CBOE's *direct*).

<sup>42</sup> In 2005, the Commission approved a proposal by the CBOE to eliminate the requirement that DPMs act as the agent in the options in which it is registered as the DPM on the Exchange. See Securities Exchange Act Release No. 52798 (November 18, 2005), 70 FR 71344 (November 28, 2005) (Commission order approving removing agency responsibilities of DPMs).

<sup>43</sup> The Commission stated that the "contention that all existing options exchanges provide strict customer priority is an overstatement." The Commission noted that several options exchanges had rules to permit market makers to be on parity with customer orders in certain circumstances. See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004).

<sup>44</sup> See Securities Exchange Act Release No. 54238, (July 28, 2006), 71 FR 44759 (August 7, 2006) (Commission order approving NYSE Arca's OX Trading Platform).

exchanges' rules, the Commission found them to be consistent with the Act.

The Commission believed that the BOX's and NYSE Arca's rules, which accord no priority to any public customer orders, are consistent with the Act's requirement that exchange rules be designed to protect investors and the public interest.<sup>45</sup> Similarly, the Commission believes that the ISE's proposal, which reasonably eliminates priority treatment of Professional Orders of Public Customers, is consistent with the statutory requirement.

### 3. Agency Obligations

In approving the proposed rule change, the Commission notes that, historically, exchange specialists have had substantial agency responsibilities in obtaining executions for customer limit orders. A specialist's responsibility to a customer in his or her role as agent for the limit order book was based on common law notions of fiduciary duty and incorporated in the rules of some exchanges. As exchanges increasingly have implemented automated trading systems, however, the specialist's role in handling limit orders has diminished.<sup>46</sup> On the ISE, market makers do not act as agent for incoming orders that are executable on the exchange. Orders submitted to the ISE are matched by an automated trading system and generally are not represented by a specialist acting as agent.<sup>47</sup>

The Commission's approval of ISE's proposal to no longer accord priority to Professional Orders is based solely on its determination that this proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities

exchange. The Commission is making no determination as to whether the failure of any market participant (e.g., a specialist managing an exchange's order book) to accord priority, as appropriate, to any order entrusted to that participant as an agent is consistent with the federal securities laws or any other applicable law. Accordingly, the Commission's approval of ISE's proposal does not affect fiduciary obligations under the federal securities laws or agency law principles.

### B. Issues Raised by Commenters

As noted above, the Commission has received ten comment letters regarding the proposed rule change.<sup>48</sup> Nine of these commenters opposed the proposal. One commenter endorsed the ultimate goal of the proposal, but expressed concerns regarding its implementation.<sup>49</sup> The Commission acknowledges the arguments and concerns that have been raised by the commenters, but believes that the arguments and concerns do not support the conclusion that the proposal is inconsistent with the Act.

The commenters raise essentially five main issues: (1) That the proposal is anti-competitive; (2) that it unfairly discriminates against certain Public Customers who no longer would have priority over Non-Customers; (3) that it raises technical and operational issues for firms; (4) that it is vague and therefore unenforceable; and (5) that the imposition of transaction fees for the execution of Professional Orders is unfair. In its review of the proposal, the Commission has carefully considered these issues and has evaluated them in light of the Act's provisions, as discussed below.

#### 1. ISE's Proposal Does Not Impose an Unnecessary or Inappropriate Burden on Competition

Some commenters believed that the proposed rule change would thwart competition by treating the orders of certain Public Customers on a par with orders of broker-dealers, despite the inability of those customers to participate in the market on an equal footing with broker-dealers and market makers.<sup>50</sup> These commenters argued that broker-dealers and market makers have substantial marketplace advantages over Public Customers, including lower margin and commission rates, better access to information, and superior

technology,<sup>51</sup> and, in the case of market makers, the ability to stream quotes electronically on both sides of the market.<sup>52</sup>

As discussed above, the Act does not require that the order of a public customer or any other market participant be granted priority. The objective of promoting competition and the requirement that the rules of an exchange not impose an unnecessary or inappropriate burden upon competition do not necessarily mandate that a Professional Order be granted priority while the order of a broker-dealer should not be granted the same right.

As a general matter, in developing their trading and business models, exchanges have adopted rules, with Commission approval, that grant priority to certain participants over others, or to waive fees or provide discounts for certain kinds of transactions, in order to attract order flow or create more competitive markets.

The Act itself recognizes that the operation of a marketplace can warrant exceptions to general allocation principles, for example, by exempting specialists and market makers from the requirement that a member of an exchange yield to the order of a non-member.<sup>53</sup> "Specialist entitlements"<sup>54</sup> and facilitation and solicited order guarantees,<sup>55</sup> adopted by exchanges with Commission approval, also are instances in which the need to attract

<sup>51</sup> See, e.g., Carr Letter *supra* note 4, G. Schneider Letter *supra* note 4 and Rule Letter *supra* note 4.

<sup>52</sup> See, e.g., Carr Letter *supra* note 4, Cox Letter II *supra* note 4 and Rule Letter *supra* note 4.

<sup>53</sup> See Section 11(a) of the Act, 15 U.S.C. 78k(a), and the rules thereunder.

<sup>54</sup> A "specialist entitlement" as used here is an options exchange rule that under certain circumstances guarantees a specialist (or designated primary market maker) the right to trade ahead of other participants in the trading crowd with a certain percentage of every order—when the specialist is quoting at the best price—even when the specialist has not otherwise established priority. See, e.g., ISE Rule 713, Supplementary Material .01(b); Amex Rule 935-ANTE(a)(5); CBOE Rule 8.87; NYSE Arca Rule 6.82(d)(2); Phlx Rule 1014(g)(ii).

<sup>55</sup> A "facilitation guarantee" as used here is an options exchange rule that under certain circumstances guarantees an order entry firm that has submitted a public customer order for execution on the exchange to trade with a certain percentage of that public customer order itself, ahead of other participants in the trading crowd that are prepared to trade at the same price. See, e.g., ISE Rule 716(d); Amex Rule 950-ANTE, Commentary .02; CBOE Rule 6.74(h); NYSE Arca Rule 6.47(h); A "solicited order guarantee" is an options exchange rule that entitles a broker or firm that has solicited an order from a third party to trade against its customer's order to execute a certain percentage of the customer's order against the solicited order ahead of other participants in the trading crowd that are prepared to trade at the same price. See, e.g., ISE Rule 716(e) (Solicited Order Mechanism).

<sup>45</sup> *Id.*

<sup>46</sup> On several options exchanges, including BOX and CBOE, the exchange market makers have no responsibility for executing book orders, do not receive any fees for execution of book orders, and, accordingly, have no agency responsibilities for book orders. See e.g., BOX Rules, Chapter V and CBOE Rules Chapter VIII.

<sup>47</sup> The Commission recognizes that ISE's rules mandate that a Public Customer Order be represented by an agent in a discrete situation. ISE Rule 803(c) requires Primary Market Makers ("PMMs"), as soon as practical, to address Public Customer Orders that are not automatically executed because there is a displayed bid or offer on another exchange trading the same option contract that is better than the best bid or offer on the Exchange. In such cases, PMMs are required to execute at a price that matches the best price displayed on another exchange and/or send a Linkage Order. However, ISE Rule 803(c), which pertains to futuemarket Linkage, would not be affected by the proposed rule change. As noted above, ISE rules relating to the Intermarket Linkage affecting Public Customers would continue to apply to all Public Customers—even those customers whose orders are identified as Professional Orders. See *supra* note 18 and accompanying text.

<sup>48</sup> See *supra* note 4.

<sup>49</sup> See SIFMA Letter, *supra* note 4.

<sup>50</sup> See, e.g., Cox Letter I *supra* note 4 and Weisberg Letter *supra* note 4.

order flow or provide incentives to one group of participants based on their role in the marketplace has been viewed as a valid reason to adjust the otherwise-established priority principles of an exchange. Other examples include options trading rules that adjust allocation principles under certain condition in the execution of larger orders<sup>56</sup> and the small order automatic execution systems created by options exchanges in the past.<sup>57</sup> Notably, in some prior proposals to waive or reduce customer fees, exchanges cited their need to remain competitive and attract order flow.<sup>58</sup>

The Commission believes that ISE's proposal to grant priority only to Priority Customers and no longer to waive fees for transactions involving Professional Orders likewise does not necessarily place an inappropriate burden on competition and should most reasonably be viewed as within the discretion of the Exchange,<sup>59</sup> so long as

<sup>56</sup> See, e.g., CBOE Rule 6.74(f) (Open Outcry SizeQuote Mechanism).

<sup>57</sup> In the past, options exchanges that generally operated on an open-outcry trading model adopted systems that automatically executed orders of public customers below a certain size without exposing them to the auction on the floor. These systems were designed to give investors speed, efficiency, and accuracy in the execution of their small orders, which were executed at the exchange's disseminated quotation on a rotational basis against the accounts of participating market makers. Auto-ex orders were thus not executed according to auction principles and priority rules, but were allocated to market makers on the system by turn, regardless of who was first to bid or offer (the disseminated price. For descriptions of such systems, see, e.g., Securities Exchange Act Release Nos. 48975 (December 23, 2003), 68 FR 75667 (December 31, 2003) (Amex); 44829 (September 21, 2001), 66 FR 49730 (September 28, 2001) (Phlx); 41823 (September 1, 1999), 64 FR 49285 (September 10, 1999) (Pacific Exchange); and 44104 (March 26, 2001), 66 FR 18127 (April 5, 2001) (CBOE).

<sup>58</sup> See, e.g., Securities Exchange Act Release Nos. 50469 (September 29, 2004), 69 FR 59628 (October 5, 2004) (CBOE reduction of public customer transaction fees on options on ETFs and HOLDERS); 49957 (July 1, 2004), 69 FR 41318 (July 8, 2004) (ISE waiver of surcharge on public customer transactions in certain licensed products); 44654 (August 3, 2001), 66 FR 42574 (August 13, 2001) (CBOE waiver of fees for public customer transactions in options on Standard & Poor's 100 European-style index). See also *infra*, note 101.

<sup>59</sup> The Commission previously has articulated its position regarding its application of Section 6 of the Act in evaluating distinctions among market participants proposed by exchanges and the leeway granted to an exchange to set an appropriate level of advantages and responsibilities of persons in its marketplace. See Securities Exchange Act Release No. 50484 (October 1, 2004), 69 FR 60440 (October 8, 2004), stating, *inter alia*:

[Section (b)(5)] sets forth the purposes or objectives that the rules of a national securities exchange should be designed to achieve. Those purposes or objectives, which take the form of positive goals, such as to protect investors and the public interest, or prohibitions, such as to not permit unfair discrimination among customers, issuers, brokers or dealers or to not permit any unnecessary or inappropriate burden on

these changes do not unfairly discriminate among participants.<sup>60</sup> In fact, the ISE's proposal simply restores the treatment of Professional Orders to a base line where no special priority benefits and fee waivers are granted.

Moreover, with respect to commenters' contention that broker-dealers have substantial marketplace advantages over Public Customers, it should be noted that broker-dealers, unlike Public Customers, pay significant sums for registration and membership in self-regulatory organizations ("SROs"), and incur significant costs to comply, and ensure that their associated persons comply, with the Act and the rules thereunder and SRO rules. Moreover, Public Customers who would not be Priority Customers on ISE because they place options orders on the scale contemplated by the proposal could choose to become registered broker-dealers and receive the same advantages.

With regard to commenters' contentions relating to market-maker advantages, the Commission notes that ISE market makers have obligations that customers who seek to compete with them do not have, including the responsibility to make continuous markets; to engage in a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market; and not to make bids or offers or enter into transactions that are inconsistent with such a course of dealings.<sup>61</sup> Generally, the advantages of market makers noted by commenters, such as the ability to stream quotes on two sides of the market, are granted by exchanges as the *quid pro quo* for the market makers' assumption of these obligations, in addition to the application of other rules and restrictions relating to their activities.<sup>62</sup>

competition, are stated as broad and elastic concepts. They afford the Commission considerable discretion to use its judgment and knowledge in determining whether a proposed rule change complies with the requirements of the Act. Furthermore, the subsections of Section 6(b) of the Act must be read with reference to one another and to other applicable provisions of the Act and the rules thereunder. Within this framework, the Commission must weigh and balance the proposed rule change, assess the views and arguments of commenters, and make predictive judgments about the consequences of approving the proposed rule. (citations omitted)

<sup>60</sup> See *infra* Section III.B.2 for a discussion of whether ISE's proposal is unfairly discriminatory.

<sup>61</sup> See ISE Rule 803.

<sup>62</sup> For example, pursuant to ISE Rule 803(b), a market maker on ISE has a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for the market maker's own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular options

In addition, the proposal could provide an advantage to Public Customers who would not be Priority Customers. Under the proposed rule change, Professional Orders would not be subject to cancellation fees,<sup>63</sup> which could result in partially reduced costs for those customers who place orders on an average of one order per minute and frequently cancel such orders.<sup>64</sup>

Several commenters stated that active traders provide valuable liquidity to the market and pose significant competition to market makers. According to some commenters, the proposed rule change would punish these customers who contribute liquidity,<sup>65</sup> and would force such traders from the market.<sup>66</sup>

The Commission acknowledges that Public Customers, including sophisticated algorithmic traders, provide valuable liquidity to the options markets and compete with market makers. In the Commission's view, however, the contribution of these participants to the market does not mean that their orders are entitled to favorable priority and fee treatment, even if—as commenters argue—they would not be able to supply this liquidity without being granted such priority and fee advantages. Market makers and broker-dealers also provide valuable liquidity to the marketplace and do not have priority. Thus, the Commission believes that it is consistent with the Act for the ISE to amend its rules so that Professional Orders, like the orders of broker-dealers and market makers, are not granted special priority.

Two commenters appeared to acknowledge that customers who enter orders on the scale that the proposed rule change would establish likely have

contract, or a temporary distortion of the price relationships between options contracts of the same class. Public Customers, including customers who seek to compete with market makers, have no such obligations. Under ISE's proposal, Public Customers who submit Professional Orders would not be subject to market maker obligations.

<sup>63</sup> The Exchange charges a cancellation fee, currently \$2.00 per cancellation, on each clearing EAM that cancels at least 500 Public Customer orders in a month for itself or for an introducing broker, for each cancelled order in excess of the total number of orders executed for itself or for such introducing broker that month. The cancellation fee does not apply to the cancellation of Public Customer Orders that improve ISE's disseminated quote at the time the orders were entered. There currently are no fees for the cancellation of Non-Customer Orders, and Professional Orders would not incur such fees under the proposed rule change.

<sup>64</sup> The Commission notes that, contrary to the apparent belief of some commenters, the proposal would not impose cancellation fees on Professional Orders. See Cox Letter II *supra* note 4 and Carr Letter *supra* note 4.

<sup>65</sup> See, e.g., A. Schneider Letter *supra* note 4 and Weisberg Letter *supra* note 4.

<sup>66</sup> See, e.g., Lampert Letter *supra* note 4.

information and technology that allows them to compete in a sophisticated manner.<sup>67</sup> However, they argued that the proposal's creation of the category of Professional Orders suggests that "any person who wishes to consider themselves a retail customer [must] forego any type of trading technology, which of course is widely available in today's market." \* \* \*<sup>68</sup>

The Commission disagrees with this contention. The proposed rule does not ask Public Customers to forego technology and does not limit the technology that Public Customers who would not be Priority Customers can use to access the ISE's marketplace. Rather, it establishes that customers who place orders at the level proposed by the ISE—irrespective of their use of trading technology—are engaged in a course of active trading that need not be accorded the special deference paid to those customers who do not place orders as frequently.

In support of its proposal, the ISE contends that traders who place orders on the scale set forth in the proposal have the same technological and informational advantages over retail investors as broker-dealers trading for their own account—which enables them to compete effectively with broker-dealer orders and market maker quotes for execution opportunities in the ISE marketplace.<sup>69</sup> The Commission, however, does not believe that access to or use of sophisticated technology is the key issue in considering whether it is consistent with the Act for ISE to treat Professional Orders in the same manner as broker-dealer orders in specified circumstances. Instead, the Commission believes that the pivotal issue is whether, under the Act, the exchange can grant certain advantages, which it initially established for all public customers, to only those public customers who place no more than 390 orders per day.

The Commission notes that currently customers who are positioned to place orders in the number and frequency specified in the proposed rule change are treated on a par with customers who may not have this ability, or even if they have this ability, do not place orders on the average of one order per minute per over the trading day. Under the Exchange's proposal, customers who place orders less frequently would be advantaged by the Exchange's grant of

priority over Non-Customer Orders and market maker quotes at the same price, even if they have access to sophisticated options trading technology. Further, the Commission disagrees with the argument that customers would have to forego using trading technology under the Exchange's proposal. The ISE's proposal does not limit, prohibit, or proscribe the type of technology any customer uses. Customers could still use sophisticated technology to trade options and their orders would not be considered Professional Orders, as long as those customers placed fewer than one order per minute per day on average during a calendar month for their own beneficial account(s).

One commenter believed that the proposed rule change limited competition and was collusive because "it requires the cooperation of other competing exchanges." \* \* \*<sup>70</sup> The Commission notes, however, that the proposed rule change requires EAMs to conduct a quarterly review of customer activity only as reflected in the EAM's own records. The proposal does not require either EAMs or the Exchange to seek information from other broker-dealer firms or exchanges regarding a customer's activity.<sup>71</sup>

## 2. ISE's Proposal Is Not Unfairly Discriminatory

Many of the commenters argued that the proposed rule change is unfairly discriminatory against those Public Customers who would not be Priority Customers by denying them priority rights and imposing transaction fees on their orders.<sup>72</sup> In the ISE's view, public customers today range from individuals who infrequently place options orders to sophisticated algorithmic traders that trade many options classes on a daily basis.<sup>73</sup> ISE proposes to continue to grant priority to, and waive transaction fees for, individuals who place orders below the threshold, as a means to encourage their participation. The Exchange believes, however, that priority rights and fee waivers are no

longer warranted for market participants who place more than one order per minute on average during a calendar month, a level of activity that it believes is akin to that of broker-dealers. The Exchange therefore proposes to refrain from providing priority and fee incentives for such participants.

The Commission notes that the Act does not require that the Exchange's rules be designed to prohibit all discrimination, but rather they must not permit unfair discrimination.<sup>74</sup> With regard to public customer priority, the Commission has noted above ample precedent demonstrating that public customer orders are not entitled *per se* to priority treatment over the orders of other market participants. The Commission similarly believes that the ISE's proposal to grant such priority treatment only to Priority Customers is consistent with the Act and, in particular, is not unfairly discriminatory.

As discussed above, the Commission does not believe that the current rules of ISE and other exchanges that accord priority to all public customers over broker-dealers and market makers are unfairly discriminatory. Nor does the Commission believe that it is unfairly discriminatory to accord priority to only those customers who on average do not place more than one order per minute as ISE proposes.

Because, as discussed in Section III.A.1. above, the Commission believes that ISE's proposal is consistent with the Act in that it does not impose an undue burden on competition, the Commission believes that a grant of such priority is an exchange's prerogative and within the exchange's business judgment. As such, a decision to grant priority—which, after all, is a special benefit—to the orders of one type of customer (for example, a retail customer) and not to the orders of another (for example, an institutional investor) may be an economic decision that an exchange may make to provide some customers with incentives and fee waivers. In the Commission's view, nothing in the Act requires an exchange to provide the same incentives and discounts to all market participants equally, as long as the exchange does not unfairly discriminate among participants with regard to access to exchange systems.<sup>75</sup>

<sup>74</sup> 15 U.S.C. 78f(b)(5). See also Securities Exchange Act Release No. 50484, *supra* note 59.

<sup>75</sup> In this regard, the Commission notes that ISE amended the proposal to remove the changes it had originally proposed to ISE Rules 715 and 723(c), which would have prevented access by all Public Customers to the Exchange's PIM. See Amendment No. 2, *supra* note 5.

<sup>67</sup> See, e.g., Carr Letter *supra* note 4 and Cox Letter II *supra* note 4.

<sup>68</sup> See Carr Letter *supra* note 4. The commenter believed that the proposal, as a result, would require retail customers who forego technology to "wander into the marketplace blind and helpless."

<sup>69</sup> See Notice, *supra* note 3, at 73 FR 7346.

<sup>70</sup> See Cox Letter III *supra* note 4. The commenter stated further: " \* \* \* I fail to see how the ISE can request trading information from a person or entity trading from another exchange, particularly when other exchanges have business models that promote order entry: the exact behavior the ISE is attempting to punish with its rule."

<sup>71</sup> Confirmed in telephone conversation between Ira Brandriss, Special Counsel, Division, Commission, and Katherine Simmons, Deputy General Counsel, ISE, on April 29, 2008. See also *supra* note 17 and accompanying text. See also ISE Rules 401, 706, and 712.

<sup>72</sup> See, e.g., G. Schneider Letter *supra* note 4, Lampert Letter *supra* note 4, Rule Letter *supra* note 4, Cox Letter II *supra* note 4 and Cox Letter III *supra* note 4.

<sup>73</sup> See Notice, *supra* note 3, at 73 FR 7346.

The Commission believes that the line that the ISE seeks to draw between Priority Customers and Public Customers whose orders would be treated as Professional Orders most simply reflects a belief—from the point of view of operating a marketplace—that the orders of a person who submits, on average, more than one order every minute of the trading day need not (or should not) be granted the same benefit or incentive that is granted to Public Customers who do not utilize the marketplace on such a scale.

The same can be said with regard to relief from transaction fees. Exchanges can and do have fee structures that vary depending on the market participant.<sup>76</sup> Various fee structures are permitted provided that they are consistent with the Act (including the requirement that the fees not be unfairly discriminatory). Such differing fee structures are based on the judgment of those responsible for the financial operation of the exchange, and are tied to exchange assumptions about market participant behavior, the impact of incentives and discounts, and other factors relating to the specific business model adopted by the exchange. A decision to waive or discount fees for orders of one kind of participant and not another, based on the extent of their participation in the market, is a reasonable decision for an exchange, provided it is otherwise consistent with the Act.<sup>77</sup>

<sup>76</sup> For example, some exchanges impose different fees for different market participants, depending on whether the market participant adds liquidity by posting a quote or order, or takes liquidity by executing against a quote or order that is already posted on the exchange. Some exchanges' transaction fees, before additional charges are assessed, are identical for market makers and member firms, while on other exchanges market makers and member firms are charged at different rates. Some exchanges provide volume discounts; some place a cap on charges to particular participants. Some impose transaction fees upon certain participants for complex orders; others do not. As a result, the fees imposed upon various market participants can vary significantly from exchange to exchange. Each exchange's schedule of fees is available on the exchange's Web site. See e.g., the fee schedule of CBOE at <http://www.cboe.com/AboutCBOE/FeeSchedule.aspx>; the fee schedule of BOX at [http://www.bostonoptions.com/box\\_regulations/PDF/feeschedjun06.pdf](http://www.bostonoptions.com/box_regulations/PDF/feeschedjun06.pdf); and the fee schedule of NYSE Arca at <http://www.nyse.com/futuresoptions/nysearcapptions/1147128317287.html>.

<sup>77</sup> Similar to other exchanges, ISE charges different fees depending on whether an individual is a Public Customer, Non-Member Broker-Dealer, EAM, ISE Market Maker or Non-ISE Market Maker. For example, ISE charges Public Customers a \$0.05 fee for Non-Premium Products and the \$0.03 Comparison Fee for the orders of Public Customers are currently waived while Non-Member Broker-Dealers and EAMs pay a \$0.15 fee for orders in Premium and Non-Premium Products (subject to volume discounts) and a \$0.03 Comparison Fee. Comparatively, ISE market makers are subject to a fee for transactions in Premium and Non-Premium

### 3. The Proposal Can Be Implemented on a Technical and Operational Level

One commenter, SIFMA, endorsed the underlying goal of the proposed rule change, but expressed concern about various aspects of the proposal. First, SIFMA was concerned that, under the proposed rule, EAMs would "have no ability to identify the end-user customer and count orders."<sup>78</sup> SIFMA's comment letter noted that EAMs would have to rely on the broker-dealers that route orders to them and have the customer relationship to identify the professional customer and code orders correctly. Moreover, SIFMA stated that, in general, firms do not count the number of orders directed by customers under the same beneficial owners and do not have the ability to break down, by beneficial owner, the number of orders placed. SIFMA further believed that EAMs would need to rely on the Options Clearing Corporation ("OCC") member firm that ultimately clears the professional customer to identify such accounts. SIFMA stated, however, that such reliance would not be possible because OCC member clearing firms see only the number of cleared contracts at the end of the day, and not the number of executions. Moreover, SIFMA noted the lack of access by clearing firms to information regarding a customer's cancellations, replacements, modifications, or corrections of orders, and the resulting inability of such firms to accurately determine the number of orders a customer has placed.<sup>79</sup>

In its response, ISE stated that these concerns were based on the erroneous assumption that compliance with the proposal would require analysis by an ISE member's clearing firm of cleared data provided by the OCC to determine whether a customer had crossed the threshold of placing more than 390 orders per day, on average, over the course of a calendar month.<sup>80</sup> ISE clarified that only broker-dealers that received orders from the ultimate customers—not clearing firms—would be required under the proposal to monitor the number of orders they receive from each such customer and to mark the orders correctly. "These types of activities are routinely performed by broker-dealers who deal directly with customers," the ISE maintained, adding that broker-dealers have a regulatory

Products between \$0.12–\$0.21 (subject to volume discounts). The amount of this fee is based on the average daily volume of transactions on the Exchange, and is currently \$0.13 per contract. See ISE Schedule of Fees. See also discussion *infra* note 105.

<sup>78</sup> See SIFMA Letter *supra* note 4.

<sup>79</sup> *Id.*

<sup>80</sup> See ISE Response Letter *supra* note 6.

responsibility to know their customer, "and, in fact, do know if they have customers that conduct this high level of activity."<sup>81</sup>

With regard to ISE members that submit customer orders to the Exchange when those orders were routed to them by other, non-ISE-member broker-dealers, SIFMA indicated its concern that such members "will be forced to rely on the good faith and effort of its broker-dealer client \* \* \* to identify the professional customer and code the order correctly."<sup>82</sup> In response, the ISE noted that the Exchange and all other options exchanges currently have a variety of order marking requirements for which ISE members that route orders on behalf of other broker-dealers have regulatory responsibility. The ISE further noted that its EAMs would need to have reasonable procedures in place to confirm that their broker-dealer customers had implemented the appropriate procedures to monitor their customers' trading activity in a way that would enable them to code orders properly to comply with the proposal.<sup>83</sup>

The Commission believes that the ISE's response clarifies its proposal and addresses the concerns raised by SIFMA regarding the counting and marking of customer orders. The proposal would require any ISE member submitting a Public Customer Order to the ISE to identify such order as either a Priority Customer Order or a Professional Customer Order. Based on the ISE's representations, the Commission believes that ISE members that directly submit their Public Customers' orders to the Exchange for execution can readily determine the number of orders that their customers place and can mark those orders accordingly. The Commission notes that the Exchange has stated that EAMs would need to have reasonable procedures in place to confirm that their broker-dealer customers have instituted policies and procedures to enable them to monitor their customers' trading activity in a

<sup>81</sup> *Id.* The ISE also stated that it consulted with a variety of firms that accept orders directly from customers, and that those firms did not believe it would be difficult for them to determine, on a quarterly look-back basis, whether a customer had on average entered more than 390 orders per day during any month. *Id.*

<sup>82</sup> See SIFMA Letter *supra* note 4.

<sup>83</sup> *Id.* According to the Exchange, an EAM would be required to have such procedures in place to comply with its obligation under ISE Rule 712(a) to properly mark orders. Telephone conversation between Katherine Simmons, Deputy General Counsel, ISE, and Nancy J. Burke-Sanow, Assistant Director, Division, Commission, on December 15, 2008.

way that would allow them to mark their customer orders properly.<sup>84</sup>

The Commission believes that ISE members, as well as non-member broker-dealers who accept customer orders and route them to EAMs for execution on the Exchange, have the ability to ascertain for each customer account, by beneficial owner, the number of orders placed by a customer. As the ISE points out, the proposal requires the broker-dealer that has a relationship with, and knows, the ultimate customer to monitor the number of orders it is entering on the customer's behalf and to conduct a quarterly review to assure that the firm is marking the orders appropriately. This monitoring is accomplished by the ISE member directly in the case of its own customers or by the ISE member contractually requiring that its broker-dealer customers have reasonable procedures in place to ascertain whether their customers are submitting orders that should be marked as Professional Orders.

Second, SIFMA expressed concern that professional customers could "game" the system and inappropriately take advantage and avoid the purpose of the rule.<sup>85</sup> SIFMA noted the frequent use by Professional Customers of multiple firms for execution and clearing purposes, which would limit the review by any one EAM or OCC clearing member of a customer's activity. SIFMA further noted that customers could electronically route orders to an exchange without a Professional Order designation and, due to linkage and best execution requirements, these orders could be sent to the ISE without the proper coding.<sup>85</sup> ISE acknowledged that customers could place orders at multiple firms, such that each individual broker-dealer would not know the full extent of its customer's trading activity, making it impossible for a particular firm to measure the total number of orders entered by a particular customer through multiple firms. ISE stated, however, that it believed that "it might be impractical for a customer to conduct professional trading activities through multiple broker-dealer platforms." The Exchange also stated that it would conduct surveillance designed to identify any such behavior, and that if it does detect such activity, it would alert the relevant ISE members. In addition, ISE agreed that, through the operation of the options linkage rules, the order for the account of a customer Professional Order might be routed to

other exchanges that do not have the same order designation and ultimately receive the price available on the ISE indirectly.<sup>86</sup> The Commission believes that the rule change, as proposed, meets the Exchange's aim with regard to those customers who do not employ such stratagems, and thus the potential for a customer to circumvent the proposed rule, does not, in this instance, make it inconsistent with the Act.

Third, SIFMA believed that, for the proposed rule change to be properly implemented, customer trading information would need to be disseminated across desks within a single firm that typically are separated by information barriers. Regarding this issue, SIFMA requested specific guidance on how to implement the proposed requirements without violating applicable privacy regulations.<sup>87</sup> ISE responded that putting procedures in place to comply with its proposal would not result in disclosure of information about particular orders entered by a customer either pre- or post-trade, nor would it result in disclosures about any positions held by a customer. The Exchange stated that it is not aware of any information barrier rule or privacy regulations that would prevent a firm from marking an order as required under the proposal.<sup>88</sup> The Commission agrees with the ISE's position in this regard. The Commission believes that the determination of whether a Public Customer's orders are categorized as Priority Customer Orders or Professional Orders, which would be based on information compiled retrospectively each quarter, can be made at a level in the firm that is "above" the information barrier, and in any case does not require disclosure of any particular orders placed by a customer or any positions held by a customer.

Finally, one commenter expressed the concern that the proposal would be burdensome because it would require EAMs to purchase expensive technology to track the number of orders a person entered per day.<sup>89</sup> Another commenter, SIFMA, believed that the ISE's proposal would require broker-dealers to expend significant resources to comply with the rule and potentially would present large retail firms with difficulties in implementing a new order origin code within the proposal's timeframe.<sup>90</sup>

ISE acknowledged that systems changes to accommodate new coding of

orders could be required for some broker-dealers, but did not believe that such systems changes would be particularly costly "relative to other rule changes routinely made by the ISE and other exchanges."<sup>91</sup> SIFMA also expressed a concern that the proposal could require significant revisions to the customer option account agreements used by firms, because customers could be designated as professional customers.<sup>92</sup> The Commission believes that it is within the business judgment of the Exchange to accept orders for execution in its marketplace contingent upon their submission with a particular order marking, even when that marking may require additional expense on the part of member firms. Exchanges routinely add new order types<sup>93</sup> and the ISE's proposal is no different in this regard. Thus, the Commission believes that the new order designations in the proposed rule change are consistent with the Act, even though they will require members to incur costs associated with systems changes and customer account agreements may need to be revised to reflect these new order designations. As a general matter, the Commission notes that membership in an exchange comes with the expectation that rule changes will be made by the exchange that could require member firms to make adjustments in their systems and procedures.

SIFMA further noted that the proposal would require additional systemic and procedural enhancements for firms to track the new fees that would be established under the proposal.<sup>94</sup> In response, the Exchange maintained that fees vary widely among exchanges and are changed frequently, and that firms routinely make changes in their systems to accommodate exchange fee changes.<sup>95</sup> The Commission notes that fee changes are commonly introduced by exchanges, and members can expect that they will need to adjust their tracking systems as needed when changes are made.

Finally, SIFMA further expressed a concern that the five-day timeframe allotted at the end of a quarter for firms to start coding for Priority Customer and Professional Orders is unrealistic.<sup>96</sup> In response, the ISE acknowledged that it may take more than five days for a

<sup>81</sup> See ISE Response Letter *supra* note 6.

<sup>82</sup> See SIFMA Letter *supra* note 4.

<sup>83</sup> See, e.g., Securities Exchange Act Release Nos. 33800 (March 20, 2008), 73 FR 13267 (March 20, 2008); and 56072 (July 13, 2007), 72 FR 39867 (July 20, 2007).

<sup>84</sup> See SIFMA Letter *supra* note 4.

<sup>85</sup> See ISE Response Letter *supra* note 6.

<sup>86</sup> See SIFMA Letter *supra* note 4.

<sup>84</sup> *Id.*

<sup>85</sup> See SIFMA Letter *supra* note 4.

<sup>86</sup> See ISE Response Letter *supra* note 6.

<sup>87</sup> See SIFMA Letter *supra* note 4.

<sup>88</sup> See ISE Response Letter *supra* note 6.

<sup>89</sup> See Cox Letter III *supra* note 4.

<sup>90</sup> See SIFMA Letter, *supra* note 4.

broker-dealer to make the system changes necessary to accommodate the new order code, and stated that it would give members at least one full quarter, following Commission approval of the proposal to make these changes. The Exchange stated, however, that once the initial systems changes were implemented, five days would be sufficient to change the order code associated with a particular customer account.<sup>97</sup> The Commission notes that the Exchange has committed to working with its members to assure that there is adequate time to make the initial systems changes necessary to implement the new coding,<sup>98</sup> and believes that not less than one full quarter is a reasonable amount of time to achieve this aim. The Commission, however, will monitor whether any issues may arise that would require the ISE to postpone the proposal's implementation timeframe.

#### 4. ISE's Proposal Is Not Vague

One commenter contended that the proposal was vague and unenforceable.<sup>99</sup> The Commission believes that the ISE's proposed rule change is amply clear regarding the kind of order that would not receive priority at the same price and would incur transaction fees as a result of the proposal. The proposal sets forth specific and objective numeric thresholds in its provisions, defining "Priority Customer" as "a person or entity that (i) is not a broker or dealer in securities, and (ii) does not place more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s)." It further defines the term "Professional Order" as "an order that is for the account of a person or entity that is not a Priority Customer." The Commission believes that these definitions are clear and provide notice of the parameters of the rule.

#### 5. Transaction Fees for Professional Orders Are Not Inequitable

As noted above, Section 6(b)(4) of the Act requires that the rules of an exchange must provide for the equitable allocation of reasonable dues, fees, and

other charges among its members and issuers and other persons using its facilities. In evaluating whether a proposed fee can be considered an equitable allocation of a reasonable fee, the Commission considers all of the relevant factors including, among others, the amount of the fee and whether the fee is an increase or decrease, the classes of persons subject to the fee, the basis for any distinctions in classes of persons subject to the fee, the potential impact on competition, and the impact of any disparate treatment on the goals of the Act.<sup>100</sup>

Under the proposed rule change, transaction fees would be charged for the execution of certain Public Customer Orders that currently are not subject to such fees. The Commission notes, however, that options exchanges have charged transaction fees for the execution of public customer orders in the past,<sup>101</sup> and in many cases continue to do so when necessary to defray the costs of maintaining a market and associated expenses for a particular product or category of products.<sup>102</sup> The ISE itself currently imposes fees on certain Public Customer Orders.<sup>103</sup>

Moreover, Public Customer Orders that today incur no transaction fees on the ISE are not indefinitely exempted from such fees. The Exchange's Fee Schedule specifically sets forth transaction fees for customer orders, while indicating that these fees (other than fees for "Premium Products") currently are waived.<sup>104</sup> The

Commission notes that different market participants pay fees based on their status on the Exchange (e.g., Public Customer, non-member broker-dealer, EAM, non-ISE market maker and ISE market maker).<sup>105</sup> Under the proposal, customers whose orders are identified as Professional Orders would pay the same fees as non-member broker-dealers.

The Commission notes that the customers who enter more than 390 orders per day on average during a calendar month are using the Exchange's facilities to place approximately 8,000 orders, on average one order for every minute of every trading day, over the course of the month and nearly 100,000 orders per year. The Commission believes that it is consistent with the Act for ISE to allocate to customers who participate in the market at this level of activity—

those for "Premium Products," currently waived until June 30, 2009).

<sup>105</sup> *Public Customers*—The \$0.05 fee for Non-Premium Products and the \$0.03 Comparison Fee for the orders of Public Customers are currently waived. Public Customers currently pay a fee of \$0.15 for certain orders in Premium Products and Complex Orders, orders entered in response to special order broadcasts and orders entered in PIM. Public Customers are also subject to an order cancellation fee of \$1.75 per order. See *supra* notes 9 and 64.

*Non-member Broker-Dealers*—Non-member broker-dealers pay a \$0.15 fee for orders in Premium and Non-Premium Products (subject to volume discounts) and a \$0.03 Comparison Fee. Customers whose orders are identified as Professional Orders would incur these fees under the proposal.

*EAMs*—EAMs pay the same fees for orders as non-member broker-dealers. In addition to non-member broker-dealer fees, EAMs also pay a one time application fee of \$3500, a regulatory fee of \$5000 per year and a monthly access fee of \$500.

*ISE Market Makers*—ISE market makers are subject to a fee for transactions in Premium and Non-Premium Products between \$0.12–\$0.21 (subject to volume discounts). The amount of this fee is based on the average daily volume of transactions on the Exchange, and is currently \$0.13 per contract. See Fee Notice to ISE Members dated March 3, 2008, available at <http://www.iseoptions.com>. In addition, ISE market makers pay a \$0.03 Comparison Fee, a fee for payment for order flow (only for customer orders) of \$0.65 per contract and \$0.10 per contract for options on issues that are participating in the Penny Pilot (subject to available rebates).

In addition to these market maker fees, PMMs and Competitive Market Makers ("CMMs") pay additional fees including, but not limited to, the fees described below. PMMs have a minimum monthly transaction fee of \$50,000, a one time application fee of \$7500, a regulatory fee of \$7500 per year, a monthly access fee of \$4000 and an inactivity fee of \$100,000 per month. CMMs have a one time application fee of \$5500, a regulatory fee of \$5000 per year, a monthly access fee of \$2000 and an inactivity fee of \$5,000 per month.

*Non-ISE Market Makers*—Non-ISE market makers pay a \$0.37 fee for transactions in Premium and Non-Premium Products (subject to volume discounts) except for a \$0.16 fee for orders entered in the Facilitation and Solicitation Mechanisms and a \$0.03 Comparison Fee.

<sup>100</sup> See, e.g., Securities Exchange Act Release No. 50484 (October 1, 2004), 69 FR 60440 (October 8, 2004).

<sup>101</sup> Subsequently, however, some exchanges have rescinded transaction fees for manually executed equity options orders for public customers. See, e.g., Securities Exchange Act Release Nos. 42798 (May 18, 2000), 65 FR 34239 (May 26, 2000); and 43343 (September 26, 2000), 65 FR 59243 (October 4, 2000).

<sup>102</sup> For example, the exchanges generally charge transaction fees for executions of public customer orders in index options. See, e.g., Securities Exchange Act Release No. 52983 (December 20, 2005), 70 FR 76475 (December 27, 2005) (Commission notice of filing and immediate effectiveness of a proposed rule change adopting a flat execution fee for Public Customer Orders in premium products).

<sup>103</sup> As noted at *supra* note 9, Public Customer Orders incur fees for certain transactions in Premium Products and Complex Orders, orders entered in response to special order broadcasts, and orders entered in PIM. Public Customer Orders also are subject to fees for cancellation.

<sup>104</sup> See Securities Exchange Act Release Nos. 42370 (April 28, 2000), 65 FR 26256 (May 5, 2000) (Commission order adopting original ISE Fee Schedule), in which the Commission found that the fee schedule was "not unreasonable" and "should not discriminate unfairly among market participants." See also the current ISE Fee Schedule, dated August 12, 2008 and Securities Exchange Act Release No. 58139 (July 10, 2008), 73 FR 41142 (July 17, 2008) (customer fees, except

<sup>97</sup> See ISE Response Letter *supra* note 6.

<sup>98</sup> The Exchange stated that it would work with its members to assure that there is adequate time to implement systems changes as necessary. ISE Response Letter, *supra* note 6, n.6. The Exchange further advised that it would issue a notice to its members informing them of the implementation date of the proposed rule change. Telephone conversation between Katherine Simmons, Deputy General Counsel, ISE, and Nancy J. Burke-Sonow, Assistant Director, Division, Commission, on December 15, 2008.

<sup>99</sup> See Cox Letter III, *supra* note 4.

which enables them to compete with Non-Customers who are registered broker-dealers—the same transaction fees that it charges to such Non-Customers.

*C. Accelerated Approval of Proposed Rule Change, as Modified by Amendment Nos. 1 and 2*

Pursuant to Section 19(b)(2) of the Act,<sup>106</sup> the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th 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 hereby finds good cause for approving the proposed rule change, as modified by Amendment Nos. 1 and 2, before the 30th day after the date of publication of notice of filing thereof in the **Federal Register**.<sup>107</sup> The Commission notes that the proposal, as modified by Amendment No. 1, was published for comment in the **Federal Register** on February 7, 2008. The revisions made to the proposal in Amendment No. 2 deleted proposed changes to ISE Rules 715 and ISE Rule 723(d)(2). These revisions appropriately clarify that the proposed rule change would not limit a Public Customer's access to the Exchange's PIM. Accordingly, pursuant to Section 19(b)(2) of the Act,<sup>108</sup> the Commission finds good cause to approve the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the Act. Comments may be submitted by any of the following methods:

*Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-ISE-2006-26 on the subject line.

*Paper Comments*

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission,

100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-ISE-2006-26. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-ISE-2006-26 and should be submitted on or before February 20, 2009.

**IV. Conclusion**

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>109</sup> that the proposed rule change (SR-ISE-2006-26), as modified by Amendment Nos. 1 and 2, be, and it hereby is, approved on an accelerated basis.

By the Commission.

**Florence E. Harmon,**

*Deputy Secretary.*

[FR Doc. E9-1979 Filed 1-29-09; 8:45 am]

BILLING CODE 8011-01-P

**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-59288; File No. SR-ISE-2009-03]

**Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Fee Changes**

January 23, 2009.

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 January 15, 2009, the International Securities Exchange, LLC (the "Exchange" or the "ISE") filed with the Securities and Exchange Commission the proposed rule change, as described in Items I, II, and III below, which items have been prepared by the self-regulatory organization. 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 ISE is proposing to amend its Schedule of Fees to establish fees for transactions in options on 4 Premium Products.<sup>3</sup> The text of the proposed rule change is available on the Exchange's Web site (<http://www.ise.com>), at the principal office of the Exchange, and at the Commission's Public Reference Room.

**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 self-regulatory organization 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 IV below. The self-regulatory organization 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 is proposing to amend its Schedule of Fees

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

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

<sup>3</sup> Premium Products is defined in the Schedule of Fees as the products enumerated therein.

<sup>106</sup> 15 U.S.C. 78s(b)(2).

<sup>107</sup> See *supra* note 3.

<sup>108</sup> 15 U.S.C. 78s(b)(2).

<sup>109</sup> 15 U.S.C. 78s(b)(2).

# **EXHIBIT B**

### **Rule 6.53C. Complex Orders on the Hybrid System**

(a) **Definition:** A complex order is any order for the same account as defined below:

1. **Spread Order:** A spread order is as defined in Rule 6.53(d).
2. **Straddle Order:** A straddle order is as defined in Rule 6.53(f).
3. **Strangle Order:** A strangle order is an order to buy (sell) a number of call option contracts and the same number of put option contracts in the same underlying security, which contracts have the same expiration date ( e.g., an order to buy two XYZ June 35 calls and to buy two XYZ June 40 puts).
4. **Combination Order:** A combination order is as defined in Rule 6.53(e).
5. **Ratio Order:** A spread, straddle or combination order may consist of legs that have a different number of contracts, so long as the number of contracts differs by a permissible ratio. For purposes of this section, a permissible ratio is any ratio that is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00). For example, a one-to-two (.5) ratio, a two-to-three (.667) ratio, or a two-to-one (2.00) ratio is permissible, whereas a one-to-four (.25) ratio or a four-to-one (4.0) ratio is not.
6. **Butterfly Spread Order:** A butterfly spread order is an order involving three series of either put or call options all having the same underlying security and time of expiration and, based on the same current underlying value, where the interval between the exercise price of each series is equal, which orders are structured as either (i) a "long butterfly spread" in which two short options in the same series offset by one long option with a higher exercise price and one long option with a lower exercise price or (ii) a "short butterfly spread" in which two long options in the same series are offset by one short option with a higher exercise price and one short option with a lower exercise price.
7. **Box/Roll Spread Order:** Box spread means an aggregation of positions in a long call option and short put option with the same exercise price ("buy side") coupled with a long put option and short call option with the same exercise price ("sell side") all of which have the same aggregate current underlying value, and are structured as either: A) a "long box spread" in which the sell side exercise price exceeds the buy side exercise price or B) a "short box spread" in which the buy side exercise price exceeds the sell side exercise price.
8. **Collar Orders and Risk Reversals:** A collar order (risk reversal) is an order involving the sale (purchase) of a call (put) option coupled with the purchase (sale) of a put (call) option in equivalent units of the same underlying security having a lower (higher) exercise price than, and same expiration date as, the sold (purchased) call (put) option.
9. **Conversions and Reversals:** A conversion (reversal) order is an order involving the purchase (sale) of a put option and the sale (purchase) of a call option in equivalent units with the same strike price and expiration in the same underlying security, and the purchase (sale) of the related instrument.
10. **Stock-Option Order:** This order type is defined in Rule 1.1(ii). All components of a Stock-Option Order must be transmitted to the Exchange for it to be handled electronically by the Hybrid System.

(b) **Types of Complex Orders:** Complex orders may be entered as fill-or-kill, immediate or cancel, or as all-or-none orders as defined in Rule 6.53, or as good-till-cancelled.

#### **(c) Complex Order Book**

(i) **Routing of Complex Orders:** The Exchange will determine which classes and which complex order origin types ( i.e., non-broker-dealer public customer, broker-dealers that are not Market-Makers or specialists on an options exchange, and/or Market-Makers or specialists on an options exchange) are eligible for entry into the COB and whether such complex

orders can route directly to the COB and/or from PAR to the COB. Complex orders not eligible to route to COB (either directly or from PAR to COB) will route to PAR or at the order entry firm's discretion to the order entry firm's booth.

(ii) Execution of Complex Orders in the COB: Notwithstanding the provisions of Rule 6.42, the Exchange will determine on a class-by-class basis whether complex orders that are submitted to the COB may be expressed on a net price basis in a multiple of the minimum increment (i.e., \$0.10 or \$0.05 or \$0.01, as applicable) or in a smaller increment that may not be less than \$0.01. Complex orders that are submitted to the COB may be executed without consideration to prices of the same complex orders that might be available on other exchanges, and the legs of a complex order may be executed in \$0.01 increments, regardless of the minimum quoting increments otherwise appropriate to the individual legs of the order. Complex orders that are submitted to the COB may trade in the following way:

- (1) Orders and Quotes in the EBook: A complex order in the COB will automatically execute against individual orders or quotes residing in the EBook provided the complex order can be executed in full (or in a permissible ratio) by the orders and quotes in EBook.
- (2) Orders in COB: Complex orders in the COB that are marketable against each other will automatically execute. The allocation of a complex order within the COB shall be pursuant to the rules of trading priority otherwise applicable to incoming electronic orders in the individual component legs.
- (3) Market participants, as defined in Rule 6.45A or 6.45B, as applicable, may submit orders or quotes to trade against orders in the COB. Market participants entering orders or quotes that are not eligible to rest in the COB pursuant to subparagraph (c)(i) above may only enter IOC orders and such other order or quote types as the Exchange may determine on a class-by-class basis. Quotes types that are not eligible to rest or trade against the COB will be automatically cancelled. The allocation of complex orders among market participants shall be done pursuant to Rule 6.45A(c) or 6.45B(c), as applicable.

(iii) Complex orders in the COB may be designated as day orders or good-til-cancelled orders. Only those complex orders with no more than four legs and having a ratio of one-to-three or lower, as determined by the Exchange, are eligible for placement into the COB.

**(d) Process for Complex Order RFR Auction:** Prior to routing to the COB or once on PAR, eligible complex orders may be subject to an automated request for responses ("RFR") auction process.

(i) For purposes of paragraph (d):

- (1) "COA" is the automated complex order RFR auction process.
- (2) A "COA-eligible order" means a complex order that, as determined by the Exchange on a class-by-class basis, is eligible for a COA considering the order's marketability (defined as a number of ticks away from the current market), size, complex order type (as defined in paragraphs (a) and (b) above) and complex order origin types (as defined in subparagraph (c)(i) above). Complex orders processed through a COA may be executed without consideration to prices of the same complex orders that might be available on other exchanges.

(ii) Initiation of a COA: On receipt of a COA-eligible order and request from the member representing the order that it be COA'd, the Exchange will send an RFR message to all members who have elected to receive RFR messages. The RFR message will identify the component series, the size of the COA-eligible order and any contingencies, if applicable, but will not identify the side of the market.

(iii) Bidding and Offering in Response to RFRs: Each Market-Maker with an appointment in the relevant option class, and each member acting as agent for orders resting at the top of the COB in the relevant options series, may submit responses to the RFR message ("RFR Responses") during the Response Time Interval.

(1) RFR Response sizes will be limited to the size of the COA-eligible order for allocation purposes and may be expressed on a net price basis in a multiple of the minimum increment ( i.e., \$0.10, \$0.05 or \$0.01, as applicable) or in a smaller increment that may not be less than \$0.01, as determined by the Exchange on a class-by-class basis. RFR Responses will not be visible (other than by the COA system).

(2) The "Response Time Interval" means the period of time during which responses to the RFR may be entered. The Exchange will determine the length of the Response Time Interval on a class-by-class basis; provided, however, that the duration shall not exceed three (3) seconds.

(iv) Processing of COA-Eligible Orders: At the expiration of the Response Time Interval, COA-eligible orders will be allocated in accordance with subparagraph (v) below or routed in accordance with subparagraph (vi) below.

(v) Execution of COA-Eligible Orders: COA-eligible orders may be executed without consideration to prices of the same complex orders that might be available on other exchanges, and the legs of a COA-eligible order may be executed in one cent increments, regardless of the minimum quoting increments otherwise appropriate to the individual legs of the order. COA-eligible orders will trade first based on the best net price(s) and, at the same net price, will be allocated in the following way:

(1) The individual orders and quotes residing in the EBook shall have first priority to trade against a COA-eligible order provided the COA-eligible order can be executed in full (or in a permissible ratio) by the orders and quotes in the EBook. The allocation of a COA-eligible order against the EBook shall be consistent with the UMA allocation described in Rule 6.45A or 6.45B, as applicable.

(2) Public customer complex orders resting in the COB before, or that are received during, the Response Time Interval and public customer RFR Responses shall, collectively have second priority to trade against a COA-eligible order. The allocation of a COA-eligible order against the public customer complex orders resting in the COB shall be according to time priority.

(3) Non-public customer orders resting in the COB before the Response Time Interval shall have third priority to trade against a COA-eligible order. The allocation of a COA-eligible order against non-public customer orders resting in the COB shall be pursuant to the UMA allocation described in Rule 6.45A or 6.45B, as applicable.

(4) Non-public customer orders resting in the COB that are received during the Response Time Interval and non-public customer RFR responses shall, collectively, have fourth priority. The allocation of a COA-eligible order against these opposing orders shall be consistent with the CUMA allocation described in Rule 6.45A or 6.45B, as applicable.

(vi) Routing of COA-Eligible Orders: If a COA-eligible order cannot be filled in whole or in a permissible ratio, the order (or any remaining balance) will route to the COB or back to PAR, as applicable.

(vii) Firm Quote Requirement for COA-Eligible Orders: RFR Responses represent non-firm interest that can be modified or withdrawn at any time prior to the end of the Response Time Interval. At the end of the Response Time Interval, RFR Responses shall be firm only with respect to the COA-eligible order for which it is submitted, provided that RFR Responses that exceed the size of a COA-eligible order are also eligible to trade with other incoming COA-eligible orders that are received during the Response Time Interval. Any RFR Responses not accepted in whole or in a permissible ratio will expire at the end of the Response Time Interval.

(viii) Handling of Unrelated Complex Orders: Incoming complex orders that are received prior to the expiration of the Response Time Interval for a COA-eligible order (the "original COA") will impact the original COA as follows:

(1) Incoming complex orders that are received prior to the expiration of the Response Time Interval for the original COA that are on the opposite side of the market and are marketable against the starting price of the original COA-eligible order will cause the original COA to end. The processing of the original COA pursuant to subparagraphs (d)(iv)

through (d)(vi) remains the same. For purposes of this Rule, the "starting price," shall mean the better of the original COA-eligible order's limit price or the best price, on a net debit or credit basis, that existed in the EBook or COB at the beginning of the Response Time Interval.

(2) Incoming COA-eligible orders that are received prior to the expiration of the Response Time Interval for the original COA that are on the same side of the market, at the same price or worse than the original COA-eligible order and better than or equal to the starting price will join the original COA. The processing of the original COA pursuant to subparagraphs (d)(iv) through (d)(vi) remains the same with the addition that the priority of the original COA-eligible order and incoming COA-eligible order(s) shall be according to time priority.

(3) Incoming COA-eligible orders that are received prior to the expiration of the Response Time Interval for the original COA that are on the same side of the market and at a better price than the original COA-eligible order will join the original COA, cause the original COA to end, and a new COA to begin for any remaining balance on the incoming COA-eligible order. The processing of the original COA pursuant to subparagraphs (d)(iv) through (d)(vi) remains the same with the addition that the priority of the original COA-eligible order and incoming COA-eligible order shall be according to time priority.

Approved February 28, 2005 (04-45); amended December 22, 2005 (05-95); July 12, 2006 (05-65); December 5, 2007 (07-68); January 9, 2008 (08-01); May 23, 2008 (06-02); August 7, 2008 (08-82); July 24, 2009 (09-038).

*... Interpretations and Policies:*

.01 All pronouncements regarding determinations by the Exchange pursuant to Rule 6.53C and the Interpretations and Policies thereunder will be announced to the membership via Regulatory Circular.

Adopted January 9, 2008 (08-01); amended May 23, 2008 (08-02).

.02 Reserved.

Approved February 28, 2005 (04-45); amended January 9, 2008 (08-01); March 17, 2009 (09-017).

.03 The N-second timer for complex order transactions will be established at the same length as for non-complex order transactions.

Approved February 28, 2005 (04-45); amended January 9, 2008 (08-01).

.04 With respect to the initiation of a COA (as described in Rule 6.53C(d)(ii)), members routing complex orders directly to the COB may request that the complex orders be COA'd on a class-by-class basis and members with resting complex orders on PAR may request that complex orders be COA'd on an order-by-order basis.

Amended July 12, 2006 (05-65); January 9, 2008 (08-01).

.05 A pattern or practice of submitting orders that cause a COA to conclude early will be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1. Disseminating information regarding COA-eligible orders to third parties will be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 and other Exchange Rules.

Amended July 12, 2006 (05-65); January 9, 2008 (08-01).

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\*\*\* CONTINUATION OF INTERRUPTED FAX \*\*\*  
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RECIPIENT INFORMATION:

NAME: Elizabeth M. Murphy, Secretary, Sec. & Exch. Comm'n

COMPANY:

FAX NUMBER: 1-202-772-9324

CONTACT PHONE:

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\*\*\* CONTINUATION OF INTERRUPTED FAX \*\*\*  
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.06 Special Provisions applicable to Stock-Option Orders: (a) Stock Component. The stock portion of a Stock-Option Order shall be electronically executed on the CBOE Stock Exchange (CBSX) consistent with CBSX order execution rules. A Stock-Option Order shall not be executed on the Hybrid System unless the stock leg is executable on CBSX at the price(s) necessary to achieve the desired net price.

(b) Option Component. Notwithstanding the special priority provisions contained in paragraphs (c) and (d) below, the option leg of a Stock-Option Order shall not be executed on the Hybrid System at the Exchange's best bid (offer) in that series if one or more public customer orders are resting at that price on the electronic book, unless the option leg trades with such public customer order(s). The option leg of a Stock-Option Order may be executed in a one-cent increment, regardless of the minimum quoting increment applicable to that series.

(c) Complex Order Book. Stock-Option Orders submitted to the COB will trade in the following sequence: (1) against other Stock-Option Orders in the COB using public customer priority and then time priority; (2) against individual orders or quotes on the Exchange provided the Stock-Option Order can be executed in full (or in a permissible ratio); and (3) against orders or quotes submitted by Market Participants as set forth in subparagraph (c)(ii)(3) of this Rule.

(d) Complex Order Auction. Stock-Option Orders executed via COA shall trade in the sequence set forth in subparagraph (d)(v)(1)-(4) of this Rule except that subparagraph (d)(v)(1) will be applied last in sequence.

(e) N-second Group Timer. The N-second group timer shall not be in effect for Stock-Option Orders.

(f) Stock-Option Orders with More Than One Option Leg. A conversion, reversal or any other complex order with stock that has more than one option leg shall be handled in the same manner as Stock-Option Orders as set forth in paragraph (a) through (e) of this Interpretation and Policy (and all references to Stock-Option Orders shall include such conversion, reversal, or stock-option orders) except that the requirements of paragraph (b) relating to public customer orders will apply only if there are public customer orders resting on the Hybrid System at the Exchange's best bid (offer) in the electronic book for each of the option legs of the conversion, reversal or stock-option order.

Adopted December 5, 2007 (07-68); amended March 17, 2009 (09-017).

.07 In lieu of permitting RFR Responses by Market-Makers with an appointment in the relevant option class and each member acting as agent for orders resting at the top of the COB in the relevant options series ("Qualifying Members") as provided in subparagraph (d)(iii) above, the Exchange may determine on a class-by-class basis to permit RFR Responses by all CBOE Market-Makers and Qualifying Members. All other provisions of the Rule shall apply unchanged.

Adopted June 6, 2008 (08-58).

.08 Price Check Parameters: On a class by class basis, the Exchange may determine (and announce to the membership via Regulatory Circular) that COB will not automatically execute eligible complex orders that are: (a) Market orders if (i) the width between the Exchange's best bid and best offer in any individual series leg is not within an acceptable price range or (ii) the width between the Exchange's best net priced bid and best net priced offer in the individual series legs comprising the complex order is not within an acceptable price range. For purpose of this paragraph (a):

(1) An "acceptable price range" shall be determined by the Exchange (and announced to the membership via Regulatory Circular) on a series by series basis for each series comprising the complex order (or, in the case of subparagraph (a)(ii), based on the sum of each individual series leg of a complex order) and be no less than 1.5 times the corresponding bid/ask differentials for individual series legs in Rule 8.7(b)(iv)(A); and

(2) The senior official in the Control Room or two Floor Officials may grant intra-day relief by widening the acceptable price range.

(3) Such complex orders under this paragraph (a) will be routed on a class by class basis to PAR, BART, or at the order entry firm's discretion to the order entry firm's booth printer.

(4) Notwithstanding paragraph (a) above, if part of a market order may be executed within an acceptable price range, that part of the order will be executed automatically and the part of the order that would execute at a price outside the acceptable price range will be routed as described in subparagraph (a)(3) above.

(b) Market orders that would be executed at a net credit (debit) price after receiving a partial execution at a net debit (credit) price. Such complex orders under this paragraph (b) will be routed on a class by class basis to PAR, BART, or at the order entry firm's discretion to the order entry firm's booth printer.

(c) Market orders that would be executed at a net (debit) price or orders priced at a net credit (debit) price, that consist of at least two series and would result in an execution to:

(1) Buy (sell) a number of call option contracts and sell (buy) the same number or applicable ratio (as determined by the Exchange on a class by class basis) of call option contracts in a series with the same underlying security and expiration date but a higher exercise price; or

(2) Buy (sell) a number of put option contracts and sell (buy) the same number or applicable ratio (as determined by the Exchange on a class by class basis) of put option contracts in a series with the same underlying security and expiration date but a lower exercise price.

(3) Such complex orders under this paragraph (c) will be rejected if these conditions exist when the order is routed to COB. To the extent the parameters under this paragraph (c) are triggered once an order is resting in COB or after an incoming order receives a partial execution, such complex orders will be routed on a class by class basis to PAR, BART, or at the order entry firm's discretion to the order entry firm's booth printer.

Adopted August 20, 2006 (08-83)

# **EXHIBIT C**

**Rule 6.74A. Automated Improvement Mechanism ("AIM")**

Notwithstanding the provisions of Rule 6.74, a member that represents agency orders may electronically execute an order it represents as agent ("Agency Order") against principal interest or against a solicited order provided it submits the Agency Order for electronic execution into the AIM auction ("Auction") pursuant to this Rule.

(a) Auction Eligibility Requirements. A member (the "Initiating Member") may initiate an Auction provided all of the following are met:

- (1) the Agency Order is in a class designated as eligible for AIM Auctions as determined by the Exchange and within the designated Auction order eligibility size parameters as such size parameters are determined by the Exchange;
- (2) if the Agency Order is for 50 contracts or more, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of the NBBO or the Agency Order's limit price (if the order is a limit order);
- (3) if the Agency Order is for less than 50 contracts, the Initiating Member must stop the entire Agency Order as principal or with a solicited order at the better of (A) the NBBO price improved by one minimum price improvement increment, which increment shall be determined by the Exchange but may not be smaller than one cent; or (B) the Agency Order's limit price (if the order is a limit order); and
- (4) at least three (3) Market-Makers are quoting in the relevant series.

(b) Auction Process. Only one Auction may be ongoing at any given time in a series and Auctions in the same series may not queue or overlap in any manner. The Auction may not be cancelled and shall proceed as follows:

(1) Auction Period and Request for Responses (RFRs).

- (A) To initiate the Auction, the Initiating Member must mark the Agency Order for Auction processing, and specify (i) a single price at which it seeks to cross the Agency Order (with principal interest or a solicited order) (a "single-price submission"), or (ii) that it is willing to automatically match as principal the price and size of all Auction responses ("auto-match") in which case the Agency Order will be stopped at the NBBO (if 50 contracts or greater) or one cent/one minimum increment better than the NBBO (if less than 50 contracts). Once the Initiating Member has submitted an Agency Order for processing pursuant to this subparagraph, such submission may not be modified or cancelled.
- (B) When the Exchange receives a properly designated Agency Order for Auction processing, a Request for Responses ("RFR") detailing the side and size of the order will be sent to all members that have elected to receive RFRs.
- (C) The RFR will last for 1 second.
- (D) Each Market-Maker with an appointment in the relevant option class may submit responses to the RFR (specifying prices and sizes). Such responses cannot cross the disseminated Exchange quote on the opposite side of the market.
- (E) Members acting as agent for orders resting at the top of the Exchange's book opposite the Agency Order may submit responses to the RFR (specifying prices and sizes) on behalf such orders. Such responses cannot cross the disseminated Exchange quote on the opposite side of the market, and may not exceed the size of the booked order being represented.

(F) RFR responses shall not be visible to other Auction participants, and shall not be disseminated to OPRA.

(G) The minimum price increment for RFR responses and for an Initiating Member's single price submission shall not be smaller than the minimum price improvement increment established pursuant to subparagraph (a)(3)(A) above.

(H) An RFR response size at any given price point may not exceed the size of the Agency Order.

(I) RFR responses may be modified or cancelled.

2) Conclusion of Auction. The Auction shall conclude at the sooner of (A) through (E) below with the Agency Order executing pursuant to paragraph (3) below.

(A) The end of the RFR period;

(B) Upon receipt by the Hybrid System of an unrelated order (in the same series as the Agency Order) that is marketable against either the Exchange's disseminated quote (when such quote is the NBBO) or the RFR responses;

(C) Upon receipt by the Hybrid System of an unrelated limit order (in the same series as the Agency Order and on the opposite side of the market as the Agency Order) that improves any RFR response;

(D) Any time an RFR response matches the Exchange's disseminated quote on the opposite side of the market from the RFR responses; or

(E) Any time there is a quote lock on the Exchange pursuant to Rule 6.45A(d).

3) Order Allocation. At the conclusion of the Auction, the Agency Order will be allocated at the best price(s) pursuant to the matching algorithm in effect for the class subject to the following:

(A) Such best prices may include non-Auction quotes and orders.

(B) Public customer orders in the book shall have priority.

(C) No participation entitlement shall apply to orders executed pursuant to this Rule.

(D) If an unrelated market or marketable limit order on the opposite side of the market as the Agency Order was received during the Auction and ended the Auction, such unrelated order shall trade against the Agency Order at the midpoint of the best RFR response and the NBBO on the other side of the market from the RFR responses (rounded towards the disseminated quote when necessary).

(E) If an unrelated non-marketable limit order on the opposite side of the market as the Agency Order was received during the Auction and ended the Auction, such unrelated order shall trade against the Agency Order at the midpoint of the best RFR response and the unrelated order's limit price (rounded towards the unrelated order's limit price when necessary).

(F) If the best price equals the Initiating Member's single-price submission, the Initiating Member's single-price submission shall be allocated the greater of one contract or a certain

percentage of the order, which percentage will be determined by the Exchange and may not be larger than 40%. However, if only one Market-Maker matches the Initiating Member's single price submission then the Initiating Member may be allocated up to 50% of the order.

(G) If the initiating Member selected the auto-match option of the Auction, the Initiating Member shall be allocated its full size at each price point until a price point is reached where the balance of the order can be fully executed. At such price point, the Initiating Member shall be allocated the greater of one contract or a certain percentage the remainder of the order, which percentage will be determined by the Exchange and may not be larger than 40%.

(H) If the Auction does not result in price improvement over the Exchange's disseminated price at the time the Auction began, resting unchanged quotes or orders that were disseminated at the best price before the Auction began shall have priority after any public customer order priority and the Initiating Member's priority (40%) have been satisfied. Any unexecuted balance on the Agency Order shall be allocated to RFR responses provided that those RFR responses will be capped to the size of the unexecuted balance and that the Initiating Member may not participate on any such balance unless the Agency Order would otherwise go unfilled.

(I) If the final Auction price locks a customer order in the book on the same side of the market as the Agency Order, then, unless there is sufficient size in the Auction responses to execute both the Agency Order and the booked customer order (in which case they will both execute at the final Auction price), the Agency Order will execute against the RFR responses at one minimum RFR response increment worse than the final Auction price against the Auction participants that submitted the final Auction price and any balance shall trade against the customer order in the book at such order's limit price.

If an unexecuted balance remains on the Auction responses after the Agency Order has been executed and such balance could trade against any unrelated order(s) that caused the Auction to conclude, then the RFR balance will trade against the unrelated order(s).

Approved February 3, 2006 (05-60); amended May 23, 2008 (06-02); July 2, 2008 (08-16); August 5, 2008 (08-79).

**... Interpretations and Policies:**

.01 The Auction may be used only where there is a genuine intention to execute a bona fide transaction.

Approved February 3, 2006 (05-60).

.02 A pattern or practice of submitting unrelated orders that cause an Auction to conclude before the end of the RFR period will be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1. It will also be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 to engage in a pattern of conduct where the Initiating Member breaks-up an Agency Order into separate orders for two (2) or fewer contracts for the purpose of gaining a higher allocation percentage than the Initiating Member would have otherwise received in accordance with the allocation procedures contained in subparagraph (b)(3) above.

Approved February 3, 2006 (05-60).

.03 Initially, and for at least a Pilot Period expiring on July 17, 2010, there will be no minimum size requirement for orders to be eligible for the Auction. During this Pilot Period, the Exchange will submit certain data, periodically as required by the Commission, to provide supporting evidence that, among other things, there is meaningful competition for all size orders and that there is an active and liquid market functioning on the Exchange outside of the Auction mechanism. Any data which is submitted to the Commission will be provided on a confidential basis.

Approved February 3, 2006 (05-60); amended July 14, 2006 (06-64); July 18, 2007 (07-80); July 18, 2008 (08-76); July 17, 2009 (09-051).

.04 Any solicited orders submitted by the Initiating Member to trade against the Agency Order may not be for the account of a Market-Maker assigned to the option class.

Approved February 3, 2006 (05-60).

.05 Any determinations made by the Exchange pursuant to this Rule such as eligible classes, order size parameters and the minimum price increment for RFR responses shall be communicated in a Regulatory Circular.

Approved February 3, 2006 (05-60).

.06 Subparagraph (b)(2)(E) of this rule will be effective for a Pilot Period until July 17, 2010. During the Pilot Period, the Exchange will submit certain data, periodically as required by the Commission, relating to the frequency with which early termination of the Auction occurs pursuant to this provision as well as any other provision, and also the frequency with which early termination pursuant to this provision results in favorable pricing for the Agency Order. Any data which is submitted to the Commission will be provided on a confidential basis.

Approved February 3, 2006 (05-60); amended July 14, 2006 (06-64); July 18, 2007 (07-80); July 18, 2008 (08-76); July 17, 2009 (09-051).

.07 Complex orders may be executed through the Auction at a net debit or net credit price provided the Auction eligibility requirements in paragraph (a) of this Rule 6.74A are satisfied and the Agency Order is eligible for the Auction considering its complex order type, order origin code (i.e., non-broker-dealer public customer, broker-dealers that are not Market-Makers or specialists on an options exchange, and/or Market-Makers or specialists on an options exchange), class, and marketability as determined by the Exchange. Order allocation will be the same as in paragraph (b)(3), provided that the complex order priority rules applicable to bids and offers in the individual series legs of a complex order contained in Rule 6.53C(d) or 6.53C.06, as applicable, will continue to apply.

Adopted April 3, 2008 (08-14)

.09 In lieu of the procedures in paragraphs (a) through (b) above, an Initiating Member may enter an Agency Order for the account of a non-broker-dealer customer paired with a solicited order for the account of a non-broker-dealer customer and such paired orders will be automatically executed without an Auction Period provided the execution price is in the applicable standard increment and will not trade through the NBBO or at the same price as any resting customer order, and provided further that:

(a) the Agency Order is in a class designated as eligible for AIM customer-to-customer immediate crosses as determined by the Exchange and within the designated Auction order eligibility size parameters as such size parameters are determined by the Exchange; and

(b) if the Exchange determines on a class-by-class basis to (i) designate complex orders as eligible for AIM customer-to-customer immediate crosses or (ii) permit orders of 500 or more contracts and that have a premium value of at least \$150,000 to be executed without considering prices that might be available on other options exchanges, then the NBBO condition shall not apply to such orders and instead the execution price will not trade through the Exchange's BBO.

Rules 6.45A.01 and 6.45B.01 prevent an order entry firm from executing agency orders to increase its economic gain from trading against the order without first giving other trading interests on the Exchange an opportunity to either trade with the agency order or to trade at the execution price when the member was already bidding or offering on the book. However, the Exchange recognizes that it may be possible for a firm to establish a relationship with a customer or other person to deny agency orders the opportunity to interact on the Exchange and to realize similar economic benefits as it would achieve by executing agency orders as principal. It would be a violation of Rule 6.45A.01 or 6.45B.01, as applicable, for a firm to circumvent Rule 6.45A.01 or 6.45B.01, as applicable, by providing an opportunity for (i) a customer affiliated with the firm, or (ii) a customer with whom the firm has an arrangement that allows the firm to realize similar economic benefits from the transaction as the firm would achieve by executing agency orders as principal, to regularly execute

against agency orders handled by the firm immediately upon their entry as AIM customer-to-customer immediate crosses.

Adopted March 17, 2008 (08-19); amended August 20, 2009 (09-040).

# **EXHIBIT D**

Release No. 18523, Release No. 34-18523, 24 S.E.C. Docket 1036, 1982 WL 523516 (S.E.C. Release No.)

Securities and Exchange Commission (S.E.C.)

SECURITIES EXCHANGE ACT OF 1934

In the Matter of Petition of  
BOARD OF TRADE OF THE CITY OF CHICAGO  
and  
CHICAGO MERCANTILE EXCHANGE  
For Stay of Order Approving Rule  
Changes of the American Stock  
Exchange, Inc. and the Chicago  
Board Options Exchange, Incorporated

File Nos: SR-Amex-81-1 SR-CBOE-81-27

March 3, 1982

ORDER DENYING STAY

On January 25, 1982, the Board of Trade of the City of Chicago ('CBOT') and the Chicago Mercantile Exchange ('CME') ('Petitioners') applied to the Securities and Exchange Commission (the 'Commission') for a stay<sup>[FN1]</sup> pending judicial review of a Commission order approving,<sup>[FN2]</sup> pursuant to Section 19(b)(2) of the Securities Exchange Act of 1934 (the 'Exchange Act'), proposed rule changes submitted by the American Stock Exchange, Inc. ('Amex') (SR-Amex-81-1) and the Chicago Board Options Exchange, Incorporated ('CBOE') (SR-CBOE-81-27) to establish markets for trading standardized put and call options on certain United States Treasury securities ('Treasury options').<sup>[FN3]</sup> On February 22, 1982, the Commission received a submission from Amex urging denial of the petition for a stay. After reviewing the foregoing submissions as well as the record underlying its approval order, the Commission has determined, for the reasons discussed below, that the request for a stay should be denied.

**I. Background**

The Amex and CBOE proposals to trade options on Treasury securities were submitted on March 4, 1981, and April 17, 1980, respectively. As required under Section 19(b)(2) of the Exchange Act, the Commission published the proposals and all substantive amendments for public comment.<sup>[FN4]</sup> The Commission also issued a release discussing various aspects of the proposals and identifying for commentators a number of specific issues raised.<sup>[FN5]</sup> In addition, letters were sent to the Commodity Futures Trading Commission ('CFTC'), the Federal Reserve Bank of New York ('FRB-NY'), the Board of Governors of the Federal Reserve System ('FRB'), and the U.S. Department of the Treasury ('Treasury') specifically inviting the views of those agencies.<sup>[FN6]</sup>

The Commission received comments from the FRB-NY, the FRB, and the Treasury, as well as from major brokerage firms, endorsing the concept of exchange trading of Treasury options as an effective and efficiently-priced means of hedging against the risks associated with changes in interest rates.<sup>[FN7]</sup> Moreover, the FRB-NY and the FRB stated that properly regulated Treasury options markets could be expected to improve the efficiency and liquidity of the cash market for Treasury instruments. On the basis of these comments and its own evaluation of the Amex

and CBOE proposals, the Commission concluded that the proposed rules governing the marketing and trading of Treasury options and the specific terms of the proposed Treasury options contracts are consistent with the requirements of the Exchange Act applicable to national securities exchanges and, in particular, Section 6 and the rules and regulations thereunder.

\*2 In the course of evaluating the Amex and CBOE proposals, the Commission also received comment letters from the CFTC and from the Petitioners stating that the Commission lacks the statutory authority to regulate the proposed Treasury options markets and that, in any event, the Commodity Exchange Act prohibits Commission approval of the trading of such options.<sup>[FN8]</sup> The Commission gave careful consideration to the views expressed by these commentators. In addition, the Commission considered elaborations of these legal arguments presented in the briefs of the CBOT, as petitioner, and the CFTC, *amicus curiae*, in Board of Trade of the City of Chicago v. Securities and Exchange Commission and the Chicago Board Options Exchange, Incorporated, Civil No. 81-1660 (7th Cir., filed April 24, 1981) ('GNMA options litigation'),<sup>[FN9]</sup> which challenges the Commission order approving a proposed CBOE rule change to establish a market for trading options on Government National Mortgage Association pass-through securities ('GNMA options').<sup>[FN10]</sup> For the reasons set forth in the Commission's order approving the Amex and CBOE Treasury options proposals,<sup>[FN11]</sup> as amplified in the Commission's answering brief in the GNMA options litigation,<sup>[FN12]</sup> the Commission concluded that it has authority to approve proposed rule changes by national securities exchanges that provide for the trading of options on U.S. Treasury securities and to regulate that trading, and that nothing in the CEA restricts that authority. The Treasury options approval order also indicates that, in the Commission's view, its approval of the Treasury options proposals is consistent with the agreement reached between the Commission and the CFTC with respect to a number of jurisdictional issues, which specifies that the Commission has jurisdiction over exchange-traded options on exempted securities, even if those exempted securities are, for other purposes, commodities under the CEA.<sup>[FN13]</sup>

## II. Discussion

In requesting a stay pending judicial review of the Commission's order approving the Amex and CBOE Treasury options proposals, Petitioners argue that the failure to stay the commencement of trading would result in irreparable harm to the Petitioners and that the public interest requires that a stay be granted. The Amex, in its submission opposing the Petitioners' request for a stay, argues that Petitioners do not raise any legal impediments to Commission approval of the Treasury options proposals that previously have not been addressed by the Commission, and that the SEC-CFTC jurisdictional accord precludes the possibility of prejudice to investors.

The Commission has broad discretion to grant a stay of a rule or order under Section 25(c)(2) of the Exchange Act when 'it finds that justice so requires.'<sup>[FN14]</sup> In applying this standard, the Commission generally has considered requests for a stay in light of the traditional criteria for an equitable stay.<sup>[FN15]</sup> In deciding whether or not to issue stays, courts traditionally have applied four criteria: (A) whether the issuance of a stay would be likely to serve the public interest; (B) whether the petitioner has shown that, without a stay, he will suffer irreparable injury; (C) whether there would be substantial harm to other parties if a stay were granted; and (D) whether the petitioner has made a strong showing that he is likely to prevail on the merits.<sup>[FN16]</sup>

### A. Whether the issuance of a stay would be likely to serve the public interest

\*3 Petitioners contend that permitting the Amex and CBOE to commence trading in Treasury options without a 'definitive resolution' of the Commission's authority to authorize such a market 'would be dangerous to the public investor and the public interest.'<sup>[FN17]</sup> To the contrary, the Commission believes that allowing the Amex and CBOE markets to go forward is consistent with the public interest.

In the course of its consideration of the Treasury options proposals, the Commission received a number of comment letters endorsing the concept of options on Treasury instruments as a useful device to be utilized by interest rate sensitive enterprises to hedge against the risks associated with adverse interest rate movements.<sup>[FN18]</sup> A stay would operate contrary to the public interest by depriving market participants of the opportunity to utilize such options as a component of an investment or business strategy for the management of interest rate risk. In addition, as noted

above, the FRB-NY and FRB have stated that a properly regulated Treasury options market could improve the efficiency and liquidity of the cash market for Treasury Securities. Accordingly, a stay would deprive participants in those markets of any benefits that may accrue from options trading.

Moreover, the Commission cannot concur with Petitioners' suggestion that permitting trading prior to the resolution of the litigation would result in injury to public investors as the result of subsequent judicial action. Petitioners' assumption of harm to investors appears to rest, in large part, on the possibility that the Treasury options market could be closed down as the result of an adverse judicial decision.<sup>[FN19]</sup> As the Commission noted, however, in its response opposing the CBOT's motion for a stay in the GNMA options litigation, a court has general equitable powers by which it can prescribe an orderly method for the termination of options trading.<sup>[FN20]</sup> Accordingly, were it to become necessary to terminate trading in Treasury options (which the Commission views as unlikely<sup>[FN21]</sup>), a court would have a number of feasible alternatives which would permit the market to be closed without excessive disruption.<sup>[FN22]</sup>

In addition, public participants in the Treasury options markets will be able to evaluate fully the potential effects of a subsequent adverse judicial decision prior to entering into a Treasury options transaction based upon the disclosure provided by the Treasury options prospectus.<sup>[FN23]</sup> If the risks are perceived to outweigh the benefits, individuals or institutions can refrain from participating in those markets.<sup>[FN24]</sup>

**B. Whether the Petitioners have shown that, without a stay, they will suffer irreparable injury**

Petitioners claim that their markets and, in turn, futures market participants will suffer irreparable harm if trading in Treasury options commences prior to a final resolution of the jurisdictional issues that they have raised.<sup>[FN25]</sup> Specifically, Petitioners assert that the absence of such a resolution would have an adverse impact on the options markets, and contend that because of a claimed pricing relationship between options and futures on Treasury instruments 'any dysfunction in the pricing and trading of options arising from the risks and uncertainties surrounding the markets will affect the operations of the futures markets.'<sup>[FN26]</sup>

\*4 The Commission does not believe, however, that the Petitioners' claims of irreparable harm are persuasive. First, Petitioners fail to substantiate their claims that the alleged legal uncertainties would have an effect on the options market. Absent such evidence, it is not at all clear to the Commission that any legal uncertainties generated by the Petitioners' litigation, in fact, would create any pricing 'dysfunction' in the options market. Prior to engaging in an options transaction customers will be informed by means of the Treasury options prospectus of the pending legal proceedings. The Commission believes that, rather than participate in the market on the basis of discounted prices, persons harboring uncertainties concerning legality of the market likely would refrain from trading Treasury options.<sup>[FN27]</sup> Secondly, even assuming that Petitioners' assertions of illegality do create a pricing dysfunction in the Treasury options market, any such impact on the pricing mechanism should be confined to the options market. In the futures market, which is not subject to the alleged legal uncertainties, prices should remain unaffected.

Petitioners also assert that if the options markets subsequently are closed due to judicial action, 'substantial disruptions of the futures markets will occur.'<sup>[FN28]</sup> In particular, Petitioners contend that a finding of illegality would require options market participants with corresponding futures positions immediately to readjust their futures positions, which Petitioners seem to suggest will have an adverse effect on the operations of the futures market. The Commission questions, however, whether the 'substantial disruptions' alleged by the Petitioners would occur. First, the Commission questions whether the basis for Petitioners' allegations is valid.<sup>[FN29]</sup> In addition, even if Petitioners' contention were valid, a court, as discussed previously,<sup>[FN30]</sup> has general equitable power by which it can provide for an orderly termination of trading. By allowing for the orderly winding down of options trading any potentially disruptive impact on the futures market could be further minimized. Finally, the Commission notes that a stay will be issued by a court only if the harm threatened is irreparable.<sup>[FN31]</sup> Based on the foregoing, the Commission believes that the harm conjectured by the Petitioners is both highly speculative and, if true, of minimal significance. Accordingly, it does not view the contentions of the Petitioners as providing a sufficient basis for the stay.

C. Whether there would be substantial harm to other interested parties if a stay were granted

As previously discussed, several commentators have indicated that investors would find the proposed Treasury options to be extremely useful.<sup>[FN32]</sup> If, as projected, the proposed Treasury options markets would attract significant participation, a stay of the commencement of the Amex and CBOE programs would prevent both exchanges from entering potentially lucrative markets.

\*5 A stay also would have certain anti-competitive consequences. The Amex's and CBOE's Treasury options proposals were filed in March 1981 and April 1980, respectively, whereas one of the Petitioners, CBOT, only recently filed with the CFTC for authorization to trade an option on Treasury bond futures contracts.<sup>[FN33]</sup> Because Treasury options likely would compete with options on futures on the same underlying instruments as financial risk management devices, a stay would penalize the initiative of the Amex and CBOE if the CFTC were to approve the CBOT proposal in the near future by depriving both exchanges of the opportunity to compete with the CBOT.<sup>[FN34]</sup>

D. Likelihood that the Petitioners Will Prevail on the Merits

Petitioners maintain that the Commission lacks authority under the securities laws to approve and regulate trading in Treasury options, and that, under the CEA, the jurisdiction of the CFTC over Treasury options is exclusive. As discussed in the Commission's answering brief in the GNMA options litigation,<sup>[FN35]</sup> approval of a proposal by a national securities exchange to establish a market for trading options on a security is a proper exercise of the Commission's comprehensive regulatory authority under the Exchange Act. Moreover, the Commission's authority in this area, which extends to options on Treasury securities, is unimpaired by the CFTC's exclusive jurisdiction over commodity futures trading.

Briefly summarized, the Commission's supervisory authority over registered national securities exchanges encompasses the authority to approve or disapprove all proposed rule changes of an exchange relating to activities conducted in its capacity as a national securities exchange.<sup>[FN36]</sup> This includes review of all proposed rule changes relating to trading in any type of security. Debt obligations issued by the U.S. Department of the Treasury are securities under the Exchange Act.<sup>[FN37]</sup> In addition, standardized options contracts on U.S. Treasury securities, which convey to the purchaser the right to purchase or sell specific U.S. Treasury securities within a prescribed time period are themselves separate securities under the Exchange Act.<sup>[FN38]</sup> Accordingly, approval of exchange rules to accommodate the listing and trading of options on Treasury securities clearly is within the Commission's authority.<sup>[FN39]</sup>

The Commission also rejects Petitioner's contention that the CFTC has jurisdiction over Treasury options. While Treasury securities are 'commodities' under the CEA by virtue of CFTC authorization of trading in contracts for future delivery with respect to such instruments,<sup>[FN40]</sup> this designation does not deprive such instruments of their status as 'securities.' Although the CFTC is given broad authority with respect to the regulation of certain types of instruments,<sup>[FN41]</sup> in certain areas its jurisdiction is carefully circumscribed by specific provisions of the CEA. In particular, in order to preclude the CFTC from exercising its authority in areas where Congress believed it was unnecessary, the 1974 amendments to the CEA included the so-called 'exclusionary sentence' in Section 2(a)(1), which provides that nothing in the CEA shall be deemed to govern or in any way be applicable to transactions in certain specified instruments unless such transactions 'involve the sale thereof for future delivery conducted on a board of trade.' Among the instruments specified in this provision are 'security rights' and 'government securities.' Thus, the exclusionary sentence eliminates the possibility that the CEA could apply to options on Treasury securities. Moreover, to ensure that the expanded powers of the CFTC did not infringe on the authority of the Commission, Congress provided that, with the exception of matters over which the CFTC has exclusive jurisdiction, 'nothing contained in this [Section 2(a)(1)] shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission . . . , or (ii) restrict [it] . . . from carrying out [its] duties and responsibilities . . . .' Largely on the basis of the foregoing statutory language, the Commission has concluded that Congress did not intend to remove the regulation of standardized put and call options contracts traded on a national securities exchange from the jurisdiction of the Commission.<sup>[FN42]</sup>

III. Conclusion

\*6 It appears to the Commission that the public interest, as well as the interests of Amex and CBOE, will be adversely affected if a stay is granted. Moreover, in the view of the Commission, Petitioners have not shown that they or their markets would suffer irreparable harm if a stay is not granted. Finally, Petitioners have not demonstrated a sufficient likelihood of prevailing on the merits. Accordingly, the Commission finds that in this instance justice does not require a stay.

IT IS THEREFORE ORDERED, pursuant to Section 25(c)(2) of the Act, that the application of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange, filed on January 25, 1982, for a stay of the Commission's order of December 23, 1981, approving the rule changes of the American Stock Exchange, Inc. and the Chicago Board Options Exchange, Incorporated be, and it hereby is, denied.

By the Commission.

George A. Fitzsimmons  
Secretary

FN1 Request of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange for a Stay of the Commission's Order Approving Proposed Rule Changes, SEA Release No. 18371. ('Petitioners' Request for a Stay') The Petitioners also filed a supplemental memorandum in support of their initial request. Supplemental Memorandum in Support of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange's Request that the Commission Stay Its Order Approving Trading in Options on Treasury Instruments (February 8, 1982).

FN2 Securities Exchange Act Release No. 18371 (December 23, 1981), 46 FR 63423 (December 31, 1981).

FN3 On January 21, 1982, Petitioners filed with the United States Court of Appeals for the Seventh Circuit a petition for review of the Treasury options approval order. Board of Trade of the City of Chicago and Chicago Mercantile Exchange v. Securities and Exchange Commission. In their petition for review, Petitioners assert that the Commission lacks authority under both the securities laws and the Commodity Exchange Act ('CEA') to approve the Amex and CBOE proposals, and requested that the Commission's order be set aside or that the proceedings be remanded to the Commission with instructions to modify the order.

FN4 With respect to the Amex proposal, see Securities Exchange Act Release Nos. 17632 (March 16, 1981) (46 FR 17936 (March 20, 1981)); 17944 (July 16, 1981) (46 FR 37582 (July 21, 1981)); and 18266 (November 17, 1981) (46 FR 57795 (November 25, 1981)). With respect to the CBOE proposal, see Securities Exchange Act Release Nos. 17325 (November 21, 1980) (45 FR 79612 (December 1, 1980)); 18039 (August 17, 1981) (46 FR 42390 (August 20, 1981)); 18090 (September 10, 1981) (46 FR 47335 (September 25, 1981)); and 18293 (November 30, 1981) (46 FR 59682 (December 7, 1981)).

FN5 Securities Exchange Act Release No. 17795 (May 11, 1981) (46 FR 27430 (May 19, 1981)).

FN6 Letters from Douglas Scarff, Director, Division of Market Regulation, to James A. Culver, Director, Division of Economics and Education, CFTC; Stephen H. Axilrod, Director, Office of Staff Director for Monetary and Financial Policy, FRB; Peter D. Sternlight, Manager for Domestic Operations, System Open Market Account, FRB-NY; and Roger W. Mehle, Assistant Secretary-Domestic Finance, Treasury, dated May 11, 1981.

FN7 Letters to Douglas Scarff, Director, Division of Market Regulation, from Peter D. Sternlight, Senior Vice President, FRB-NY (August 6, 1981); Stephen H. Axilrod, Staff Director for Monetary and Financial Policy, FRB (September 18, 1981); and Roger W. Mehle, Assistant Secretary (Domestic Finance), Treasury (June 22, 1981). Letters to George A. Fitzsimmons, Secretary, SEC, from William A. Schreyer, Chairman, Merrill Lynch (July 1,

1981), and George M. Bollenbacher, Vice President, Paine Webber (June 9, 1981). File Nos. SR-Amex-81-1 and SR-CBOE-80-7.

FN8 Letter to Douglas Scarff, Director, Division of Market Regulation, from James A. Culver, Director, Division of Economics and Education, CFTC (August 24, 1981), and letters to George A. Fitzsimmons, Secretary, SEC, from Robert K. Wilmouth, President, CBOT (June 30, 1981); Mahlon M. Frankhauser, Kirkland and Ellis, counsel for the CBOT (September 1, 1981 and October 16, 1981); and Clayton Yeutter, President, CME (October 16, 1981).

FN9 The CFTC's amicus brief in the GNMA options litigation is incorporated by reference in its comment letter on the Treasury options proposals. See footnote 8, supra. Similarly, the Petitioners cite to the legal arguments advanced in the GNMA option litigation in their request for a stay. See footnote 1, spra.

FN10 The CBOT also has petitioned the Court of Appeals for the Seventh Circuit for review of, and to suspend and to set aside, an order of the Commission approving a proposed rule change of the Options Clearing Corporation ("OCC") relating to the issuance, clearance, exercise and settlement of exchange-traded GNMA options contracts. Board of Trade of the City of Chicago v. Securities and Exchange Commission and Options Clearing Corporation and the Chicago Board Options Exchange, Incorporated, Civil No. 81-2587 (7th Cir., filed October 5, 1981).

FN11 Securities Exchange Act Release No. 18371, at 3, footnote 7.

FN12 Answering Brief of the SEC, Respondent (August 28, 1981). The Commission takes notice of this brief in connection with its consideration of Petitioners' request for a stay.

FN13 See Joint Press Releases of the SEC and the CFTC (December 7, 1981 and February 2, 1982).

FN14 See Allan v. Securities and Exchange Commission, 577 F.2d 388 (7th Cir. 1978).

FN15 See, e.g., In re Board Brokers Association, Securities Exchange Act Release No. 15620 (March 7, 1979), 16 SEC Docket 1278 (March 20, 1979).

FN16 Washington Metropolitan Area Transit Commission v. Holiday Tours, Inc., 559 F.2d 841, 842-43 (C.A. D.C. Cir. 1977); Taylor Diving & Salvage Co. v. United States Department of Labor, 537 F.2d 819, at 821, footnote 8 (5th Cir. 1976); Associated Securities Corp. v. Securities and Exchange Commission, 283 F.2d 773, 774-75 (10th Cir. 1960); Eastern Air Lines v. Civil Aeronautics Board, 281 F.2d 830 (2d Cir. 1958); Virginia Petroleum Jobbers Association v. Federal Power Commission, 259 F.2d 921, 925 (D.C. Cir. 1958).

FN17 Petitioners' Request for a Stay, at 3-4.

FN18 See Amex, The Amex Plan for Trading Options on U.S. Treasury Department Securities; CBOE, A Market for Options on Government Securities; letters to George A. Fitzsimmons, Secretary, SEC, from William A. Schreyer, Chairman, Merrill Lynch (July 1, 1981) and George M. Bollenbacher, Vice President, Paine Webber (June 9, 1981); and comment letter of Ross M. Starr, Hedging Interest Rate Risks With Bond Options Markets (June 19, 1981) File Nos. SR-Amex-81-1 and SR-CBOE-80-7.

FN19 In this regard it should be noted that, on February 16, 1982, the CFTC issued proposed Regulation 34.1 under the CEA to remove the applicability of CFTC regulations with respect to options on certain instruments traded on national securities exchanges. Assuming that the Commission properly exercised its authority under the Exchange Act, the adoption of this proposed regulation would remove the possibility that the commodities laws would require a halt of Treasury options trading.

FN20 See Response of the Securities and Exchange Commission to Petitioner's Motion for a Stay Pending Review, or, in the Alternative, Motion for Expedited Hearing and Decision, at 5-6 (August 13, 1981). The Commission takes notice of this document.

FN21 See pp. 15-18, *infra*, for a discussion of the Commission's conclusion that the Petitioners are unlikely to prevail on the merits.

FN22 For example, a court could order trading for liquidation only, which would enable market participants to unwind their options positions in the marketplace at any time prior to the expiration of their options contracts. Alternatively, a court, by analogy, could apply the procedure utilized by the options exchanges to delist options on underlying securities that no longer qualify for options trading. This solution would permit trading to continue in existing options series, but would prohibit the opening of new series. See, e.g., CBOE Rule 5.4.

FN23 At or prior to the time the account of a customer is approved for trading in Treasury options, the customer must be furnished with a Treasury options prospectus which will include a discussion of the risks associated with such instruments, including the specialized risks raised by the litigation initiated by the Petitioners. See Amex Rule 926 and CBOE Rule 21.21.

FN24 Petitioners also cite as contrary to the public interest a possible proliferation of litigation based upon the illegality of the market under the CEA. Because the Commission is of the view that Petitioners are unlikely to prevail on the merits, Petitioners' concerns in this regard appear to be unfounded. In addition, if the CFTC adopts its proposed Regulation 34.1, litigation based on the application of the CEA to the trading of Treasury options on national securities exchanges would appear to be foreclosed.

FN25 The CBOT is designated as a contract market for trading futures contracts on Treasury bonds and notes and has applied to the CFTC for designation as a contract market for trading options on Treasury bond futures. The CME is designated as a contract market for trading futures contracts on Treasury notes and bills.

FN26 Petitioners' Motion for a Stay, at 4-5.

FN27 In this regard the Commission notes the availability of alternative leveraged investment and hedging instruments.

FN28 Petitioners' Motion for a Stay, at 5.

FN29 For example, Petitioners cite as a possible source of disruption open arbitrage transactions where one side of the transaction becomes void or voidable. Intermarket arbitrageurs or other futures market participants involved in the Treasury options market, however, could be expected to establish both long and short options positions in both puts and calls. Accordingly, in the event that an adverse judicial decision with respect to the options market would require an unwinding of futures positions, the existence of both long and short corresponding futures positions should minimize the impact on the futures market.

FN30 See text at footnote 22, *supra*.

FN31 As stated in Virginia Petroleum Jobbers Association v. Federal Power Commission, 259 F.2d 921, 925 (D.C. Cir. 1958):

Mere injury, however substantial, in terms of money, time and energy necessarily expended in the absence of a stay, are not enough. The possibility that adequate compensatory or other corrective relief will be available at a

later date, in the ordinary course of litigation, weighs heavily against a claim of irreparable harm.

FN32 See text at footnote 7, supra.

FN33 Rules to accommodate the trading of options on futures contracts on boards of trade were approved by the CFTC on October 28, 1981 (46 FR 54500, November 3, 1981).

FN34 Historical experience both in the options and futures markets suggests that existence of a successful market in terms of offering a viable product in a liquid trading environment acts as a substantial barrier to the entry of a competing market offering the same or a substantially identical product. See Report of the Special Study of the Options Markets to the Securities and Exchange Commission, H.R. Rep. IFC3, 96th Cong., 1st Sess., at 853 (Comm. Print 1978), and Silver, William L., 'Innovation, Competition and New Contract Design in Futures Markets,' J. of Futures Markets, at 145 (1981).

FN35 See Answering Brief of the SEC, Respondent (August 28, 1981).

FN36 Section 19(b)(2) of the Exchange Act requires the Commission to approve a proposed rule change if it is 'consistent with the requirements of [the Exchange Act] and the rules and regulations thereunder.' The substantive standards for evaluation of a proposed rule change of a national securities exchange are set forth primarily in Section 6(b) of the Exchange Act which, among other things, requires that an exchange's rules be designed to protect investors and the public interest, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to remove impediments to a free and open market and a national market system. In addition, an exchange's rules must not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers or to impose any burdens on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

FN37 Section 3(a)(10) of the Exchange Act provides that the term 'security' includes and 'any note . . . bond [or] debenture' without qualification with respect to the issuer. That such debt obligations are backed by the full faith and credit of the United States and therefore are 'exempted securities' under Section 3(a)(12) of the Exchange Act does not alter their status as securities.

FN38 As provided in Section 3(a)(10) of the Exchange Act the definition of 'security' encompasses 'any warrant or right to subscribe to or purchase' any security. On the basis of this language courts consistently have concluded that 'call' options are securities. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 750-51 (1975); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1026 n. 40 (6th Cir. 1979); Lutgert v. Vanderbilt Bank, 508 F.2d 1035, 1038 (5th Cir. 1975); Lloyd v. Industrial Bio-Test Laboratories, Inc., 454 F. Supp. 807, 810-11 (S.D.N.Y. 1978). 'Put' options also are considered securities under the securities laws. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751 (1975). See generally Loss, Securities Regulation (Vol. I) 469 (2d ed. 1961) (both put and call options on securities are subsumed under "interest or instrument commonly known as a 'security'" in statutory definition.) See also Securities Exchange Act Rule 3a11-1 (17 CFR § 240.3a11-1 (1980)) which defines the term 'equity security' to include 'any put, call, straddle, or other option or privilege of buying . . . a security from or selling . . . a security to another without being bound to do so.'

FN39 Moreover, Section 9(f) of the Exchange Act does not, as Petitioners contend, alter the Commission's responsibility for reviewing such proposed rule changes. By its terms, Section 9(f) limits Commission authority only with respect to the direct rulemaking powers granted under Section 9 and does not alter the Commission's authority to review exchange rule proposals lawfully submitted pursuant to Section 19(b) of the Act. See S. Rep. No. 75, 94th Cong., 1st Sess. at 22-23 (1975).

FN40 Section 2(a)(1) of the CEA defines the term 'commodity' to include 'all services, rights, and interests in

which contracts for future delivery are presently or in the future dealt in.'

FN41 Section 2(a)(1) defines as 'exclusive' the CFTC's jurisdiction over agreements (including options) and transactions that involve contracts of sale of a commodity for future delivery. Section 4c(b) grants to the CFTC plenary authority to regulate options trading involving certain commodities regulated under the CEA.

FN42 The Commission's conclusions in this regard are reinforced by statements in the legislative history. See, e.g., Report of the Senate Comm. on Agriculture and Forestry to Accompany H.R. 13113, S. Rep. No. 93-1131, 93d Cong., 2d Sess. 23 (1974) where it is stressed that '[w]hile the Committee did wish the jurisdiction of the Commodity Futures Trading Commission to be exclusive with regard to the trading of futures on organized contract markets, it did not wish to infringe on the jurisdiction of the Securities and Exchange Commission . . . .'

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