

RAN-01-12
February 15, 2001

TO: All PCX Members and Member Organizations

FROM: Department of Regulatory Policy

**SUBJECT: Interim Intermarket Options Linkage
(File No. SR-PCX-01-10)**

On February 5, 2001, the Exchange filed a rule change proposal with the SEC that would allow the Exchange to participate in the Interim Intermarket Linkage Program with the other options exchanges that are participating in the Program. This rule change became effective upon filing with the SEC. However, the PCX believes that the Program will not be ready for implementation for at least 30 days.

The rule change will allow PCX Lead Market Makers to send option orders to other option exchanges for automatic execution on those exchanges' automatic execution systems, subject to the terms and conditions of the rule change. This interim linkage would utilize existing systems to facilitate the sending and receiving of order flow between PCX Market Makers and their counterparts on the other option exchanges as an interim step towards development of a "permanent" linkage.

The SEC has approved a linkage plan that now includes all five option exchanges. The option exchanges continue to work towards implementation of this linkage. However, because the implementation may take a significant amount of time, the option exchanges have discussed implementing an "interim" linkage. Such a linkage would use the existing market infrastructure to route orders between Market Makers on the participating exchanges in a more efficient manner.

The key component of the interim linkage would for the participating exchanges to open their automated customer execution systems, on a limited basis, to Market Maker orders. Specifically, Market Makers would be able to designate certain orders as "customer" orders, and thus would receive automatic execution of those orders on participating exchanges.

The rule change authorizes the PCX to implement bilateral or multilateral interim arrangements with the other exchanges to provide for equal access between Market Makers on our respective exchanges. The Exchange currently anticipates that the initial arrangements would allow PCX Designated Lead Market Makers ("LMMs") and their equivalents on the other exchanges, when they are holding customer orders, to effectively send those orders to the other market for

execution when the other market has a better quote. Such orders would be limited in size to the lesser of the size of the two markets' automatic execution size for customer orders.

All interim linkage orders must be "immediate or cancel" (that is, they cannot be placed on an exchange's limit order book), and a Market Maker may send a linkage order only when the other (receiving) market is displaying the national best bid or offer and the sending market is displaying an inferior price. This will allow a Market Maker to access the better price for its customer. In addition, if the interim linkage includes principal orders, it would allow Market Makers to attempt to "clear" another market displaying a superior quote. Any exchange participating in the interim linkage will implement heightened surveillance procedures to help ensure that their Market Makers send only properly-qualified orders through the linkage.

LMM participation in the interim linkage will be voluntary. Only when an LMM and its equivalent on another exchange believe that this form of mutual access would be advantageous will the exchanges employ the interim linkage procedures. The rule change is intended to benefit investors and to provide a useful experience that will help the exchanges in implementing the full linkage.

Following is the text of the rule change. Questions regarding this bulletin may be directed to Michael Pierson at (415) 393-4107.

Text of the Rule Change:¹

**RULES OF THE BOARD OF GOVERNORS
OF THE PACIFIC EXCHANGE, INC.**

INTERIM INTERMARKET LINKAGE PROGRAM

RULE 6.91 *Pilot Program for Away Market Maker Access.*

(a) *Definitions.* Solely for the purpose of this Rule:

(1) "*Corresponding Rule*" means a rule of a Participating Exchange that is substantially identical to this Rule 6.91.

(2) "*Customer Size*" means the lesser of (i) the number of option contracts that the Participating Exchange sending the order guarantees it will automatically execute at its disseminated quotation in an Eligible Option Class for Public Customer Orders and (ii) the number of option contracts that the Participating Exchange receiving the order

¹ New text is underscored.

guarantees it will automatically execute at its disseminated quotation in an Eligible Option Class for Public Customer Orders. This number will be no fewer than 10.

(3) “Eligible Away Market Maker” (“EAMM”) means, with respect to an Eligible Option Class, a market maker, as that term is defined in Section 3(a)(22) of the Exchange Act, on a Participating Exchange that:

(i) is assigned to, and is providing two-sided quotations in the Eligible Option Class; and

(ii) that is participating in its market’s automatic execution system in such Eligible Option Class.

(4) “Eligible Away Principal Market Maker” (“EAPMM”) means: with respect to the American Stock Exchange and the Philadelphia Stock Exchange, a Specialist in an Eligible Option Class; with respect to the Chicago Board Options Exchange, a Designated Primary Market Maker in an Eligible Option Class; and with respect to the International Securities Exchange, a Primary Market Maker in an Eligible Option Class.

(5) “Eligible Option Class” means all option series overlying a security, including both put and call options, which class is traded by the Exchange and at least one other Participating Exchange, to the extent that such Participating Exchanges have mutually agreed to include the option class in the Pilot Program.

(6) “Eligible Order” means an order for the account of a Lead Market Maker, an EAMM or an EAPMM that can be sent to a Participating Exchange marked as a Public Customer Order pursuant to subsections (b), (c) and (d) of this Rule.

(7) “Participating Exchange” means (i) the Exchange and (ii) one or more of the American Stock Exchange, the Chicago Board Options Exchange, the International Securities Exchange, and the Philadelphia Stock Exchange, as the Chairman of the Exchange, or his designee, has designated from time to time as having adopted a Corresponding Rule.

(8) “Pilot Program” means the program established by this Rule and the Corresponding Rules of the other Participating Exchanges.

(9) “Principal Size” means the number of option contracts that two or more Participating Exchanges mutually agree that they will automatically execute during the Pilot Program at their disseminated quotation for orders sent for the principal account of a market maker, an EAMM or an EAPMM that does not correspond to an Underlying Customer Order. This number will be no fewer than 10.

(10) “Underlying Customer Order” means an unexecuted Public Customer Order for which a Lead Market Maker or EAPMM is acting as agent and which underlies an Eligible Order.

(b) Access to Other Participating Exchanges by Market Makers. Pursuant to the Pilot Program, a market maker participating in the program may send an order to another Participating Exchange for execution as a Public Customer Order only if the market maker complies with the following conditions:

(1) the order is an immediate-or-cancel order;

(2) the price of the order is equal to the bid (offer) disseminated by the Participating Exchange at the time the market maker sends an order to sell (buy), and such bid (offer) is equal to the national highest bid (offer) in that series of an Eligible Option Class, as calculated by the Exchange;

(3) the Exchange's bid (offer) at the time the market maker sends the order to sell (buy) is not then equal to the national highest bid (offer) in that series of an Eligible Option Class, as calculated by the Exchange;

(4) the order is no larger than the Principal Size; and

(5) except with respect to orders a Lead Market Maker is sending pursuant to paragraph (c), below, the market maker has not received an execution of another such order in the same series of an Eligible Option Class on the same Participating Exchange pursuant to the Pilot Program in the previous one minute period.

(c) Additional Access to Other Participating Exchanges by Lead Market Makers. In addition to the access to other Participating Exchanges provided in paragraph (b), above, a Lead Market Maker participating in the Pilot Program may send an order to another Participating Exchange for execution as a Public Customer if:

(1) the Lead Market Maker complies with subparagraphs (1) through (3) of paragraph (b), above;

(2) the order reflects the same terms as an Underlying Customer Order the Lead Market Maker is holding; and

(3) the order is no larger than the Customer Size.

(d) Access to the Exchange by Eligible Market Makers on Other Participating Exchanges. Notwithstanding any other Rule of the Exchange, a Member may send to the Exchange for execution as a Public Customer Order an order for the account of an EAMM or an EAPMM that complies with the Corresponding Rule of the EAMM's or EAPMM's Participating Exchange.

(e) Implementation of the Pilot Program. The Chairman, or his designee, may implement the Pilot Program, in whole or in part, with respect to specific Participating Exchanges, to the extent that any such Participating Exchange has agreed to implement corresponding aspects of the Pilot Program. Lead Market Maker participation in the Pilot Program will be voluntary.