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December 12, 2000

TO: **All Members and Member Organizations**

FROM: **Department of Regulatory Policy**

SUBJECT: **New SEC Rules on Firm Quotes and Trade-Through Disclosure for Options (Release No. 34-43591, File No. S7-17-00)**

On November 17, 2000, the SEC adopted new rules under the Securities Exchange Act of 1934 to require options exchanges and options market makers to publish firm quotes and to require a broker-dealer to disclose to its customer when its customer's order for listed options is executed at a price inferior to a better published quote and what that better quote was, unless the transaction was effected on a market that is a participant in an intermarket linkage plan approved by the SEC. Following is a summary of the new rules that the SEC has approved.

A. <u>Trade-Through Disclosure Rule</u>

Under this new rule, which will become operative on April 1, 2001, brokers will be required to disclose to their customers when their customer's order for listed options is executed at a price that is inferior to a better published quote, and to disclose the better published quote available at that time. No disclosure will be required, however, if the customer's order is executed on an exchange that is participating in an approved linkage plan that is reasonably designed to prevent trade-throughs (and that meets other certain conditions). The current Options Linkage Plan does not yet qualify for this exemption. Therefore, it must be amended before broker-dealers effecting transactions on exchanges participating in the Options Linkage Plan will be exempt from the disclosure requirements of the Trade-Through Disclosure Rule. The PCX is currently a participant in the Options Linkage Plan (*see* Securities Exchange Act Release No. 43310 (September 20, 2000)). There is also an exception to the Disclosure Rule for block trades involving 500 contracts or more and a premium value of $150,000.

The SEC identified four circumstances that would not be considered to be trade-throughs for purposes of the Trade-Through Disclosure Rule: (1) where OPRA is experiencing queuing, (2) when an exchange has verified that another exchange publishing a better price is experiencing systems malfunctions, (3) where the other market is experiencing unusual market conditions that relieve its members from firm quote obligations, and (4) where a better market away fails to respond to an order for 30 seconds.

(The SEC declined to include other circumstances or exceptions to the Trade-Through Disclosure Rule, including ones for trade-throughs by small amounts (a <u>de minimus</u> exception), trade-throughs involving broker-dealer orders, transactions executed as a complex trade (such as a spread), and trades for which the customer requests that its order be executed on a particular market, regardless of price.)

The SEC's order emphasizes that the Trade-Through Disclosure Rule does not prohibit intermarket trade-throughs. It states that, at times, investors may value speed, size or liquidity over price. By not prohibiting trade-throughs, the rule permits investors to achieve their goals and provides them with information that will facilitate their ability to actively monitor whether the quality of executions they receive is satisfactory. Therefore, the SEC believes that the rule will help ensure that the decision not to pursue publicly-displayed superior prices is rooted in the interests of customers, not that of intermediaries. The Exchange notes, however, that the Options Linkage Plan must be amended so that it reasonably designed to prohibit trade-throughs before it will give rise to exceptions from the Trade-Through Disclosure Rule.

B. <u>Quote Rule Amendments</u>

The new rule, which will also be operative on April 1, 2000, will require that option quotes must be firm for a minimum of one contract for both customer and broker-dealer orders. The options exchanges will also be required to publicize the size for which its quotes will be firm, either on a quote-by-quote basis or by publicizing its rule establishing its firm quote sizes. The rule change is intended to allow market participants, including broker-dealers, to rely on quotes up to their published size in routing orders that are not eligible for execution in the exchanges' automatic execution systems.

The exchanges can comply with the new rule in two ways: Under the first alternative (publicizing on a quote-by-quote basis), they can collect from their members and make available to vendors the size associated with each quote (although this alternative will not be available until the exchanges and OPRA can disseminate market size). If this alternative is followed, an exchange would be required to establish procedures for collecting quotes from individual members and making the aggregate size available to vendors. Thus, if an exchange collects quotes from three market makers, and each market maker's quote is firm for 20 contracts, the exchange quote must be firm for at least 60 contracts, 20 for each market maker.

Under the second alternative (publicizing its rule establishing its firm quote sizes), an exchange may establish by rule and periodically publish the size for which its best bid and offer is firm. Under this alternative, each responsible broker-dealer may satisfy its firm quote obligation by executing any order to buy or sell a listed option in an amount up to the size established by the exchange's rules.

Under the Quote Rule amendments, Market Makers must *immediately* execute orders to buy or sell a number of options equal to (or less than) the firm quote size. If the size of an order is greater than the firm quote size, each responsible market maker must respond *within 30 seconds* by either (1) executing the entire order, or (2) executing the portion of the order equal to either: (a) the firm quote size established by rule (this provision only applies to exchanges that use the second alternative, i.e., publicizing their rules establishing their firm quote sizes); or (b) the published quotation size (this provision only applies to exchanges that use the first alternative, i.e., publicizing their firm quotes on a quote-by-quote basis). Once that portion of the order has been executed, the responsible broker or dealer is obligated to revise its bid or offer. If a bid or offer has been so revised, then in the case of exchanges that use the first alternative (i.e., publicizing their firm quotes on a quote-by-quote basis) the SEC expects that, in the absence of a price movement in the underlying security, the responsible broker-dealer will not reinstate its bid or offer *for at least 30 seconds*, even if a competing market maker independently quotes at the original price during that 30-second period. The SEC noted in its order that a market maker that executes a trade at its disseminated quote and then changes the terms or "breaks" the trade may well, absent exceptional circumstances, be in violation of its Firm Quote Rule obligations. (For purposes of this rule, the term "responsible broker or dealer" is defined in SEC Rule 11Ac1-1(a)(21).)

The SEC's order allows that firm quotes for customers may be different from the firm quotes for broker-dealers. If an exchange follows the first alternative, it may disseminate a firm quote for customers via vendors and also adopt a rule on firm quotes for broker-dealers that would be published periodically. Under the second alternative, an exchange may establish a firm quote size for customers and a separate firm quote size for broker-dealers. These would each be adopted by rule and published periodically. In either case, if an exchange allows quotes to be firm in different sizes for broker-dealer orders than for customer orders, its rules must require its market makers to be firm for a minimum of one contract.

The new rule does not affect the ability of the options exchanges to provide execution guarantees through their automatic execution systems. Options exchanges will continue to have the flexibility to publish a different firm quote size for a particular option issue than its auto-ex guaranteed size.

There are two exceptions to the Quote Rule Amendments. Quotes need not be firm: (1) during trading rotations; or (2) if an exchange is following the first alternative, it need not publish firm quotes if its volume is one percent or less of the aggregate volume for a calendar quarter, as published by OPRA.

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The text of the SEC's order approving the new rules is available on the SEC's website (www.sec.gov) by clicking on "Final Rules" under "Current SEC Rulemaking." Questions regarding this Bulletin may be directed to Michael Pierson at (415) 393-4107.