

offering at the same price for the same series.

Orders of controlled accounts must yield priority to customer orders.<sup>28</sup> Off-floor broker-dealer accounts, a subset of "controlled accounts," must also yield priority to customer orders at the same price. Therefore, if an off-floor broker-dealer limit order is placed on the limit order book, followed by a customer limit order placed on the limit order book at the same price, the off-floor broker-dealer limit order must yield priority to the customer limit order, even though the customer limit order was placed on the limit order book after the off-floor broker-dealer order.<sup>29</sup>

## II. Comment Summary

The Commission received one comment letter on the proposed rule change that generally opposed the Exchange's proposal relating to its crossing procedures pursuant to Rule 1080(ii).<sup>30</sup>

Specifically, ISE stated that the Exchange's proposed term "off-floor broker-dealer," which included two alternative definitions of the same term, appeared to be redundant. The term "off-floor broker-dealer" would involve either: (1) A broker-dealer that delivers orders from off the floor of the Exchange for the proprietary account(s) of such broker-dealers; or (2) a market maker located on an exchange or trading floor other than the Exchange's trading floor who elects to deliver orders via AUTOM for the proprietary account(s) of such market maker. ISE argued that the Exchange does not need the second clause above, since orders of market makers from other exchanges are also proprietary orders of a broker-dealer.

Furthermore, ISE believed that the exposure requirement does not appear sufficiently broad because the Exchange stated that the exposure requirement would apply to customer limit order submitted "in conjunction" with a proprietary contra-side order via AUTOM. ISE stated that if this were the case, then the exposure requirement would be too narrow, as it would allow broker-dealers to enter two orders

separately, but within a few seconds of each other, to avoid the 30-second exposure requirement altogether.

ISE also believed that the Exchange should include an exposure requirement (*i.e.*, 30 seconds) for solicited transactions.

In addition, ISE argued that the Exchange should adopt provisions: (1) To prohibit Exchange members from entering into arrangements with other broker-dealers to do crossing transactions without applying the same exposure requirement; and (2) to prohibit Exchange members from violating the exposure requirement for solicited orders.

On July 8, 2003, the Exchange submitted Amendment No. 4 in response to ISE's comments. In particular, the Exchange amended the proposed rule text relating to the term "off-floor broker-dealer," to clarify that off-broker-dealer orders include orders of market makers from other exchanges.<sup>31</sup> The Exchange also amended the proposed rule text to clarify that the exposure requirement would also apply to solicited transactions.<sup>32</sup> Furthermore, the Exchange proposed to add new rule text, pursuant to PHLX Rules 1080(b)(ii)(B), to prevent any Exchange member or member organization from being a party to any arrangement to circumvent the proposed crossing procedures, pursuant to PHLX Rule 1080(b)(ii)(A), by providing an opportunity for a customer, member, member organization, or non-member broker-dealer to execute against an agency order immediately, whether delivered via AUTOM or represented in the trading crowd by a member or a member organization.<sup>33</sup>

## III. Discussion

The Commission has reviewed carefully the proposed rule change, the comment letter, the Exchange's response to the comments, and all the amendments and finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b)(5)<sup>34</sup> of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>35</sup> In particular, the Commission believes that the proposed rule change, as amended by Amendments No. 4 and 5, is consistent with Section 6(b)(5) of the

Act,<sup>36</sup> which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to facilitate transactions in securities, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general to protect investors and the public interest.

The Commission anticipates that the Book Match should help to provide faster execution of certain eligible inbound customer and off-floor broker-dealer options orders, while reducing the burden on the Exchange's specialists to manually execute these orders. The Commission believes that the Book Match proposal should benefit customers using the AUTO-X system, as well as customers whose orders are residing in the Exchange's customer limit order book that are at the NBBO.

Moreover, the PHLX represents that the Book Match function would operate consistent with the Plan and PHLX Rules 1083 through 1087 adopted to implement the Plan, and that Book Match would execute eligible linkage orders at the Firm Customer Quote Size in the case of P/A Orders (*i.e.*, the inbound customer orders), and at the Firm Principal Quote Size (*i.e.*, the inbound off-floor broker-dealer orders) in the case of P Orders.

The SEC notes that the Exchange has specifically clarified that off-floor broker-dealer orders are subject to the priority-yielding provision of PHLX Rule 1014(g)(i). The Commission believes that this requirement of the proposal should ensure that retail customers are not adversely affected and should promote investor protection by retaining customer orders' priority on the book.

Moreover, the SEC finds that the proposed rules relating to internalization of orders delivered via AUTOM should address the commenter's concern that the proposed exposure requirement should be applied to any pre-arranged proprietary or solicited crosses.<sup>37</sup> Specifically, by requiring an Exchange member or member organization to expose to the trading crowd for at least 30 seconds an agency order before executing any part of the order as principal, or before such order may be executed by any order solicited by the originating broker-dealer, these rules should potentially ensure that the crossing and facilitation

<sup>28</sup> The Commission recently approved PHLX's proposal to require orders of controlled accounts to yield priority to customer orders in all circumstances. See Securities Exchange Act Release No. 47739 (April 25, 2003), 68 FR 23354 (May 1, 2003). Previously, PHLX ROTs closing in-person were not required to yield priority to orders of customer accounts. *Id.*

<sup>29</sup> At the request of the Exchange, the discussion under this section has been modified slightly to reflect recent changes to the PHLX rules. Telephone conversation between Richard S. Rudolph, Director and Counsel, PHLX and Hong-Anh Tran, Special Counsel, Division, Commission, on September 5, 2003.

<sup>30</sup> See ISE Letter, *supra* note 7.

<sup>31</sup> See Amendment No. 4, *supra* note 9.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> 15 U.S.C. 78f(b)(5).

<sup>35</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>36</sup> 15 U.S.C. 78f(b)(5).

<sup>37</sup> The Commission previously approved similar provisions as part of ISE's rules and CBOEDirect's rules. See ISE Rules 717(d) and (e), Supplemental Materials .01 and .02; and CBOE Rule 43.12C.