

participants to act competitively,⁷ the Exchange is proposing a two-step program: (1) Providing a method for registered options traders to input and have disseminated quotes that better the current best bid or offer, together with a means for ensuring that the next execution occurring at that bid or offer is specifically allocated to the registered options traders that caused the improved bid or offer to be disseminated; and (2) the development and implementation of an integrated system that will allow registered options traders through the use of a hand-held auto-quote device to input quotes that better the current market and provide for the automated allocation of trades to that registered options trader. The first step could be implemented upon approval of the proposed rule filing and the second step at a future date to be discussed below.

Registered Options Traders Use of the Electronic Entry Device

Given the number of series traded for each option class and the necessity for the re-calculating and re-quoting of each series in response to changes in the price of the underlying security, the Exchange developed an automated quotation updating system known as XTOPS. The specialist and registered options traders rely upon XTOPS to calculate and disseminate a single immediately updated quotation for each option series. XTOPS uses option valuation formulas (such as the Black-Scholes Model) to generate options quotations based on a number of variables.⁸ It is the specialist's responsibility to determine for each option class the variables used in the XTOPS formula. However, the quotations generated and displayed by XTOPS may result in firm quote obligations of both the specialist and registered options traders to buy or sell options at quoted prices and sizes.⁹ The

dissemination of an XTOPS quote can be overridden when a customer limit order represents the best bid or offer or when a registered options trader chooses on a series-by-series basis to better the disseminated bid or offer.

In order to more effectively and efficiently enable registered options traders to cause their own quotes to be disseminated, the Exchange proposes to expand the use of the Electronic Entry Device ("EE Device"). The EE Device is currently used by Exchange-employed systems clerks in busy option classes to input individual quotes from the specialist on a series by series basis that better the quote being calculated and disseminated by XTOPS. A quote entered using the EE Device is sent directly to the Exchange's Market Data System for immediate dissemination to the Options Price Reporting Authority. This quote, when it betters the market being disseminated by XTOPS, will override or displace the XTOPS quote. Today, the Exchange-employed systems clerks generally receive their instructions to input quotes from the specialist. The EE Device is also used by the systems clerks to input trades that have been executed outside the Amex Options Display Book.

The Exchange is now proposing to allow registered options traders' direct access to the EE Device to input their own quotes for dissemination as the best bid or offer. The EE Device would be available for registered options traders use in all option classes traded on the Exchange. In active option classes where there is currently an Exchange-employed systems clerk, registered options traders would either input their own quotes or instruct a systems clerk to do so on their behalf. Only registered options traders physically located in the trading crowd would be permitted to directly input quotes into the EE Device or give such instructions to a systems clerk.

Once the registered options trader or systems clerk inputs the quote into the EE Device, the proposed rule would require that: (i) The price improving registered options trader announce loudly and audibly in the crowd that he has improved the displayed market to ensure that other crowd participants are aware that the market has been improved, enabling other crowd participants to also quote competitively, adding liquidity to the market; and (ii) the specialist be specifically alerted so that a "book bid or offer" indicator is activated and the next otherwise Auto-Ex eligible trade is routed directly to the AODB for allocation to the registered options trader that caused the improved quote to be disseminated. In addition to

blocking an otherwise eligible Auto-Ex order from being executed and allocated by the Auto-Ex system, activation of the "book bid or offer" indicator would block an XTOPS calculated quote that is worse than the registered options trader's disseminated quote from being disseminated. Activation would not, however, block a quote that is better than the registered options trader's disseminated quote from being disseminated.

Once an execution occurs and/or the price improving registered options trader is no longer entitled to priority, the specialist would be required to remove the "best bid or offer" indicator so that Auto-Ex eligible orders would again be sent to Auto-Ex and the dissemination of XTOPS calculated quotes is resumed. The EE Device would not automatically decrement the size of the disseminated quote when an execution occurs. The quote would be required to be manually adjusted to reflect any revision to the disseminated size.

The price improving registered options trader would be permitted to cancel his quote at any time prior to the execution of a trade using the same method in which it was entered—through the use of the EE Device (regardless of whether inputted by the registered options trader or the systems clerk), if that was the method in which the quote was entered or through the specialist, if that was the method chosen. The registered options trader would be required also to alert the specialist that he is removing his quote, so the specialist can in turn remove the "book bid or offer" indicator in XTOPS, and announce loudly and audibly that he is canceling his quote.

Pursuant to the requirements of the Quote Rule and Exchange Rule 958A, the registered options trader as the responsible broker or dealer is obligated to execute any customer order at his bid or offer up to the disseminated size. To be relieved of that obligation with respect to a specific quote, one of the exceptions to the Quote Rule must apply, which generally provide that the responsible broker or dealer must communicate a revised quotation to the Exchange prior to the presentation of an order. Thus, a registered options trader using the EE Device to disseminate quotes would continue to be obligated pursuant to the Quote Rule until he has communicated a revised quote to the Exchange through the removal or cancellation of the quote on the EE Device.

Registered options traders would be required to improve the best bid or offer by an amount equal to at least the

⁷ Subparagraph IV.B.h(i)(aa) of the Commission's September 11, 2000 Order ("Order") requires the Exchange to "adopt new, or amend existing, rules concerning its automated quotation and execution systems which substantially enhance incentives to quote competitively and substantially reduce disincentives for market participants to act competitively." Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions. Securities Exchange Act Release No. 43268 (September 11, 2000).

⁸ These variables include the price of the underlying stock, time remaining to expiration, interest rates (or "cost to carry", the amount of interest on the money used to pay for the options position during the period prior to expiration of the option series), dividends (both declared and anticipated) and volatility.

⁹ See Rule 11Ac1-1 under the Act ("Quote Rule"), 17 CFR 240.11Ac1-1, and Amex Rule 958A.