

Order or BOX-Top Order interacts with a PIP Order before the PIP's conclusion. This data should aid the Commission in evaluating the effect of these rules. The following information will be provided:

(1) The number of times that a Market Order or BOX-Top Order in the same series on the same side of the market as the PIP Order prematurely terminated the PIP, and (a) the number of times such orders were entered by the same (or affiliated) firm that initiated the PIP that was terminated, and (b) the number of times such orders were entered by a firm (or an affiliate of such firm) that participated in the execution of the PIP Order;

(2) For the orders addressed in each of 1(a) and 1(b) above, the percentage of PIP premature terminations due to the receipt of a Market Order or BOX-Top Order in the same series on the same side of the market as the PIP Order that occurred within one second of the start of the PIP; the percentage that occurred between one and two seconds of the start of the PIP; and the percentage that occurred between two and three seconds of the start of the PIP; and the average amount of price improvement provided to the PIP Order where the PIP is prematurely terminated during each of these time periods;

(3) The number of times that a Market Order or BOX-Top Order in the same series on the opposite side of the market as the PIP Order immediately executed against the PIP Order, and (a) the number of times such orders were entered by the same (or affiliated) firm that initiated the PIP, and (b) the number of times such orders were entered by a firm (or an affiliate of such firm) that participated in the execution of the PIP Order;

(4) For the orders addressed in each of 3(a) and 3(b) above, the percentage of PIP early executions due to the receipt of a Market Order or BOX-Top Order in the same series on the opposite side of the market as the PIP Order that occurred within one second of the start of the PIP; the percentage that occurred between one and two seconds of the start of the PIP; and the percentage that occurred between two and three seconds of the start of the PIP; and the average amount of price improvement provided to the PIP Order where the PIP Order is immediately executed during each of these time periods; and

(5) The average amount of price improvement provided to the PIP Order when the PIP runs the full three seconds.

V. Accelerated Approval of Amendment No. 4

Pursuant to Section 19(b)(2) of the Act,²¹ 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 do publishes its reasons for so finding. The Commission hereby finds good cause for approving Amendment No. 4 to the proposal prior to the 30th day after publishing notice of Amendment No. 4 in the **Federal Register**. The Commission believes that the proposed revisions made by Amendment No. 4 simplify and clarify the proposed rule change and do not change its substance. As such, the Commission believes it is appropriate to accelerate approval of Amendment No. 4 so that BSE can implement the proposed rule change without delay. In addition, in Amendment No. 4, BSE represents that it will provide specified information each month that the Commission believes will aid it in its evaluation of the PIP. Accordingly, pursuant to Section 19(b)(2) of the Act,²² the Commission finds good cause to approve Amendment No. 4 prior to the 30th day after notice of Amendment No. 4 is published in the **Federal Register**.

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5) of the Act.²³

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (SR-BSE-2004-51) and Amendment Nos. 1, 2, and 3 are approved; and that Amendment No. 4 thereto is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁵

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. E5-3093 Filed 6-15-05; 8:45 am]

BILLING CODE 8010-01-P

²¹ 15 U.S.C. 78s(b)(2).

²² 15 U.S.C. 78s(b)(2).

²³ 15 U.S.C. 78f(b)(5).

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-51818; File No. SR-ISE-2005-18]

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to the Preferring of Orders to Exchange Market Makers

June 10, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 31, 2005, the International Securities Exchange, Inc. ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On May 31, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.³ On June 7, 2005, the Exchange filed Amendment No. 2.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons and is approving the proposal, as amended, on an accelerated basis, for a pilot period through July 22, 2005.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend the allocation procedures contained in Exchange Rule 713 to allow Electronic Access Members to designate "Preferred Market Makers" on the Electronic Access Members' orders (*i.e.*, "preference" orders to a particular market maker), who would receive an enhanced allocation if such market maker is quoting at the national best bid or offer ("NBBO") at the time such order is received by the Exchange. The text of the proposed rule change is set forth below. *Italics* indicate additions; [brackets] indicate deletions.

* * * * *

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Form 19b-4 dated May 31, 2005 ("Amendment No. 1"). Amendment No. 1 replaced and superseded the original filing in its entirety.

⁴ See Partial Amendment dated June 6, 2005 ("Amendment No. 2"). In Amendment No. 2, the Exchange proposed that the length of the pilot period for the proposed rule change be reduced from one year from the date of approval to six weeks from the date of approval. Amendment No. 2 also modified the Exchange's representations regarding surveillance in note 10 *infra*.

Rule 713. Priority of Quotes and Orders
No change.

Supplementary Material to Rule 713

.01 no change.

(a) Subject to the two limitations in subparagraphs (b) and (c) below and subject to paragraph .03 (Preferred Orders), Non-Customer Orders and market maker quotes at the best price receive allocations based upon the percentage of the total number of contracts available at the best price that is represented by the size of the Non-Customer Order or quote;

(b) no change.

(c) no change.

.02 no change.

.03 Preferred Orders. For a pilot period ending [insert date six-weeks from approval], an Electronic Access Member may designate a "Preferred Market Maker" on orders it enters into the System ("Preferred Orders").

(a) A Preferred Market Maker may be the Primary Market Maker appointed to the options class or any Competitive Market Maker appointed to the options class.

(b) If the Preferred Market Maker is not quoting at a price equal to the NBBO at the time the Preferred Order is received, the allocation procedure contained in paragraph .01 shall be applied to the execution of the Preferred Order.

(c) If the Preferred Market Maker is quoting at the NBBO at the time the Preferred Order is received, the allocation procedure contained in paragraph .01 shall be applied to the execution of the Preferred Order except that the Primary Market Maker will not receive the participation rights described in paragraphs .01(b) and (c), and instead the Preferred Market Maker shall have participation rights equal to the greater of:

(i) the proportion of the total size at the best price represented by the size of its quote, or

(ii) sixty percent (60%) of the contracts to be allocated if there is only one (1) other Non-Customer Order or market maker quotation at the best price and forty percent (40%) if there are two (2) or more other Non-Customer Orders and/or market maker quotes at the best price.

* * * * *

Rule 804. Market Maker Quotations

(a) through (d) no change.

(e) Continuous Quotes. A market maker must enter continuous quotations for the options classes to which it is appointed pursuant to the following:

(1) Primary Market Makers. Primary Market Makers must enter continuous

quotations and enter into any resulting transactions in all of the series listed on the Exchange of the options classes to which he is appointed on a daily basis.

(2) Competitive Market Makers. (i) On any given day, a Competitive Market Maker must participate in the opening rotation and make markets and enter into any resulting transactions on a continuous basis in all of the series listed on the Exchange of at least sixty percent (60%) of the options classes for the Group to which the Competitive Market Maker is appointed or 60 options classes in the Group, whichever is lesser. [and all the series of such options classes listed on the Exchange.]

(ii) Whenever a Competitive Market Maker enters a quote [or order] in an options class to which it is appointed, it must maintain continuous quotations for all series of the options class listed on the Exchange [within the same expiration month] until the close of trading that day; provided, however, if such quote or order is entered in an options series during the month in which such series expires, the Competitive Market Maker must participate in the opening rotation and maintain continuous quotations for all series in that month each day through their expiration].

(iii) A Competitive Market Maker may be called upon by an Exchange official designated by the Board to submit a single quote or maintain continuous quotes in one or more of the series of an options class to which the Competitive Market Maker is appointed whenever, in the judgment of such official, it is necessary to do so in the interest of fair and orderly markets.

* * * * *

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 Exchange 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 III below. The Exchange 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

According to the Exchange, the purpose of the proposed rule change is to assure that the Exchange remains competitive with other options exchanges that have proposed to allow order-flow providers to designate or "preference" non-specialist market makers, and to provide enhanced allocations to those preferred market makers in order to reward them for attracting order flow to the Exchange.⁵ The Exchange proposes to implement the rule change on a six-week pilot basis.

The proposal amends the Exchange's procedure for allocating trades among market makers and non-customer orders under Exchange Rule 713 to provide an enhanced allocation to a "Preferred Market Maker" when the Preferred Market Maker is quoting at the NBBO. Specifically, under the proposal, an Electronic Access Member may designate any market maker appointed to an options class to be a Preferred Market Maker on orders the Electronic Access Member enters into the Exchange's system ("Preferred Orders"). If the Preferred Market Maker is not quoting at the NBBO at the time the Preferred Order is received, the Exchange's existing allocation and execution procedures would be applied to the execution.⁶

Under existing Exchange Rule 713, Supplementary Material .01, no market participant can execute a greater number of contracts than is associated with the price of the market participant's existing interest. After all Public Customer Orders are filled, Non-Customer Orders and market maker quotes at the best price automatically receive allocations based upon the percentage of the total number of contracts available at the best price that is represented by the size of the Non-Customer Order or quote (*i.e.*, pro-rata based on size). However, if the Primary Market Maker is quoting at the best price, it automatically receives an enhanced participation equal to the greater of: (i) The proportion of the total

⁵ See Securities Exchange Act Release Nos. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (order approving SR-Phlx-2004-91); and 51779 (June 2, 2005), 70 FR 33564 (June 8, 2005) (order approving SR-CBOE-2004-71).

⁶ Marketable customer orders are not automatically executed at prices inferior to the NBBO. If the Exchange's best bid or offer is inferior to the NBBO, the marketable customer order is handled by the Primary Market Maker according to Exchange Rule 803(c).

size at the best price represented by the size of the Primary Market Maker's quote, or (ii) 60 percent of the contracts to be allocated if there is only one other Non-Customer Order or market maker quote at the best price, 40 percent if there are two other Non-Customer Orders and/or market maker quotes at the best price, and 30 percent if there are more than two other Non-Customer Orders and/or market maker quotes at the best price. In addition, the Primary Market Maker has priority to execute orders for five contracts or fewer if the Primary Market Maker is quoting at the best price.⁷

Under the proposal, if a Preferred Market Maker is quoting at the NBBO at the time a Preferred Order is received, the allocation procedure would be modified so that the Preferred Market Maker—instead of the Primary Market Maker⁸—would receive an enhanced allocation equal to the greater of: (i) The proportion of the total size at the best price represented by the size of its quote, or (ii) 60 percent of the contracts to be allocated if there is only one other Non-Customer Order or market maker quote at the best price and 40 percent if there are two or more other Non-Customer Orders and/or market maker quotes at the best price.⁹ Unexecuted contracts remaining after the Preferred Market Maker's allocation would be allocated pro-rata based on size as described above.¹⁰

As part of this proposal, the Exchange also proposes to increase the quotation obligations of Competitive Market Makers. Pursuant to current Exchange Rule 802, the Exchange allocates options classes into ten Groups and then appoints Primary Market Makers and Competitive Market Makers to the Groups. Under current Exchange Rule 804(e), a Primary Market Maker is required to maintain continuous quotations in all of the series of all of the options classes to which the Primary Market Maker is appointed, *i.e.*, all of the series in all of the options classes in the Primary Market Maker's appointed Group. Competitive Market Makers are

required to maintain continuous quotations in all of the series in at least 60 percent of the options classes in the Group to which they are appointed. However, a Competitive Market Maker may enter continuous quotes in less than all of the series in the remaining 40 percent of the classes in its appointed Group, subject to a requirement to maintain continuous quotes in those and related series through the end of the day and, in certain circumstances, through expiration of the series.

Because under the proposal, all Competitive Market Makers would be eligible to be designated as a Preferred Market Maker by Electronic Access Members and receive an enhanced allocation in any options series in which the Competitive Market Maker is quoting at the NBBO, the Exchange proposes to amend Exchange Rule 804(e) to require that a Competitive Market Maker maintain continuous quotes in all of the series of any options class it is quoting. Specifically, under the proposed amendment to Exchange Rule 804(e), a Competitive Market Maker would continue to be required to make markets in all of the series of a minimum number of options classes in its appointed Group, but also would be required to enter continuous quotes in all of the series of any options class in which it seeks to make markets above the minimum requirement. Accordingly, a Competitive Market Maker would be required to maintain continuous quotations in all of the series of any options classes in which it might receive an enhanced participation as the result of being designated as a Preferred Market Maker.¹¹

The proposal also seeks to amend the 60 percent requirement to more fairly apply the minimum quotation requirement on Competitive Market Makers. The number of options classes allocated to the ten different Groups changes as options classes are listed and delisted by the Exchange. Because the minimum requirement is a percentage of the number of options classes in a Group, some Competitive Market

Makers are required to maintain continuous quotes in a much larger number of options classes than others. While the Exchange believes a percentage-based minimum requirement remains appropriate, it believes there should be a limit to the number of options classes a Competitive Market Maker is required to continuously quote. Accordingly, the Exchange proposes to amend Exchange Rule 804(e)(2) to provide that a Competitive Market Maker must quote at least 60 percent of the options classes in the Group or 60 options classes, whichever is lesser. The Exchange believes that this change would assure that Competitive Market Makers appointed to Groups with more than 100 options classes would not be required to quote more than 60 options classes. The proposed amendment would not change the minimum requirement for any Competitive Market Maker appointed to a Group with less than 100 options classes, which, according to the Exchange, currently is the case in eight of the ten Groups.

The Exchange believes the proposed rule change is a necessary competitive response to the preferencing proposals filed by other options exchanges and will help the Exchange attract and retain order flow. The Exchange further believes that such order flow will add depth and liquidity to the Exchange's markets and enable the Exchange to continue to compete effectively with other options exchanges.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹² in that the proposed rule change is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system because a Preferred Market Maker must be quoting at the NBBO in order to receive the proposed enhanced allocation.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange believes that the proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

⁷ According to the Exchange, all allocations are automatically performed by the Exchange's system.

⁸ A Primary Market Maker may be the Preferred Market Maker, in which case such market maker would receive the enhanced allocation for Preferred Market Makers.

⁹ According to the Exchange, all allocations are automatically performed by the Exchange's system.

¹⁰ In Amendment No. 2, the Exchange stated that Electronic Access Members and Preferred Market Makers may not coordinate their actions. Such conduct would be a violation of Exchange Rule 400 (Just and Equitable Principles of Trade). The Exchange represented that it will proactively conduct surveillance for, and enforce against, such violations.

¹¹ The Exchange proposes to eliminate the requirement that a market maker start quoting if the market maker enters an order in an options series. Under Exchange Rule 805(a), Competitive Market Makers are not permitted to enter limit orders that would sit on the limit order book in options in their appointed Group. The entry of an immediate-or-cancel limit order, which either executes immediately against existing bids or offers in the market or is cancelled, does not cause a market maker to disseminate a bid or offer. Accordingly, a Competitive Market Maker that enters an order would not become eligible to receive an enhanced allocation as a Preferred Market Maker, and therefore should not become subject to the increased obligation to quote all of the series of an options class.

¹² 15 U.S.C. 78f(b)(5).

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

The Exchange has not solicited, and does not intend to solicit comments on the proposed rule change. The Exchange has not received any written comments from members or other interested parties. However, on April 6, 2005, written comments were submitted to the Commission by a member regarding the proposed rule change.¹³ This written comment opposed the proposed rule change, as well as similar proposals by the Philadelphia Stock Exchange, Inc. ("Phlx") and the Chicago Board Options Exchange, Incorporated ("CBOE").¹⁴

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act and whether the pilot time frame is appropriate. 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 rules-comments@sec.gov. Please include File Number SR-ISE-2005-18 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303. All submissions should refer to File Number SR-ISE-2005-18. 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. 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-2005-18 and should be submitted on or before July 7, 2005.

IV. Commission's Findings and Order Granting Accelerated Approval of the Proposed Rule Change

The Exchange has asked the Commission to approve the proposed rule change on an accelerated basis for six weeks while the Commission seeks comment on the proposed rule change. The Exchange believes the proposed rule change is substantially similar to rule changes by Phlx and CBOE that were recently approved by the Commission.¹⁵ After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of Section 6 of the Act¹⁶ and the rules and regulations thereunder applicable to a national securities exchange¹⁷, and, in particular, the requirements of Section 6(b)(5) of the Act.¹⁸ Section 6(b)(5) requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

Pursuant to Section 19(b)(2) of the Act,¹⁹ 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 amended, prior to the

30th day after publishing notice thereof in the **Federal Register**.

The Commission received one comment letter opposing the proposal.²⁰ This commenter criticized the proposal because the commenter believes the proposal would grant a Preferred Market Maker a guarantee based solely on being at the NBBO rather than on such Preferred Market Maker's obligations.²¹ The commenter asserts that the proposal would reward a Preferred Market Maker for the Preferred Market Maker's relationships with order flow providers rather than the quality of the Preferred Market Maker's quotes, and therefore the proposal would have a negative impact on price competition.²² In addition, this commenter notes that the proposal would extend the allocation entitlement to Competitive Market Makers, who have fewer obligations to the market than Primary Market Makers.²³

The Commission has previously approved rules that guarantee a Primary Market Maker a portion of each order when the Primary Market Maker's quote is equal to the NBBO.²⁴ The Commission has closely scrutinized exchange rule proposals to adopt or amend a participation guarantee where the percentage of participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange.²⁵ Because the proposal would not increase the overall percentage of an order that is guaranteed beyond the currently acceptable threshold, but instead would allow any Competitive Market Maker appointed to an options class to be designated as a Preferred Market Maker and be eligible to receive a participation guarantee instead of the Primary Market Maker, the Commission does not believe that the proposal will negatively impact quote competition on the Exchange. Under the proposal, the remaining portion of each order will still be allocated based on the competitive bidding of market participants.

In addition, a Preferred Market Maker will have to be quoting at the NBBO at

²⁰ See *supra* note 13. This written comment opposed the proposed rule change, as well as similar proposals by the Phlx and the CBOE. See *supra* note 5.

²¹ See *supra* note 13 at 1 and 2.

²² See *supra* note 13 at 2.

²³ See *supra* note 13 at 2. The Exchange refers to its specialists as "Primary Market Makers."

²⁴ See Securities Exchange Act Release Nos. 42808 (May 22, 2000), 65 FR 34515 (May 30, 2000) (SR-ISE-2000-01); 44340 (May 22, 2001), 66 FR 29373 (May 30, 2001) (SR-ISE-2001-46); and 44641 (August 2, 2001), 65 FR 41643 (August 8, 2001) (SR-ISE-2001-17).

²⁵ See, e.g., Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48788 (August 9, 2000).

¹⁵ *Supra* note 5.

¹⁶ 15 U.S.C. 78f.

¹⁷ In approving this proposal, the commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁸ 15 U.S.C. 78f(b)(5).

¹⁹ 15 U.S.C. 78s(b)(2).

¹³ Letter from Matthew B. Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, L.L.C., on behalf of Citadel Derivatives Group LLC, to Jonathan G. Katz, Secretary, Commission, dated April 6, 2005.

¹⁴ *Supra* note 5.

the time the Preferred Order is received to capitalize on the participation guarantee. The Commission believes it is critical that the Preferred Market Maker cannot step up and match the NBBO after it receives an order, but must be publicly quoting at that price when the order is received. In this regard, the Exchange's proposal prohibits Electronic Access Members and Preferred Market Makers from coordinating their actions. The Exchange has stated that such coordinated actions would violate Exchange Rule 400, Just and Equitable Principles of Trade, and will proactively conduct surveillance for, and enforce against, such violations.²⁶

The commenter also states that specialists (*i.e.*, Primary Market Makers) currently receive participation entitlements based on their obligations to the market. The commenter believes that the proposal, by allowing any market maker quoting at the NBBO to receive a guaranteed percentage of an order without in turn increasing the market maker's obligations to the market, would "eliminate the incentive to be a specialist, thereby potentially leaving the obligations of the specialist to the market unfulfilled."²⁷ The Commission does not believe that the proposal will result in the role of the specialist going unfulfilled, and notes that it recently approved an options exchange without specialists.²⁸ Moreover, specialists' obligations to the market have been reduced through other changes, including greater automation of functions previously handled manually by the specialist. While this proposal may reduce the incentive to be a specialist, the Commission does not believe that makes the proposal inconsistent with the Act. Finally, the Commission notes that, as part of this proposal, the Exchange proposes to increase the quotation obligations of Competitive Market Makers. Currently, a Primary Market Maker is required to maintain continuous quotations in all of the series of all of the options classes to which the Primary Market Maker is appointed. Competitive Market Makers are required to maintain continuous quotations in all of the series in at least 60 percent of the options classes in the Group to which they are appointed. However, a Competitive Market Maker may enter continuous quotes in less than all of the series in the remaining 40

percent of the classes in its appointed Group, subject to a requirement to maintain continuous quotes in those and related series through the end of the day and, in certain circumstances, through expiration of the series.²⁹

Under the proposal, since all Competitive Market Makers would be eligible to be designated as a Preferred Market Maker by Electronic Access Members and receive an enhanced allocation in any options series in which the Competitive Market Maker is quoting at the NBBO, the Exchange proposes to require that a Competitive Market Maker maintain continuous quotes in all of the series of any options class it is quoting. Specifically, with respect to any series of any options class in which a Competitive Market Maker seeks to make markets above the minimum requirement, the proposal would require a Competitive Market Maker to enter continuous quotes in all of the series of any options class in which it enters quotes. Accordingly, the proposed rule change would require a Competitive Market Maker to maintain continuous quotations in all of the series of any options classes in which it might receive an enhanced participation as the result of being designated as a Preferred Market Maker.³⁰

The proposal also seeks to amend the minimum quotation requirement on Competitive Market Makers to provide that a Competitive Market Maker must quote at least 60 percent of the options classes in the Group or 60 options classes, whichever is lesser.³¹ Under the current rule, because the minimum quotation requirement is 60 percent of the number of options classes in a Group, and the number of options classes in a Group varies, according to the Exchange, some Competitive Market Makers are required to maintain continuous quotes in a much larger number of options classes than other Competitive Market Makers. The Commission notes that this change to the quotation requirement only affects Competitive Market Makers appointed to Groups with more than 100 options classes and that such Competitive Market Makers would still be required to quote continuous in 60 options classes.³² The Commission also notes that the proposed change to the quotation requirement does not affect the proposed requirement that a Competitive Market Maker maintain

continuous quotes in a series in order to be eligible to receive a participation guarantee for that series.

The Commission emphasizes that approval of this proposal does not affect a broker-dealer's duty of best execution. A broker-dealer has a legal duty to seek to obtain best execution of customer orders, and any decision to preference a particular Primary Market Maker or Competitive Market Maker must be consistent with this duty.³³ A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws.³⁴

The duty of best execution requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, *i.e.*, at the best reasonably available price.³⁵ The duty of best execution requires broker-dealers

³³ See, e.g., *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); *Certain Market Making Activities on Nasdaq*, Securities Exchange Act Release No. 40900 (January 11, 1999) (settled case) (citing *Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971); *Arleen Hughes*, 27 SEC 629.636 (1948), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Handling Rules Release").

³⁴ Order Handling Rules Release, 61 FR at 48322. See also *Newton*, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See *Newton*, 135 F.3d at 273 ("[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade and retaining the services of the broker as his agent-solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal."); *Marc N. Geman*, Securities Exchange Act Release No. 43963 (February 14, 2001) (citing *Newton*, but concluding that respondent fulfilled his duty of best execution). See also *Payment for Order Flow*, Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55009 (November 2, 1994) ("Payment for Order Flow Final Rules"). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See *Newton*, 135 F.3d at 273-274.

³⁵ *Newton*, 135 F.3d at 270. *Newton* also noted certain factors relevant to best execution-order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *Id.* at 270 n. 2 (citing *Payment for Order Flow*, Securities Exchange Act Release No. 33026 (October 6, 1993), 58 FR 52934, 52937-38 (October 13, 1993) (Proposed Rules)). See *In re E.F. Hutton & Co.* ("Manning"), Securities Exchange Act Release No. 25887 (July 6, 1988). See also *Payment for Order Flow Final Rules*, 59 FR at 55008-55009.

²⁶ See Amendment No. 2.

²⁷ *Supra* note 13 at 2.

²⁸ See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (SR-BSE-2002-15) (order approving trading rules for the Boston Options Exchange Facility).

²⁹ See Exchange Rule 804(e).

³⁰ See proposed Exchange Rule 804(e).

³¹ See proposed Exchange Rule 804(e)(2).

³² The proposed amendment would not change the minimum requirement for any Competitive Market Maker appointed to a Group with less than 100 options classes.

to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders.³⁶ Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices.³⁷ In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.³⁸

The Commission notes that the proposed rule change would be implemented on a pilot basis for six weeks. During this time, the Commission intends to evaluate the impact of the proposal on the options markets to determine whether it would be beneficial to customers and to the options markets as a whole before approving any request to extend the pilot program. The Commission believes that the proposed rule change's six-week pilot period will allow the Commission an opportunity of solicit comments on the proposed rule change prior to considering whether the approve such pilot program for an extended period. Therefore, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,³⁹ to approve the proposal, as amended, on an accelerated basis.

³⁶ Order Handling Rules Release, 61 FR at 48322-48333 ("In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security."). See also *Newton*, 135 F.3d at 271; Market 2000; An Examination of Current Equity Market Developments V-4 (SEC Division of Market Regulation January 1994) ("Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order."); Payment for Order Flow Final Rules, 59 FR at 55009.

³⁷ Order Handling Rules, 61 FR at 48323.

³⁸ Order Handling Rules, 61 FR at 48323. For example, in connection with orders that are to be executed at a market opening price, "[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders." Disclosure of order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000) (adopting new Rules 11Ac1-5 and 11Ac1-6 under the Act and noting that alternative methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

³⁹ 15 U.S.C. 78s(b)(2).

For these reasons, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act,⁴⁰ and will not jeopardize market integrity or the incentive for market participants to post competitive quotes.⁴¹

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁴² that the proposed rule change (SR-ISE-2005-18), as amended, which institutes the pilot program until July 22, 2005, is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴³

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. E5-3095 Filed 6-15-05; 8:45 am]

BILLING CODE 8010-01-P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-51814; File No. SR-NASD-2004-185]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving a Proposed Rule Change and Amendment Nos. 1 and 2 Thereto To Establish a Unitary Fee Schedule for Distribution of Real Time Data Feed Products Containing Nasdaq Market Center Data

June 9, 2005.

I. Introduction

On December 14, 2004, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to establish a unitary fee schedule for distribution of real time data feed products containing Nasdaq market center data. On February 17, 2005, Nasdaq filed Amendment No. 1 to the original filing.³ Nasdaq filed

⁴⁰ 15 U.S.C. 78f(b)(5).

⁴¹ Approval of this proposal is in no way an endorsement of payment for order flow by the Commission.

⁴² 15 U.S.C. 78s(b)(2).

⁴³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced and superseded the original proposed rule change in its entirety.

Amendment No. 2 on April 14, 2005.⁴ The proposed rule change, as amended, was published for comment in the **Federal Register** on April 28, 2005.⁵ The Commission received one comment on the proposed rule change.⁶ This order approves the proposed rule change, as amended.

II. Description of the Proposal

Nasdaq proposes to modify NASD Rule 7010 to establish a unitary fee schedule for the distribution of Nasdaq Market Center real time data feed products. Nasdaq offers various data products that firms may purchase and redistribute either within their own organizations or to outside parties. According to Nasdaq, "distributor fees" are designed to encourage broad distribution of the data, and allow Nasdaq to recover what it describes as the relatively high fixed costs associated with supporting connectivity and contractual relationships with distributors. Nasdaq believes that because the data products and associated fees were established over many years, the method of calculating such fees should be updated. Accordingly, Nasdaq proposes to establish a revised monthly distributor pricing structure for its real time data feed products that it believes will allocate equitably data fees across the customer base of data distributors and consumers of Nasdaq market data.

Specifically, the proposed rule change will establish a distributor fee pricing structure for four real time data feed products: TotalView, OpenView, Mutual Fund Quotation Service ("MFQS"), and Real Time Index. The proposed fees will be assessed to distributors of these real time data feed products, defined in the proposed rule change to include any entity that receives a feed or data file of Nasdaq data directly from Nasdaq or indirectly through another entity and then distributes it either internally (within that entity) or externally (outside the entity). The new distributor fees would not apply to Nasdaq's Web-based historical data products, which are governed by NASD Rule 7010(p), and they would not apply to data feeds that are produced pursuant to the national market system plan governing Nasdaq stocks ("Nasdaq UTP Plan"). The proposed distributor pricing is also distinct from any per display device or

⁴ Amendment No. 2 replaced and superseded the original proposed rule change, as amended.

⁵ See Securities Exchange Act Release No. 51598 (Apr. 21, 2005), 70 FR 22162.

⁶ See letter from Gene L. Finn to Jonathan Katz, Secretary, Securities and Exchange Commission dated May 17, 2005 ("Finn Letter").