

Regulatory Information Circular – 2001-06

To: ISE Market Makers

Date: April 2, 2001

Re: Firm Quotes

Today, April 2, 2001, amendments to the Securities and Exchange Commission's "Firm Quote Rule" (Rule 11Ac1-1 under the Exchange Act) have become effective. Those amendments apply the rule to the options exchanges. On March 1, 2001, in Regulatory Information Circular 2001-03 we discussed the application of those rule amendments to the ISE's "trade-or-fade" policy.¹

As required under the SEC's Firm Quote Rule, the ISE has adopted amendments to our own rules to parallel the provisions of the SEC's rule. A copy of the ISE's rule amendments is attached. Generally, these rules do not impose new or additional obligations on ISE market makers. Nevertheless, ISE market makers should be aware that a breach of these existing requirements now could result in a violation of the SEC's rules as well as a violation of the ISE's rules.

The amendments to the ISE rules provide that all market maker quotes (both PMM and CMM quotes) are firm for (i) their stated size for orders of public customers, and (ii) at least one contract for orders of persons other than public customers. Exceptions to these firmness requirements continue to include obvious errors and system malfunctions or other circumstances that impair the Exchange's ability to disseminate or update market quotes in a timely and accurate manner. The ISE adopted additional exceptions to the ISE quotation rule to parallel the Firm Quote Rule. These exceptions are as follows:

- A formal declaration by the ISE of a "fast market" in an option. In such cases, both for the ISE and the other markets, the Options Price Reporting Authority will append a suffix (or "code type") "F" to indicate that an option is in a "fast market" on that particular exchange and that the market's quote is not firm for the purposes of the Firm Quote Rule. While the ISE "fast market" procedures will continue to apply as they do today, the rule amendment makes clear that

¹ Under the Firm Quote Rule, a market maker cannot requote at the same price within 30 seconds of being automatically moved from a price as a result of the trade-or-fade process. This reflects a change to the previous ISE policy, increasing the time a market maker cannot requote from 15 seconds to 30 seconds. While a market maker can requote at any time at the same price to reflect a corresponding movement in the underlying security, a market maker cannot requote at that price within 30 seconds to match another member's quote or limit order. See Regulatory Information Circular 2001-03 for a further discussion of this issue.

market makers are not in violation of SEC rules for failure to provide an execution against these quotes.

- Quotations disseminated during trading rotations.
- Before receiving an order, the market maker has communicated to the ISE a revised bid or offer.
- At the time it receives an order, the market maker is in the process of effecting a transaction in the option and, immediately after executing that transaction, the market maker communicates a new bid or offer to the ISE.

For further information on order frequency, or if you have any questions, please contact Patrick Gillespie, Associate Director – Trading Analysis at 212-897-8130, or Jim Sampson, Director, Market Surveillance and Regulation at 212-897-0235.

Text of the New ISE Rules Governing Firm Quotations

[Brackets] indicates deletions from current rules; underline indicates additions.

Rule 804. Market Maker Quotations

(a) No change.

(b) *Size Associated with Quotes.* A market maker's bid and offer for a series of options contracts shall be accompanied by the number of contracts at that price the market maker is willing to buy from or sell [at that price] to (i) Public Customers (the "Public Customer Size") and (ii) Non-Customers (the "Non-Customer Size"). Unless the Exchange has declared a fast market pursuant to Rule 704, a market maker may not initially enter a bid or offer [for] with a Public Customer Size of less than ten (10) contracts. Where the size associated with a market maker's bid or offer falls below ten (10) contracts due to executions at that price and consequently the size of the best bid or offer on the Exchange would be for less than ten (10) contracts, the market maker shall enter a new bid or offer for at least ten (10) contracts, either at the same or a different price. Every market maker bid or offer must have a Non-Customer Size of at least one (1) contract.

(c) No change.

(d) *Firm Quotes.* (1) [With respect to Public Customer Orders, market] Market maker bids and offers are firm for Public Customer Orders and Non-Customer Orders both under this Rule and Rule 11Ac1-1 under the Exchange Act ("Rule 11Ac1-1") for the number of contracts specified for each according to the requirements of paragraph (b) above [associated with each, unless:]. Market maker bids and offers are not firm under this Rule and Rule 11Ac1-1 if:

(i) the Exchange determines that an exception is warranted, on a case by case basis, because of an obvious error; [or]

(ii) a system malfunction or other circumstance impairs the Exchange's ability to disseminate or update market quotes in a timely and accurate manner[.];

(iii) the level of trading activities or the existence of unusual market conditions is such that the Exchange is incapable of collecting, processing, and making available to quotation vendors the data for the option in a manner that accurately reflects the current state of the market on the Exchange, and as a result, the market in the option is declared to be "fast" pursuant to Rule 704;

(iv) during trading rotations; or

(v) any of the circumstances provided in paragraph (c)(3) of Rule 11Ac1-1 exist.

(2) Within thirty seconds of receipt of a Public Customer Order (Non-Customer Order) to buy or sell an option in an amount greater than the Public Customer Size (Non-Customer Size), that portion of the order equal to the Public Customer Size (Non-Customer Size) will be executed and the bid or offer price will be revised.

[(2) With respect to Non-Customer Orders, market makers must either buy or sell the number of contracts specified in their quotes or change their quotes to reflect that the previously displayed quote is no longer available.]

{Paragraphs (e) – (f): No change.}

Rule 704. [Unusual Market Conditions] Collection and Dissemination of Quotations

[(a) Whenever an Exchange official who is designated by the Board shall have the power to determine, because of an influx of orders or other unusual conditions or circumstances and the interest of maintaining a fair and orderly market so requires, such designated Exchange official may declare the market in one or more classes of options contracts to be “fast.”]

(a) Each market maker shall communicate to the Exchange its bid and offers in accordance with the requirements of Rule 11Ac1-1 under the Exchange Act and the Rules of the Exchange.

(b) The Exchange will disseminate to quotation vendors the highest bid and the lowest offer, and the aggregate quotation size associated therewith that is available to Public Customer Orders, in accordance with the requirements of Rule 11Ac1-1 under the Exchange Act.

(c) Unusual Market Conditions.

(1) An Exchange official designated by the Board shall have the power to determine that the level of trading activities or the existence of unusual market conditions is such that the Exchange is incapable of collecting, processing, and making available to quotation vendors the data for the option in a manner that accurately reflects the current state of the market on the Exchange. Upon making such a determination, the Exchange shall designate the market in such option to be “fast.” When a market for an option is declared fast, the Exchange will provide notice that its quotations are not firm by appending an appropriate indicator to its quotations.

[(b)] (2) If a market is declared fast, designated Exchange officials shall have the power to: (i) direct that one or more trading

rotations be employed pursuant to Rule 701; (ii) suspend the minimum size requirement of Rule 804(b); or (iii) take such other actions as are deemed in the interest of maintaining a fair and orderly market.

[(c)] (3) The Exchange will monitor the activity or conditions that caused a fast market to be declared, and a designated Exchange official shall review the condition of such market at least every thirty (30) minutes. Regular trading procedures shall be resumed by the Exchange when a designated Exchange official determines that the conditions supporting a fast market declaration no longer exist. The Exchange will provide notice that its quotations are once again firm by removing the indicator from its quotations.

[(d)] (4) If the conditions supporting a fast market declaration cannot be managed utilizing one or more of the procedures described above [contained in paragraphs (b) of this Rule], then a designated Exchange official shall halt trading in the class or classes so affected.