SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–43830; File No. SR–ISE–00–19]

Self Regulatory Organizations; Notice of Filing of Proposed Rule Change by the International Securities Exchange LLC Adopting an Obvious Error Rule

January 10, 2001.

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 November 20, 2000, the International Securities Exchange LLC (''ISE'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organizations Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is proposing to adopt new ISE Rule 720, which gives the Exchange the authority to bust or adjust trades that result from clearly erroneous orders or quotations. Proposed new language is *italicized*.

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Rule 720. Obvious Errors

The Exchange shall either bust a transaction or adjust the execution price of a transaction that results from an Obvious Error as provided in this Rule.

(a) Definition of obvious Error. For purposes of this Rule only, Obvious Error will be deemed to have occurred when:

(1) during regular market conditions (including rotations), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least two (2) times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more; or

(2) during fast market conditions (i.e., the Exchange has declared a fast market status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least three (3) times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more.

(b) Definition of Theoretical Price. For purposes of this Rule only, the Theoretical Price of an option is:

(1) if the series is traded on at least one other options exchange, the last bid or offer, just prior to the trade, found on the exchange that has the most liquidity in that option as provided in Supplementary Material .02 below; or

(2) if there are no quotes for comparison purposes,as determined by the Obvious Error Panel.

(c) Adjustments. Where the execution price of a transaction executed as the result of an Obvious Error is adjusted, the adjusted price will be:

(1) the Theoretical Price of the option in the case where the erroneous price is displayed in the market and subsequently executed by quotes or orders that did not exist in the System at the time of the erroneous price was entered; or

(2) the last bid or offer, just prior to the trade, found on the exchange that has the most liquidity in that option as provided in Supplementary Material .03 below in the case where an erroneous price executes against quotes or orders already existing in the System at the time the erroneous price was entered.

(d) Obvious Error Procedure. Designated personnel in the Exchange's market control center (''Market Control'') shall administer the application of this Rule as follows.

(1) Notification. If a market maker on the Exchange believes that it participated in a transaction that was the result of an Obvious Error, it must notify Market Control within five (5) minutes of the execution. If an Electronic Access Member believes an order it executed on the Exchange was the result of an Obvious Error, it must notify Market Control within twenty (20) minutes of the execution. Except as provided below, no relief under this Rule will be provided unless notification is made within the prescribed time periods.

(2) Adjust or Bust. Market Control will determine whether there was an Obvious Error as defined above. If it is determined that an Obvious Error has occurred, Market Control shall take one of the following actions: (i) where each party to the transaction is a market maker on the Exchange, the execution price of the transaction will be adjusted unless both parties agree to bust the trade within ten (10 minutes of being notified by Market Control of the Obvious Error, or[3] *(ii) where at least one party to the Obvious Error is not a market maker on the Exchange, the trade will be busted unless both parties agree to adjust the price of the transaction within thirty (30) minutes of being notified by Market Control of the Obvious Error.*

(e) Obvious Error Panel.

(1) Composition. An Obvious Error Panel will be comprised of representatives from three (3) Members that are market makers on the Exchange, at least one (1) of which shall be a representative from a Member that is a Competitive Market Maker and not also a Primary market Maker.

(2) *Request for Review. If a party affected by a determination made under this Rule so requests, the Obvious Error Panel will review decisions made by market Control under this Rule, including whether an Obvious Error occurred, whether the correct Theoretical Price was used, and whether an adjustment was made at the correct price. A party may also request that the Obvious Error Panel provide relief under this Rule in cases where the party failed to provide the notification required in paragraph (d)(1), but unusual circumstances must merit special consideration. The Obvious Error Panel shall review the facts and render a decision on the day of the transaction. All determinations by the Obvious Error Panel shall be final.*

Supplementary Material to Rule 720

.01 For purposes of paragraph (a) of this Rule, the maximum bid/ask spread shall be the maximum bid/ask spread allowed under Rule 803(b), unless a wider spread has been allowed by the Exchange for the option because of unusual market conditions, such as high market volatility.

.02 The Theoretical Price will be determined under paragraph (b)(1) above as follows: (i) the bid price from the exchange providing the most volume will be used with respect to an erroneous bid price entered on the Exchange, and (ii) the offer price from the exchange providing the most volume will be used with respect to an erroneous offer price entered on the Exchange.

.03 The price to which a transaction is adjusted under paragraph (c)(2) above will be as follows: (i) the bid price from the exchange providing the most volume for the option will be used with respect to an erroneous offer price entered on the Exchange, and (ii) the offer price from the exchange providing the most volume for the option will be used with

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[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The ISE corrected a typographical error that appeared in the proposed rule language. Telephone conversation between Katherine Simmons, Vice President and Associate General Counsel, ISE, and Susie Cho, Attorney, Division of Market Regulation, Commission, January 10,2 001.

respect to an erroneous bid price entered on the Exchange. If there are no quotes for comparison purposes, the adjustment price will be determined by the Obvious Error Panel.

.04 When Market Control determines that an Obvious Error has occurred and action is warranted under paragraph (d)(2) above, the identity of the parties to the trade will be disclosed to each other in order to encourage conflict resolution.

.05 Each market maker firm shall designate at least one person that is knowledgeable about options market making on the ISE to be called upon by the Exchange to participate on an Obvious Error Panel. In no case shall an Obvious Error Panel include a person related to a party to the Obvious Error in question. To the extent reasonably possible, the Exchange shall call upon representatives of each market maker to participate on an Obvious Error Panel on an equally frequent basis.

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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 IV 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

The Exchange proposes to adopt new ISE Rule 720 that would allow it to either adjust or bust a transaction in circumstances where a member or its customer has made an error and the price of the execution is ''obviously'' not correct.[4] In such situations, the Exchange does not believe it is consistent with just and equitable principles of trade to permit one market participant to receive a wind-fall at the expense of another market participant that made an obvious error. Conversely, the Exchange does not seek to permit market participants to reconsider poor trading decisions. The ISE believes that the proposed rule contains objective standards regarding when a transaction was clearly the result of an ''obvious error,'' under what circumstances a trade will be adjusted or busted, and to what price a trade will be adjusted if adjustment is appropriate under the circumstances.

Under proposed ISE Rule 720, when a member believes that it has participated in a transaction that was the result of an obvious error, it must notify ISE Market Control within a specified time of the execution. The proposed rule requires Exchange market makers, who are continuously monitoring their transactions on the ISE, to notify ISE Market Control within five minutes of an execution. The proposed rule allows Electronic Access Members, which may handle customer orders on multiple exchanges simultaneously and which may need to contact customers for instruction, up to twenty minutes to notify ISE Market Control.

ISE Market Control will determine whether there was an obvious error according to the following objective criteria: (1) An obvious error will be deemed to have occurred during normal market conditions when the execution price of a transaction is higher or lower than the theoretical price[5] for the series by an amount equal to at least two times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more; and (2) an obvious error will be deemed to have occurred during fast market conditions when the execution price of a transaction is higher or lower than the theoretical price for the series by an amount equal to at least three times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more.[6] ISE Market Control is not given any discretion under proposed ISE Rule 720 to take actions with respect to transactions that do not come within the objective obvious error criteria. In situations where the theoretical price is not objectively determinable, a panel of member representatives will be convened to determine the theoretical price.

If it is determined that a transaction is the result of an obvious error, ISE Market Control will take one of the following actions: (1) Where each party to the transaction is an Exchange market maker,[7] the execution price of the transaction will be adjusted unless both parties agree to bust the trade; or (2) where at least one party to the obvious error is not a market maker on the Exchange, the trade will be busted unless both parties agree to adjust the price of the transaction. In the first instance, Exchange market makers, who commonly hedge transactions immediately, have indicated a preference for adjusting the price of a transaction rather than changing their positions. Thus, the default action will be to adjust the price of the execution according to the objective criteria discussed below. In the second instance, where customer limit orders may be involved, the Exchange does not believe it appropriate to adjust the price of a transaction without the consent of the market participants. Accordingly, the default will be to bust the trade unless both sides agree to adjust the price. The default action will be taken unless agreement is reached within ten minutes in the case where both parties are Exchange market makers, and within thirty minutes where at least one party is not an Exchange market maker.

Where an adjustment is made to a transaction price, the adjusted price will be determined by objective criteria. The adjusted price will be equal to the theoretical price of the option in the case where the erroneous price is displayed in the market and subsequently executed by quotes or orders that did not exist in the system at the time the price was entered. For example, if an option had a bid of $5 and offer of $5.20 on the options exchange with the most volume in that option and due to an erroneous quotation, the ISE displayed a bid of $7 that was executed against by an incoming sell order or market maker offer, the adjustment price would be $5, which is the fair price at which a market participant could have sold the option at the time of the transaction. The ISE would presume that, in this situation, the seller knew that the price was

[4] While current ISE Rule 804(d)(2) gives the Exchange some flexibility with respect to customer orders when a market maker's quote is obviously an error, it only states that an obviously erroneous quote may not be ''firm'' for customer orders. ISE Rule 804 does not expressly give the Exchange authority to bust an executed transaction, nor does it contain any guidelines for determining when a quotation is obviously erroneous.

[5] The theoretical price of an option in the case of an erroneous bid (offer) is the last bid (offer), just prior to the trade, found on the exchange that has the most liquidity in that option other than the ISE. If there are no quotes for comparison purposes, the theoretical price will be determined by an obvious error panel.

[6] The reason for requiring a greater deviation from the theoretical price during fast market conditions is that when the price of an underlying is moving rapidly, it is not as ''obvious'' that an option price might be in error.

[7] A party to a transaction will be considered an Exchange market maker under proposed ISE Rule 720 if the resulting position is booked in an ISE market maker account. For example, under ISE Rule 803, a Competitive Market Maker (''CMM'') on the ISE may execute up to 25 percent of its total volume in securities to which it is not appointed. An obvious error involving two CMMs will be adjusted under proposed ISE Rule 720 unless both agree to bust the trade.

obviously erroneous as compared to the price being displayed by the primary options exchange for the option.

Where a participant enters a quotation or order in error that executes against standing interest on the Exchange, the contra side to the transaction had no notice of an erroneous price and took no action to execute at the erroneous price. In this instance, the adjustment price will be the bid (offer) price from the exchange providing the most volume in the case of an erroneous offer (bid) price entered on the Exchange. The ISE believes that this will result in a more favorable adjustment price for the participant with standing interest in the book than the participant that made the error. As a result, in the previous example, if the erroneous bid of $7 executed against an offer in the system at $6.50, the adjustment price would be $5.20 (the offer price) instead of 5 (the bid price). Again, the only time an adjustment will be made to the price of a transaction is in the case where both parties were ISE market makers or where both parties agree to the adjustment.

Finally, proposed ISE Rule 720 specifies that each market maker firm will designate at least one person that is knowledgeable about options market making on the ISE to be called upon by the Exchange to participate on an obvious error panel.[8] Proposed ISE Rule 720 provides that an obvious error panel will have the authority to: (1) Determine a theoretical price when there is no quote for an option on another options exchanges; and (2) upon request by a party to a potential obvious error, review whether the correct theoretical price was used and whether an adjustment was made at the correct price. A party to a potential obvious error may also request that the obvious error panel provide relief under the proposed rule in cases where the party failed to give notice within the required time periods, but there must be unusual circumstances to merit this special consideration. All determinations by an obvious error panel will be made on the same day as the transaction in question and shall be final.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act[9] in general, and furthers the objectives of Section 6(b)(5)[10] in particular, in that it is 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 for a free an open market and a national market system, and, in general, to protect investors and the public interest.

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

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

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

The Exchange did not solicit or receive written comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR–ISE–00–19 and should be submitted by February 8, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[1]

Margaret H. McFarland,

Deputy Secretary.

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[8] In no case shall an obvious error panel include a person related to a party to the obvious error in question. To the extent reasonably possible, the Exchange shall call upon representatives of each market maker to participate on an obvious error panel on an equally frequent basis.

[9] 15 U.S.C. 78f(b).

[10] 15 U.S.C. 78f(b)(5).

[1] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–43831; File No. JR–NASA–00–72]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Nasdaq's Transaction Credit Pilot Program

January 10, 2001.

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 December 13, 2000, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), through its wholly owned subsidiary The Nasdaq Stock Market, Inc. (''NASD''), filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. Nasdaq has designated this proposal as one establishing or changing a due, fee, or other charge imposed by the Association under Section 19(b)(3)(A)(ii) of the Act,[3] which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

Nasdaq proposes to amend NASD Rule 7010, System Services, to extend Nasdaq's transaction credit pilot program for an additional three months for Tape A and B reports. The text of the proposed rule change is below. Proposed new language is in italics. Proposed deletions are in brackets.

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] 15 U.S.C. 78s(b)(3)(A)(ii).