

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No.50324 / September 7, 2004

Admin. Proc. File No. 3-11383

In the Matter of the Application of
LEK SECURITIES CORP. and SAMUEL F. LEK
For Review of Disciplinary Action Taken by the
PHILADELPHIA STOCK EXCHANGE, INC.

OPINION OF THE COMMISSION

NATIONAL SECURITIES EXCHANGE -- REVIEW OF DISCIPLINARY
PROCEEDING

Orders Eligible for Entry into the Exchange's Automated
Options Market ("AUTOM") System

Conduct Inconsistent with Just and Equitable Principles
of Trade

National securities exchange's rule, which generally stated that only "agency orders" were eligible for entry into order execution system, failed to articulate clearly that orders entered by a member organization acting as an agent for its broker-dealer customers were not permissible. Held, the exchange's findings of violations and sanctions it imposed are set aside.

APPEARANCES:

Dixie L. Johnson and Kevin J. Harnisch, of Fried, Frank, Harris, Shriver & Jacobson LLP, for Lek Securities Corp. and Samuel F. Lek.

Robert A. Intartaglio and Mark Schepps, for the Philadelphia Stock Exchange, Inc.

Appeal filed: January 23, 2004
Last brief received: April 26, 2004

Lek Securities Corp. ("LSC") and Samuel F. Lek (collectively the "Applicants") appeal from Philadelphia Stock Exchange, Inc. ("PHLX" or the "Exchange") disciplinary action. The PHLX found that, during the summer of 2000, the Applicants sent ninety-eight broker-dealer orders to the Exchange's Automated Options Market ("AUTOM") system, in violation of PHLX Rule 1080(b). The PHLX also found that the Applicants' conduct was inconsistent with just and equitable principles of trade, in violation of PHLX Rule 707. The PHLX censured and fined the Applicants \$1,000, jointly and severally. We base our findings on an independent review of the record.

II.

AUTOM is the PHLX's electronic order delivery and reporting system for Exchange-listed equity option and index option orders. AUTOM provides for the automatic entry and routing of eligible orders to the Exchange trading floor. 1/ Orders entered into AUTOM may be executed manually. In addition, certain orders are eligible for execution through AUTOM's Automatic Execution ("AUTO-X") system. 2/

PHLX Rule 1080 sets forth the provisions governing the use of the AUTOM and AUTO-X systems. During the relevant period, Rule 1080(b) provided:

Generally, only agency orders may be entered. With respect to U.S. Top 100 Index options ("TPX"), broker-dealer orders may be entered into AUTOM and are eligible for AUTO-X up to a maximum of 50 contracts. 3/

Options orders entered by members into AUTOM are routed to the appropriate specialist unit on the Exchange trading floor. 4/ When a member enters an options order into AUTOM, the member must identify whether the order is for a "customer" or a "firm." In the summer of 2000, the system was configured to reject incoming orders that were

1/ PHLX Rule 1080(a).

2/ Id. AUTO-X provides automatic execution for all eligible market and marketable limit orders. PHLX Rule 1080(c).

3/ PHLX Rule 1080(b)(i) (emphasis added). None of the parties disputes that the orders on behalf of broker-dealers sent by the Applicants did not meet the exception for broker-dealer orders for TPX options.

4/ PHLX Rule 1080(a).

marked as "firm" orders, and to route them to the appropriate floor broker on the Exchange or to the point of origin of the order. 5/

LSC is a broker-dealer and PHLX member organization. Lek is LSC's chief executive officer. LSC applied for access to AUTOM in early 2000. In connection with the AUTOM application process, the PHLX staff indicated to the Applicants that AUTOM was limited to "public customer" (non-broker-dealer) orders, and that PHLX Rule 1080(b) generally prohibited orders for a broker-dealer from being sent through AUTOM. 6/ The Applicants admitted that they were told by at least one PHLX staff member that they could not send orders on behalf of broker-dealers to AUTOM. The Applicants state that they believed that the PHLX had incorrectly interpreted its rule. They thought that Rule 1080 allowed any agency order to be entered into the system, regardless of whether LSC was acting as an agent for a public customer or for a broker-dealer customer.

On July 19, 2002, the Exchange granted LSC access to AUTOM. That same day, the Applicants began transmitting agency orders for their customers that were broker-dealers to AUTOM. Between July 19, 2000 and September 15, 2000, the Applicants sent ninety-eight orders for broker-dealer customers to AUTOM. They acknowledge that they marked each order as a "customer" order. They also included the

5/ Rule 1080 has since been amended to expand the types of orders that are eligible for entry into AUTOM. In addition to agency orders and on-floor orders for the proprietary accounts of PHLX registered options traders and specialists, Rule 1080 now provides that certain off-floor broker-dealer orders may be entered into AUTOM. See PHLX Rule 1080(b)(i)(C) (stating that "[o]ff-floor broker-dealer limit orders, up to the minimum number of contracts permitted by the Exchange, subject to the restrictions on order entry set forth in Commentary .05 of this Rule" may be entered into AUTOM; listing the types of off-floor broker-dealer limit orders that are eligible for AUTOM; defining an "off-floor broker-dealer" as "a broker-dealer that delivers orders from off the floor of the Exchange for the proprietary account(s) of such broker-dealer, including 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.").

6/ The PHLX staff also informed the Applicants that LSC was required to designate an Exchange floor broker to handle orders that were rejected by AUTOM and had to be presented to the trading crowd. LSC did not designate a broker-dealer for this purpose until mid-November 2002.

message, "This is a B/D Order," in the free text field of each order. Because the orders submitted by the Applicants were identified as "customer" orders, AUTOM allowed the orders to pass through the system without being rejected. Forty-five of the orders sent by the Applicants were automatically executed through AUTO-X.^{7/} The remaining orders were executed manually by the relevant specialists.

The PHLX's Board of Governors ("Board") determined that the Applicants "did not intend to hide the fact they were submitting broker-dealer orders over AUTOM." The Board found that the Applicants believed that the Exchange's rules "were being misinterpreted," and that they submitted agency orders on behalf of broker-dealers to AUTOM in order "to force the issue of their interpretation of 'agency orders.'"

III.

The PHLX contends that the Applicants were given guidance concerning its interpretation of "agency orders." It argues that the Applicants had specific notice, prior to their transmission of the orders in question, that the PHLX staff had interpreted the phrase "agency orders" in Rule 1080(b) as excluding orders for broker-dealers. The PHLX asserts that the Applicants were required to follow the staff's interpretation of its rule.

The Applicants contend that the PHLX staff's interpretation ignored the plain meaning of the term "agency orders" used in the Rule. In the Applicants' view, an "agency order" includes any order entered in an agency capacity. The Applicants state that they acted as an agent with respect to all of the orders in question. Consequently, those orders constituted "agency orders," and therefore were eligible for entry into AUTOM.

We believe that, considering the language and history of PHLX Rule 1080(b), it was not clear that the term "agency orders" did not encompass agency orders for broker-dealer customers. On its face, Rule 1080 contained no prohibition on members' routing orders for the accounts of broker-dealer customers through AUTOM. Instead, Rule 1080 broadly authorized "agency orders" to be sent over the system.

The Applicants observe that, in May 1997, the PHLX proposed that Rule 1080 define "agency orders" to mean agency orders for "public

^{7/} During the relevant period, Rule 1080(c) provided that "public customer" orders were eligible for automatic execution by AUTO-X.

customers" only and to exclude agency orders for broker-dealers. 8/ The PHLX subsequently deleted this definition of "agency orders" from its rule proposal. 9/ We stated, in the June 1997 release approving Rule 1080, that the term "public customer" as used in Rule 1080's proposed definition of "agency orders" "would have restricted use of the AUTOM system in a manner not necessarily consistent with the definition of 'public customer' contained in [the] PHLX's Guaranteed Quote rule for options." 10/ Thus, Rule 1080, as approved by the Commission, did not contain a definition that limited the term "agency orders" due to concerns expressed by Commission staff unrelated to the question in dispute. 11/

The Applicants' interpretation that "agency orders" could include agency orders for both public customers and broker-dealer customers also finds support in the language and history of PHLX Rule 229, governing PACE, the PHLX's automatic execution system for equity securities. PHLX Rule 229, in its original form, generally limited orders on PACE to "agency orders," but it did not define the term "agency orders." In 1989, the Exchange wanted to restrict the PACE system to public customer

8/ Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. to Adopt an AUTOM Rule and to Request Permanent Approval for the AUTOM Pilot Program, Securities Exchange Act Rel. No. 38683 (May 27, 1997), 64 SEC Docket 1796, 1796 (PHLX proposed that "an agency order is an order entered on behalf of a public customer, and does not include any order entered for the account of a broker-dealer or any account in which a broker-dealer or an associated person of a broker-dealer has a direct or indirect interest.").

9/ Order Granting Accelerated Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Thereto by the Philadelphia Stock Exchange, Inc. to Adopt an AUTOM Rule and to Request Permanent Approval for the AUTOM Pilot Program, Exchange Act Rel. No. 38792 (June 30, 1997), 64 SEC Docket 2245, 2248.

10/ Id.

11/ Id.

orders. 12/ The Exchange recognized that, unless otherwise defined, the term "agency orders" could be "defined broadly to include not only public customer orders, but also orders entered by broker-dealers or their affiliates." 13/ Given the PHLX's acknowledgment, in the Rule 229 amendment process, that the term "agency orders" includes orders for broker-dealers, and given the PHLX's deletion of a limiting definition of "agency orders" from the final version of Rule 1080, it is not clear that, in the AUTOM context, the term "agency orders" did not include any order executed on an agency basis, including an order for a member's broker-dealer customer.

The deletion of the definition of "agency order" in Rule 1080 and the use of that term in Rule 229 could be read as lending support for the Applicants' conclusion that the term "agency orders" was intended to be read to include all agency orders, including orders for broker-dealer customers. However, in the June 1997 adopting release, we explained that many of Rule 1080's provisions were designed to clarify existing Exchange procedures and did not alter the PHLX's prior interpretations and policies governing AUTOM. 14/ The June 1997 release stated, in pertinent part:

The Commission notes that many of the proposed provisions consist of rules that either previously were approved explicitly by the Commission or codify existing practice that has developed pursuant to approved guidelines. The Commission believes that such provisions of the proposal do not substantially alter the Exchange's current interpretations and policies governing AUTOM, but rather, clarify existing operational procedures and codify into the Exchange's rules improvements that have been made to

12/ Order Approving Proposed Rule Change Relating to the Definition of "Agency Order" in Connection with PACE, Exchange Act Rel. No. 26968 (June 23, 1989), 43 SEC Docket 2225, 2225; see Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to "Definition of Agency Order in Connection with PACE," Exchange Act Rel. No. 26712 (Apr. 11, 1989), 43 SEC Docket 1070.

13/ 43 SEC Docket at 1070. Rule 229 currently defines an "agency order" as "any order entered on behalf of a public customer, and does not include any order entered for the account of a broker-dealer, or any account in which a broker-dealer or an associated person of a broker-dealer has any direct or indirect interest." PHLX Rule 229.02.

14/ See 64 SEC Docket 2245.

the AUTOM system. These provisions include the types of orders eligible for AUTOM and AUTO-X, respectively. 15/

Prior to 1997, the AUTOM system was restricted to public customer orders. Thus, the reference to the provision governing the types of orders eligible for the AUTOM and AUTO-X systems appears to reflect the expectation that the Exchange's interpretation of this provision, including the term "agency orders," continued to apply notwithstanding the amendments to Rule 1080.

The PHLX suggests that subsequent Commission releases made clear that the term "agency orders" in Rule 1080 referred only to public customer orders. For example, in a 1998 proposing release concerning unrelated amendments to Rule 1080, the PHLX cited to the Commission's June 1997 release as support for the proposition that AUTOM was limited to public customer orders. However, given the fact that the June 1997 release specifically deleted the definition of "agency order" from Rule 1080, the language in the 1998 proposing release regarding "agency orders" did not clearly indicate that AUTOM was reserved for public customer orders only. 16/

In sum, we believe that the term "agency orders," as used in Rule 1080, is too ambiguous a term to warrant the PHLX's finding that

15/ Id. at 2247.

16/ Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. to Amend PHLX Rule 1080 to Permit Automatic Execution of U.S. Top 100 Index Options Orders for the Accounts of Broker-Dealers, Exchange Act Rel. No. 40681 (Nov. 16, 1998), 68 SEC Docket 1764, 1765 & nn. 6, 9.

The PHLX also cites additional releases. To the extent that these releases, both of which postdate Rule 1080, refer to Rule 229 for the argument that agency orders are limited to public customer orders, they ignore the express language of Rule 229 confining its application to PACE. See Notice of Filing of Proposed Rule Change and Amendments Nos. 1 through 7 thereto by the Philadelphia Stock Exchange, Inc. Relating to Electronic Interface with AUTOM for Phlx Specialists and Registered Options Traders, Exchange Act Rel. No. 46095 (June 20, 2002), 77 SEC Docket 2910; Order Granting Approval to Proposed Rule Change and Amendments No. 1 through 7 thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 8 Relating to Electronic Interface with AUTOM for Specialists and Registered Options Traders, Exchange Act Rel. No. 46763 (Nov. 1, 2002), 78 SEC Docket 2711.

the Applicants violated PHLX Rule 1080(b). 17/ Accordingly, we have determined to set aside the PHLX's findings of violations and the sanctions that it imposed against the Applicants. 18/

IV.

The Applicants object that the PHLX received additional submissions into the record. They contend that once they waived their right to a hearing on the charges by failing to request a hearing in the Answer, 19/ the PHLX's rules limited the PHLX's review of the record to the Statement of Charges and the Answer. We agree with the PHLX that an applicant should not be permitted to limit the record for review by waiving his right to a hearing. Here, the PHLX's rules grant the PHLX discretion to determine the manner of proceeding in light of a respondent's failure to request a hearing. 20/

Section 6(b)(7) of the Securities Exchange of 1934 requires the Exchange to provide a "fair procedure." 21/ The PHLX, when confronted with the Applicants' waiver of a hearing, permitted both

17/ The PHLX based its finding that the Applicants engaged in conduct inconsistent with just and equitable principles of trade, in contravention of Rule 707, on their finding that the Applicants violated Rule 1080. Because we do not find that the Applicants' conduct violated Rule 1080, we dismiss the findings that the Applicants violated Rule 707.

18/ To avoid this result in the future, the PHLX may wish to submit an interpretation of Rule 1080 with respect to whether the term "agency orders" refers to public customer orders, or amend the Rule to clarify its applicability.

19/ See PHLX Rule 960.4 (requiring a respondent to state in the Answer if he requests a hearing; providing that the failure to request a hearing results in a waiver of the right to a hearing).

20/ See PHLX Rule 960.4 (providing that, in the event a respondent waives the right to a hearing, the BCC "may" prepare a decision in accordance with the PHLX's rules); compare Christopher J. Peterson, 50 S.E.C. 716, 718 (1991) (holding that PHLX rule, which provided that the Exchange "may" bar a person, called for the Exchange's exercise of discretion in deciding whether to impose a bar).

21/ 15 U.S.C. § 78f.

parties to file additional pleadings, and thereby to expand the record for review. It allowed the staff to submit a Request for Decision and the Applicants to submit a response. Both parties availed themselves of the opportunity to provide additional material. The PHLX acted in a fair and even-handed manner. We find that this method of proceeding was fair.

An appropriate order will issue. 22/

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID, and ATKINS); Commissioner CAMPOS not participating.

Jonathan G. Katz
Secretary

22/ We have considered all of the parties' contentions. We have rejected or sustained their contentions to the extent that they are inconsistent or in accord with the views expressed in this opinion.

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PHILADELPHIA STOCK EXCHANGE, INC.

ORDER SETTING ASIDE DISCIPLINARY ACTION TAKEN BY NATIONAL SECURITIES
EXCHANGE

On the basis of the Commission's opinion issued this day, it is

ORDERED that the findings of violations and the sanctions
imposed by the Philadelphia Stock Exchange, Inc. in this action
against Lek Securities Corp. and Samuel F. Lek be, and they hereby
are, set aside.

By the Commission.

Jonathan G. Katz
Secretary