

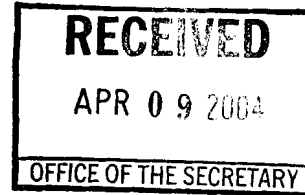


**AMERICAN
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Equities Options ETFs

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April 8, 2004



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Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: S7-07-04 (Options Concept Release)

Dear Mr. Katz:

The American Stock Exchange LLC (“Amex” or “Exchange”) appreciates this opportunity to comment on File No. S7-07-04, Competitive Developments in the Options Markets (the “Concept Release”).¹ The Concept Release addresses and seeks comment on payment for order flow (“PFOF”), internalization, specialist guarantees, enforcement of “best execution” obligations, penny quoting, disclosure of order execution quality, limit order display, and related matters. The following bullet points summarize the Exchange’s position on the various issues raised in the Concept Release:

- The Amex has long opposed PFOF in all forms and believes that the Securities and Exchange Commission (“Commission”) should prohibit PFOF in both the options and equity markets. PFOF is a cost of trading that impacts specialist and market maker quotes by encouraging wider spreads. PFOF, moreover, subverts a broker’s duty of best execution and undermines the national market system goal of routing to markets where price improvement is possible. While the Exchange has implemented a PFOF program in response to competitive pressure from other markets, the Exchange urges the Commission to prohibit the practice in all markets that it regulates.
- The Amex believes that penny quoting may reduce, but will not eliminate, PFOF. More importantly, the Exchange believes the negative consequences of penny quoting far outweigh the benefits associated with a potential reduction in PFOF. The adverse effects of penny quotes include loss of transparency in quotes, loss of liquidity at the inside market and difficulty routing orders to markets showing the best quotes. Penny quoting also will burden quote processing facilities and strain system capacity of the options markets and vendors, delaying the dissemination of quotes, frustrating order routing decisions, and generally undermining the goals of a national market system.

¹ Securities Exchange Act Release No. 49175, 69 Fed. Reg. 6124 (February 9, 2004).

- The Amex urges the Commission to refrain from extending Section 612 (“Minimum Pricing Increment”) of proposed Regulation NMS² to listed options. If this were done, all options could be traded in subpennies and options with a premium of less than \$1.00 could be quoted in subpennies. Extending subpenny quoting to options priced less than \$1.00 will overwhelm capacity limits of existing option quote processing systems. We believe, moreover, that many participants in the options market are unaware that the Commission is considering extending subpenny trading and quoting to options at a time when the Concept Release is out for comment.
- The Amex believes that the most important factor in narrowing quote widths is inter-market competition, not intra-market competition. Order flow providers are mainly concerned with the best bid and offer disseminated by each options exchange. Intra-market competition, while relevant to the competitiveness of an individual exchange, is not the primary factor for attracting order flow providers.
- The Amex believes that the Commission should not allow internalization unless internalized orders get meaningful exposure on an exchange where price improvement is possible in standard trading increments of five and ten cents. Like PFOF, internalization is antagonistic to best execution and, if conducted broadly, will have an adverse impact on market quality and transparency as exchange specialists and market makers widen and reduce the size of their markets in anticipation that only less desirable orders will be sent to the exchange. Furthermore, internalization decreases opportunities for natural buyers and sellers to meet. While the Exchange has adopted rules that allow member firms to internalize a portion of their orders sent to the Amex, the Exchange adopted these procedures in response to competitive pressure from other markets and would welcome Commission action to prohibit these practices.
- The Amex believes that specialist guarantees and internalization are unrelated and should be examined independently. As described in more detail below, specialists have important responsibilities to the market, which include the continuous dissemination of two-sided market quotations. Specialists are the heart of inter-market competition that has so benefited the options markets. Internalizers, on the other hand, have no such obligation and can “cherry pick” customer orders if they represent profitable trading opportunities. As correctly noted by the Commission in its Concept Release, specialist guarantees “reward market makers willing to perform the obligations of a specialist” and “are intended to attract and retain well-capitalized firms that are responsible under exchange rules for assuring fair and orderly markets and fulfilling other responsibilities that enhance the exchange.”
- The Concept Release expressed concern that the desire of options exchanges to attract order flow may compromise their ability to enforce the best execution obligations of upstairs member firms in making order routing decisions. The Amex believes no such conflict of interest exists in practice. The Amex reviews its floor members’ handling of

² Securities Exchange Act Release No. 49325 (February 26, 2004), 69 Fed. Reg. 11126 (March 9, 2004), p. 11172.

orders; it does not, however, review the order routing decisions of upstairs member firms. An independent SRO, the NASD, reviews such order routing decisions. We believe that the Exchange's regulatory scheme in this area (i.e., the Amex reviews on-floor order handling and NASD reviews off-floor order routing decisions) conforms to that of the other options exchanges.

- The Amex supports uniform measures of execution quality for the options markets and would welcome an initiative that seeks to develop such measures. A simple extension of 11Ac1-5 to the options markets, however, without modification would generate data of little value due to (1) the extraordinarily large number of options series relative to listed equities (the Amex alone lists more than 100,000 option series), and (2) the relative infrequency with which many series trade.
- The Amex supports the adoption of a limit order display rule in the options markets. Indeed, the Exchange has a limit order display rule pending with the Commission (SR-Amex-2000-27) and a filing to implement new trading technology for options which would include a quote assist function to aide compliance with a limit order display rule (SR-Amex-2003-89). The Amex urges the Commission to approve both filings.

Responses to Specific Questions in the Concept Release

Questions 1 & 2. To what extent, if any, does payment for order flow in the options markets affect a specialist's or market maker's incentive to quote aggressively? If commenters believe that payment for order flow diminishes a specialist's or market maker's incentives to quote aggressively, why have spreads narrowed over the past few years while payment for order flow increased?

Response

PFOF is an artificial cost of doing options business. Like other trading costs, specialists and market makers will seek to recoup PFOF costs through wider quotes. A desire to maintain wider quotes to recoup costs naturally affects a specialist and market maker's quoting behavior. Additionally, liquidity providers, whether specialist, market maker, or public limit order trader, are more likely to aggressively quote or place orders when they know that their aggressiveness will result in other orders being attracted to their quote or order. PFOF acts as a disincentive for aggressive quoting and order entry because other orders (that would have otherwise been attracted to their best prices) are going to be directed to another location, regardless of whether a market participant aggressively quotes or prices orders.

Increased inter-market competition in the past few years has offset the negative effects of PFOF. This increased competition has resulted from the introduction of two options exchanges (ISE and BOX), dissemination of quotes with size, widespread multiple listing of options contracts, auto quoting by multiple market participants, increased best execution reporting, and enhanced order routing technology. All of these factors have caused spreads to narrow in recent years. In addition, a decline in the number of high priced securities following March 2000 and a

decline in market volatility as documented in the Chicago Board Options Exchange Volatility Index, or VIX Index, have contributed to narrower spreads in absolute dollars.

The Exchange has long argued that payment for order flow undermines a broker's duty of best execution and undermines national market system goals.³ While the Exchange implemented a payment for order flow program in response to competitive pressure from other markets, the Exchange urges the Commission to prohibit the practice in all markets that it regulates.

Question 3. Where multiple market participants can quote independently and incoming orders are allocated to the market participant that sets the best quote, are market participants more or less likely to enter payment for order flow arrangements than those on markets with less intramarket quote competition?

Response

Currently, each options exchange has an exchange-sponsored PFOF program requiring all participants in its market to contribute to the payment pool. This eliminates any potential benefit of independent quoting as PFOF represents a cost of trading that is incorporated into specialists' and market makers' quote widths. In the absence of PFOF, however, independent quoting by market makers and specialists may enhance both intra-market and inter-market quote competition.

Question 4. Do current exchange rules guaranteeing specialists a certain portion of orders affect quote competition? To what extent is intramarket quote competition preserved by requiring that non-specialist market makers be permitted to compete for at least 60% of an order

³ See, e.g., letter from James R. Jones, Chairman, Amex, to Jonathan Katz, Secretary, SEC dated December 8, 1992; Testimony of James R. Jones, Chairman, Amex, before the House Subcommittee on Telecommunications and Finance, dated, April 14, 1993; Answers to Post-Hearing Questions Relating to April 14, 1993, Hearing on the Future of the Stock Market, American Stock Exchange, Inc.; letter from Jules L. Winters, Chief Operating Officer, Amex, to Jonathan Katz, Secretary, SEC, dated December 21, 1993; letter from Jules L. Winters, Chief Operating Officer, Amex, to The Honorable Edward J. Markey, Chairman, and The Honorable Jack Fields, Ranking Republican Member, House Subcommittee on Telecommunications and Finance, dated April 7, 1994; letter from James F. Duffy, Executive Vice President and General Counsel, Amex, to Jonathan Katz, Secretary, SEC, dated January 12, 1995; letters from Richard F. Syron, Chairman & CEO, Amex, to The Honorable Thomas J. Bliley, Jr., Chairman, House Committee on Commerce, and The Honorable Jack Fields, Chairman, House Subcommittee on Telecommunications and Finance, dated August 4, 1995; letter from Thomas F. Ryan, Jr. President and COO, Amex, to Jonathan Katz, Secretary, SEC, dated February 1, 1996; letter from Thomas F. Ryan, Jr., President and COO, Amex, to Jonathan Katz, Secretary, SEC, dated February 26, 1997; letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Annette Nazareth, Director, Division of Market Regulation, SEC, dated December 10, 2001; letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Jonathan Katz, Secretary, SEC, dated October 28, 2002; letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Chairman Harvey L. Pitt, Chairman, SEC, and Cynthia A. Glassman, Harvey J. Goldschmid, Paul S. Atkins, and Roel Campos, Commissioners, SEC, dated November 19, 2002, letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Jonathan Katz, Secretary, SEC, dated November 19, 2002, letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Chairman Harvey L. Pitt, Chairman, SEC, and Cynthia A. Glassman, Harvey J. Goldschmid, Paul S. Atkins, and Roel Campos, Commissioners, SEC, dated January 31, 2003; letter from Salvatore F. Sodano, Chairman & Chief Executive Officer, Amex, to Harvey L. Pitt, Chairman, SEC, dated February 6, 2003; ; letter from Salvatore F. Sodano, Chairman & Chief Executive Officer, Amex, to Harvey L. Pitt, Chairman, SEC, dated February 10, 2003.

without bettering the specialist's quote? Is the harm to quote competition, if any, decreased on those markets that permit market makers to auto-quote?

Response

The Amex is concerned that the Commission confuses the purpose and impact of specialist guarantees (which encourage liquidity and transparency in the market) with internalization (which removes liquidity from the market and reduces transparency).⁴ Specialists are required to engage in a course of dealings calculated to contribute to the maintenance of fair and orderly markets. As part of this mandate, specialists have an obligation to continuously disseminate two-sided market quotations and to trade for their own accounts when there is a temporary disparity between supply and demand or a temporary distortion of the price relationships between option contracts of the same class.⁵ As correctly noted by the Commission in its Concept Release, specialist guarantees “reward market makers willing to perform the obligations of a specialist” and “are intended to attract and retain well-capitalized firms that are responsible under exchange rules for assuring fair and orderly markets and fulfilling other responsibilities that enhance the exchange.”

Importantly, in order to benefit from specialist guarantees, specialists must be *at the quote at the time an order is received*. Moreover, the guarantees are capped and are reduced depending on the number of market makers in the crowd. Any specialist with a crowd of 2 market makers, for example, is only guaranteed 40% of an order and, as the number of market makers in the crowd increases, this guarantee can go as low as 20%.

Firms internalizing order flow, on the other hand, have no obligation to disseminate continuous two-sided market quotations, do not compete for order flow on the basis of quote competition, and can “cherry pick” when and with whom they trade. Unlike specialists who “see” an order at the same time as other market makers in the crowd, internalization allows broker-dealers to “look” at their customer orders ahead of other market participants to determine whether the order represents a profitable trading opportunity. This “cherry-picking” of orders is antagonistic to a broker's duty of best execution and, if conducted on a large scale, will lead to the deterioration of quoted markets on the options exchanges as market makers will widen their quotes in the expectation that only less desirable orders will be routed to the exchange. Wider quotes will likely provide yet additional opportunities for internalization. Additionally, unlike specialist guarantees, which are capped as described above, an internalizer's *minimum* percentage is fixed at 40% regardless of the number of market maker's competing for the order.

⁴ Internalization should be distinguished from facilitation. Unlike internalization, facilitation adds liquidity to the options markets. Facilitation occurs when a broker agrees to take the other side of a customer order to assist in that order's execution as a service to the customer (i.e., the brokers is adding order flow that is not otherwise available in the market). Internalization, on the other hand, is a process whereby brokers choose to trade with limited but more desirable order flow.

⁵ Specialists are further obligated to (1) assure that disseminated market quotations are accurate; (2) assure that each disseminated market quotation in appointed options classes is honored up to the disseminated size; (3) be present at the trading post throughout every business day; (4) participate at all times in the automated execution system for each assigned option class; and (5) resolve trading disputes, subject to Floor Official review upon the request of any party to the dispute.

Question 5. Is a market maker's incentive to quote aggressively impacted by the percentage of orders that an upstairs firm can internalize? For example, all things being equal, is a market maker less likely to quote aggressively if exchange rules or customs permit an upstairs firm to internalize a substantial portion of each order that it brings to the exchange?

Response

Internalization impacts a market maker's incentive to quote aggressively. As noted in our response to Question 4, a firm internalizing order flow has no continuous quoting requirement and can internalize only those orders that represent the most profitable trading opportunities. As the contracts available for market makers in these most favorable trades are increasingly reduced, the incentive of market makers to quote aggressively is diminished. Furthermore, as internalization is expanded to small orders (i.e., orders less than 50 contracts), inter-market quote competition will further diminish and uninformed order flow, which would most benefit from inter-market competition, will be most disadvantaged.⁶

Question 6. Do customer orders that are routed pursuant to payment for order flow arrangements ever receive less favorable executions than orders not subject to such arrangements? To what extent do exchanges' rules requiring that members avoid trading through better prices on other exchanges ensure that any order, regardless of the reason for its being routed to a particular exchange, receives at least the best published quotation price?

Response

Inter-market Options Linkage ("Linkage") has reduced but not eliminated the extent to which trades receive less favorable executions. For example, at least one exchange does not automatically execute inbound Linkage orders against orders on their book. When these Linkage orders are routed to manual handling, they may not be acted upon in the required 15 seconds and expire as a consequence. Thus, such Linkage orders may not access the better price and will likely be executed at an inferior price.

Questions 7, 8 & 9. Do market makers establish the price and size of their public quote based on the assumption that they may trade with an informed professional, which involves more risk than trading with an uninformed non-professional? If commenters agree that public quotes are based on the assumption that the market maker may trade with a professional, are such quotes wider than they would be if market makers only received uninformed, non-professional orders? Are market makers willing to trade with non-professional orders at prices better than their quote?

⁶ As noted in the December 2000 special study Payment for Order Flow and Internalization in the Options Markets prepared by the Commission's Office of Compliance Inspections and Examinations and Office of Economic Analysis, "[s]mall retail customer orders which are almost always executed at the bid and offer, tend to be relatively more profitable for specialists than the larger orders, which tend to be represented by professional traders who negotiate with the dealers for better prices."

Response

Academic literature suggests that market makers will inevitably widen and reduce the size of their markets if they believe that their counterparties have an informational advantage. As both informed professionals and uninformed non-professionals participate in the U.S. options markets, some market makers will base their quotes on an assumption that they may be trading with informed professionals while other market makers will not make such an assumption. Accordingly, whether a market maker assumes that it may be trading with an informed professional depends on the particular market maker and its trading philosophy. In addition, the willingness of a market maker to trade at a price that is better than its displayed quote may also depend upon the liquidity of the underlying stock, the size of the order, the market maker's position, and the width of the quote. If, however, insiders came to dominate the options markets through internalization (i.e., off-exchange firms all automatically screen their customer orders prior to sending them to the floor for profitable trading opportunities and only route unmatched orders to the floor that are less desirable), then market makers as a group would tend to widen their markets in anticipation that their counter parties will be professionals.

Question 10. If the Commission were to eliminate payment for order flow would non-professional orders get better prices?

Response

PFOF is a cost of trading to specialists and market makers. To the extent that trading costs are reduced, investors of all types may receive better executions. Moreover, the elimination of PFOF may increase intra-market competition and, as a result, increase opportunities for orders to receive better prices.

Question 11. Do customer orders that are internalized in whole or in part on an exchange receive less favorable executions than orders that are not internalized? If so, why?

Response

As described above, internalization has a negative impact on the market as a whole, which will increase as the practice grows. The impact of internalization is not experienced on individual orders; rather, it manifests itself through a deterioration of market quality. Stated differently, internalization has a macroeconomic impact on the market as a whole rather than a microeconomic impact on individual orders.

Question 12. Do exchange rules requiring that an auction occur prior to a trade ensure that internalized orders are executed at the best available price?

Response

Exchange rules requiring an auction to occur ensure that orders are executed at the best available price, provided that the order is given adequate exposure to other market participants.

An auction that is limited by participants or is of insufficient duration will not ensure that an order is executed at the best available price.

Questions 13 & 14. Is an SRO's enforcement of its members' best execution obligation affected by the SRO's interest in attracting and retaining order flow from those same members? To what extent does payment for order flow practices generally, or exchange-sponsored payment for order flow specifically, exacerbate the conflict an SRO has in carrying out its obligation to enforce its members' best execution obligation?

Response

A broker-dealer's duty of best execution derives from common law agency principles and has been incorporated through judicial and Commission decisions in the anti-fraud provisions of the federal securities laws. This duty requires a broker-dealer to seek the most advantageous terms available under the circumstances for a customer's order. Where a broker routes orders to a particular market based upon a predetermined routing decision, the Commission has stated that the broker must, "regularly and rigorously assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders."⁷ The duty of a customer carrying firm to route customer orders in the best interests of the customer is the most commonly expressed embodiment of the duty of best execution. In addition to the duty of upstairs firms to route orders in the best interests of their customers, the rules of some markets, such as Amex Rule 155 ("Precedence Accorded to Orders Entrusted to Specialists") and 156 ("Representation of Orders"), also embody common law agency concepts and require exchange members to use, for example, "due diligence" in the execution of orders and to yield precedence to agency orders that they represent. The duty of individual exchange members to agency orders that he or she represents is a second, less commonly discussed but nonetheless vital aspect, of a broker's duty of best execution.

The Exchange does not review the order routing decisions of upstairs member firms to determine whether these decisions are consistent with the duty of best execution and whether their order routing decisions have been corrupted by PFOF or the desire to trade as principal with "cherry-picked" orders (i.e., internalize). Instead, as the Commission is aware, NASD reviews the order routing decisions of member firms for compliance with their best execution obligations. As a result, the Exchange's desire to attract and retain order flow from its upstairs member firms does not compromise our self-regulatory program.

Question 15. Does exchange-sponsored payment for order flow affect specialists' or market makers' incentives to quote aggressively differently than other types of payment for order flow? If so, in what respects?

⁷ Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (Order Execution Obligations Adopting Release), p. 163.

Response

As stated above, PFOF is a cost of trading and all trading costs impact a specialist or market maker's ability to quote aggressively. The biggest differences between exchange sponsored PFOF and other payment mechanisms are that (1) all beneficiaries of the order flow pay into an exchange sponsored plan, and (2) funds collected and disbursed under an exchange sponsored plan are transparent and auditable.

Question 16. What safeguards, if any, should an options exchange have in place to ensure that it can carry out its regulatory responsibilities with respect to those of its members that accept payment for order flow or internalize trades? For example, would an independent SRO to oversee how brokers meet their best execution obligations be feasible and desirable?

Response

As stated above, the NASD currently reviews the order routing decisions of upstairs member firms and therefore we do not see the necessity for the Amex to adopt safeguards with respect to ensuring that its members that accept PFOF or internalize trades comply with their best execution obligations.

Section VI.A. & VI.C. Should the Commission take action at this point? (Questions 17 & 18)⁸ Should the Commission ban payment for order flow, specialist guarantees, and internalization? (Questions 21 through 26)⁹

⁸ Question 17. Do recent regulatory changes together with competitive forces in the options markets make additional regulatory action at this time unnecessary?

Question 18. What would be the likely consequences to the options markets in terms of competition and execution quality should the Commission decide to take no regulatory action at this time? Specifically, do commenters believe that the current trend toward narrower spreads in the options markets could itself eliminate payment for order flow, specialist guarantees, and internalization?

⁹ Question 21. What would be the effect of banning all payment for order flow arrangements in the options markets? If the Commission determined that a ban on payment for order flow were warranted, would a ban only on cash payments be sufficient or would non-cash inducements also have to be banned? If commenters believe that the Commission should impose such a ban, could such a ban be easily evaded in light of the numerous forms that payment for order flow arrangements can take?

Question 22. If the Commission were to ban all payment for order flow, but continue to permit firms to internalize their customers' orders, would it provide an unfair advantage to integrated firms that have customer order flow they can internalize? If a ban on payment for order flow unfairly advantaged integrated firms with broker and dealer operations, should the Commission revisit the issue of whether firms should be permitted to operate both as a broker and as a dealer for customer options orders?

Question 23. Should the Commission ban some or all specialist guarantees and internalization (i.e., dealer participation arrangements) in the options markets? Should any such ban only be done in conjunction with a ban on payment for order flow?

Question 24. What would be the impact, if any, on competition in the options markets if the Commission were to ban either payment for order flow or dealer participation arrangements without banning the other type of arrangement?

Question 25. What would be the impact of a complete ban on all such practices? For example, if the Commission banned payment for order flow and dealer participation arrangements, who would benefit? Would specialists and market makers quote better prices? Would they retain the economic benefit they now share with order entry firms? What effect would a ban have on non-dominant markets or firms seeking to attract order flow from the dominant market participants?

Response

The Exchange believes that the Commission should (1) ban PFOF, and (2) prohibit small order internalization procedures that do not provide meaningful exposure to competitive market forces. For the reasons stated earlier in this correspondence, the Exchange believes that PFOF and internalization degrade market quality. While the Exchange implemented these PFOF and internalization programs to respond to competitive pressures from other markets, the Amex would welcome a decision by the Commission to ban all such practices.

The Exchange believes that the current trend towards narrower spreads is attributable to competition among the options exchanges (i.e., inter-market competition) and that the fundamental driver of inter-market competition has been competition for order flow among the primary market makers (specialists, DPMs, LMMs, PMMs) in each market. As the Commission acknowledged in the Concept Release, specialist guarantees strengthen the primary market maker in each market and, thus, strengthen inter-market competition. These guarantees should not be eliminated as suggested in question 18. While we agree that specialist guarantees could be structured in a manner that adversely affects intra-market competition (e.g., the proposed Phlx 80/20 Plan), these guarantees currently encourage both inter-market and intra-market competition and enhance market quality. As previously stated, the Commission should not consider specialist guarantees and internalization as equivalents or even similar.

In the event that the Commission does not prohibit PFOF, but instead seeks to ensure that the benefit of these payments go to customers, we believe that the Commission should consider prohibiting all forms of PFOF except exchange-sponsored plans since these plans (unlike other payment schemes) provide a transparent and auditable method for funds collected and disbursed.

Section VI.D. Should the Commission ban only Exchange sponsored payment for order flow? (Questions 27 & 28)¹⁰

Question 26 In response to a recent request for the views of the options markets on payment for order flow arrangements, one of the markets stated that the Commission's review of payment for order flow and internalization should not be limited to the options markets but rather should include the equities markets as well. Are there differences between the equities and options markets that warrant different treatment? If so, what are those differences? If different treatment is not warranted, should the Commission consider a market-wide ban on payment for order flow and dealer participation arrangements?

¹⁰ **Question 27** What would be the effect on the options markets and market participants if the Commission were to restrict only those payment for order flow arrangements that are sponsored or sanctioned in some way by a registered options exchange, as Phlx has proposed in its petition? In particular, would such a restriction favor a specialist that can be assured of trading with the largest proportion of order flow routed to its exchange? In other words, would such a ban unfairly disadvantage an exchange on which market makers compete more aggressively with the specialist?

Question 28 Would banning exchange-sponsored programs, while continuing to permit other types of payment for order flow and dealer participation arrangements, address the concerns discussed above regarding wider spreads, best execution, and SRO conflicts of interest?

Response

A selective ban on PFOF that prohibits only current exchange-sponsored programs would favor markets that have the lowest levels of intra-market competition like the Phlx, which proposed the selective ban of exchange sponsored payment programs. Current exchange-sponsored PFOF programs impose a fee on all primary and supplemental market makers that benefit from the order flow. These programs thus allow markets characterized by high levels of intra-market competition to compete on a PFOF basis against markets that have less intra-market competition where the primary market makers receive a greater percentage of trades and, thus, are able to pay more for order flow than primary market makers in a market with more supplemental traders. The Phlx proposal, consequently, is a disingenuous attempt to secure a competitive advantage through selective regulation. In addition, while an exchange-sponsored program fosters the problems associated with PFOF, it at least permits an accounting of the funds raised, persons receiving payment and amounts received.

Section VI.E. Should the Commission establish uniform rules and enforcement standards regarding internalization and specialist guarantees? (Questions 29 through 33) ¹¹

Response

We agree with the CBOE that the Commission should prohibit broker-dealers from internalizing their customers' orders if those orders have not first been exposed to the market in a manner that provides a meaningful opportunity for price improvement in standard trading increments of five and ten cents. This would involve exposing the order to the crowd for an appropriate amount of time, which will vary depending on the complexity of the order, to allow market makers a realistic opportunity to evaluate the order. In this regard, we believe that the Exchange's rules with respect to facilitated and solicited trades provide orders with a meaningful exposure to competitive market makers and opportunity for price improvement.

As described above, a broker is obligated to seek the best execution for customer orders, a principal element of which is best price. Practices that are inconsistent with a broker's best execution obligation include shopping orders to see where the firm can receive the greatest

¹¹ Question 29 Should the Commission take action, as CBOE recommends, to prohibit a broker from internalizing all or part of its customers' orders if those orders have not first been exposed to the market in a manner that provides what CBOE terms "a meaningful opportunity" for price improvement? What would constitute "a meaningful opportunity" for price improvement?

Question 30 Do the options exchanges' current rules requiring that an order first be exposed to an auction before a firm can internalize it provide a meaningful opportunity for price improvement?

Question 31 What improvements could be made to the current framework for cross-market surveillance in the options markets to improve the ability of SROs to bring a best execution case against a broker that presents an order to be facilitated on one market and cancels that order, later executing it at an inferior price on another market?

Question 32 Are there other practices, occurring frequently with respect to facilitation guarantees that are inconsistent with best execution obligations? For example, are there circumstances under which an upstairs firm should not be permitted to "shop" an order it is seeking to facilitate at more than one exchange to determine where it can get the most favorable terms for that order?

Question 33 Are the options exchanges' rules with respect to facilitation guarantees (and the application of those rules) consistent regarding which conduct should and should not be permitted?

participation or ignoring a better market. Surveillance for these violations requires coordination among the exchanges, which should be undertaken through the Intermarket Surveillance Group.

Section VI.F. Should the Commission Apply Rule 11Ac1-5 to options? (Questions 34 through 36)¹²

Response

The Amex would support an initiative to develop uniform measures of execution quality for options, and recommends that the Commission convene the options exchanges to develop such measures. Due to the extraordinarily large number of option series relative to equity securities (the Amex lists more than 100,000 option series) and the relative infrequency with which most option series trade, however, a simple extension of 11Ac1-5 data to options would be meaningless or of little value in most cases. In addition to its lack of utility, 11Ac1-5 data for options also would be expensive for the markets and firms to produce, process and store.

Section VI.G. Would penny quotes in options reduce payment for order flow? (Questions 37-41)¹³

Response

While we agree that penny quotes would tend to reduce PFOF, it would not eliminate payment, and would have a number of adverse consequences to the options markets that would outweigh benefits from any reduction in payment for order flow. As discussed in greater detail below, the adverse affects of penny quotes include loss of transparency in quotes, strain on

¹² Question 34 Would Rule 11Ac1-5 data be useful to firms routing customers' options orders to exchanges and to those customers?

Question 35 If Rule 11Ac1-5 data would be useful for options orders, what adjustments, if any, would options market centers need to make to calculate and disseminate Rule 11Ac1-5 statistics? For example, is the OPRA NBBO a sufficient measure to enable market centers to make the Rule 11Ac1-5 calculations that require a consolidated BBO? If not, what changes would need to be made to the OPRA NBBO to make it suitable for such calculations?

Question 36 Are there other reasons why Rule 11Ac1-5 should not be applied to the options markets? For example, do the anticipated benefits of having better execution quality information for the respective options market centers justify the costs that the market centers would incur in calculating and disseminating the Rule 11Ac1-5 statistics?

¹³ Question 37 If options were quoted in penny increments, would payment for order flow in the options markets cease or be diminished?

Question 38 Would a move to penny quoting in the options markets place an undue strain on existing system capacity? If so, which market participants would be most negatively impacted (e.g., broker-dealers, exchanges, vendors)?

Question 39 If so, are there ways to alleviate potential strains on system capacity to allow the options markets to begin quoting in penny increments?

Question 40 Are there other issues that make a move to penny quoting in the options markets infeasible or inadvisable? For example, what would be the impact on the rapidity of quote changes (i.e., "flickering quotes")?

Question 41 If exchanges required brokers to pay directly for the capacity that they use, would the brokers quote more efficiently, and thereby make a move to penny pricing in the options markets more feasible?

system capacity with possible damage to the national market system, loss of liquidity at the inside market, and difficulty in routing orders to the markets showing the best quotes. A simpler remedy to the problems of payment would be to simply prohibit the practice.

Penny quoting would degrade market transparency since it would be difficult for most small investors to see beyond the NBBO. In a penny quoting environment, most dealers would quote in smaller size than currently; likely in minimum lots if the experience of the Nasdaq market is any guide. As a result, investors who want to trade more than the NBBO quantity would be unable to determine the next price available and the size available at that price.

Penny quoting would fragment executions and create the multiple price executions that now exist in equities. Linkage also would make trading in pennies difficult. A P/A order may need to be sent to multiple exchanges in order to receive small “penny better” partials before the customer order could be filled. The need to send multiple linkage orders to different markets would create order execution delays.

Penny quoting, the automated quote generation systems of different market participants, and quote streaming by market makers will burden the quote processing facilities of the options markets and vendors. This may delay the dissemination of quotes, which will make the calculation of a meaningful NBBO impossible, frustrate order routing decisions, and generally undermine national market system goal of linked markets trading the same securities on the basis of accurate displayed quotations.

The adverse affects of penny quotes could be mitigated by reducing the securities and indexes underlying listed options or limiting the number of listed options series. The Commission also could require market participants to pay for the capacity that they use in generating quotes, although this would have an adverse impact on smaller exchanges and broker-dealers.

We are concerned by the suggestion in Regulation NMS, that penny trading should be extended to all options and subpenny quoting should be implemented in options priced below \$1.00.¹⁴ If penny quoting would exceed existing capacity, subpenny quoting in options priced below \$1.00 would overwhelm the system since many option series have premiums of \$1.00 or less. We also are concerned that the Commission requests comment on extending subpenny trading and quoting to options as part of Regulation NMS, when the comment period for the Concept Release has not even expired. We believe that many participants in the option markets may be unaware that the Commission is exploring the extension of subpenny trading and quoting to options in proposed Regulation NMS, and we urge the Commission to defer rulemaking with respect to subpenny and penny trades and quotes.

Section VI.H. Should the Commission apply the limit order display rule to options? (Questions 42 through 46)¹⁵

¹⁴ See footnote no. 2 above.

¹⁵ Question 42. Should the Commission apply a limit order display obligation to the options markets?

Response

The Amex has had a rule filing pending with the Commission for several years that would adopt a limit order display rule for options (SR-Amex-2000-27). The Exchange also has a rule filing pending with the Commission for its ANTE system. The ANTE system includes a "quote assist" feature that would facilitate compliance with a limit order display rule for options (SR-Amex-2003-89). The Exchange urges the Commission to approve both its limit order display and ANTE rule filings.

* * * * *

The Exchange appreciates the opportunity to submit its views on issues facing the options market and would be please to discuss its views further with the Commission or Staff.

Very truly yours,



cc: The Hon. William Donaldson, Chairman
 The Hon. Cynthia Glassman, Commissioner
 The Hon. Paul Atkins, Commissioner
 The Hon. Roel Campos, Commissioner
 The Hon. Harvey Goldschmid, Commissioner
 Annette Nazareth, Director, Division of Market Regulation
 Robert Colby, Deputy Director, Division of Market Regulation
 Elizabeth King, Associate Director, Division of Market Regulation
 Richard Strasser, Attorney Fellow, Division of Market Regulation

Question 43. Should the benefits of a uniform display requirement justify the costs of imposing such an obligation on options market participants?

Question 44. Do the options markets have unique characteristics that would make the application of a uniform limit order display obligation there less feasible than in the equities markets? If so, what are those characteristics?

Question 45. If a limit order display obligation would be beneficial for the options markets, what modifications, if any, to Rule 11Ac1-4, would be required before it could be applied to options market participants?

Question 46. If a uniform limit order display requirement is not appropriate for the options markets, are there other safeguards that could be put in place to ensure that customer limit orders are immediately displayed?