7

RECEIVED
APR 0 9 2004
OFFICE OF THE SECRETARY

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.

Thank you for taking the initiative by creating the following questionnaire and for further going out of your way to solicit responses. We agree with you and your commission that there are important issues facing the equity derivatives marketplace. Issues such as internalization and payment for order flow (PFOF) have already had negative consequences on the market place and we feel if left unchecked will further lead to a disastrous conclusion. This is why we applaud your efforts to understand why we feel the need to curb the insidious practice of payment for order flow, as well as your delving into the obvious breach of broker/client fiduciary responsibility which occurs when a broker acts as both agent and principle and trades against his own client rather than trying to get the customer a best execution.

In the proceeding paragraphs the Options Market Maker Association (OMMA) has made every attempt to answer your questions carefully and thoughtfully. If you have any questions or comments please fell free to contact me at the American Stock Exchange by phone at 212.306.1000 or e-mail me at stuyvesanttrading@hotmail.com

Best regards,

Michael Whitman

Michael Whitman
Secretary/Treasurer
Options Market Maker Association
American Stock Exchange

S7-07-04

Concept Release:
Competitive Developments in the Options Markets

Question 1. 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?

Answer 1. The greater the payment for order flow cost to the market maker the wider his quoted market is going to have to be because as his costs go up he is less able to quote aggressively. Furthermore we believe not only is there a direct correlation between higher payment for order flow costs (PFOF costs) and wider spreads, but we also feel that any payments for order flow should go directly to the customer and not to the broker handling the order as this practice entices brokers to act in their own best interests instead of their customers best interest thus violating their fiduciary responsibilities to their customer.

Question 2. 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?

Answer 2 The answer is *emphatically* that increased competition between market participants has created tighter spreads not payment for order flow plans, which limit how tight these spreads can be. Furthermore payment for order flow arrangements have nothing to do with tighter spreads but rather inhibit a market maker's ability to quote aggressively and such plans represent an appropriation of a customer asset by his broker. It is this increased competition that breeds tighter market spreads as there are now 6 exchanges vying for the same equity option trade and to stay relevant each exchange is tightening their markets to attract order flow.

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?*

<u>Answer 3.</u> In less dynamic market places that have fewer competing market maker's, those market participants will be more likely to enter into payment for order flow agreements because they are guaranteed the trade with little or no intramarket competition that could lead to price improvement for the customer. This is an important reason why the PHLX plan to eliminate exchange based PFOF plans is so disingenuous. Another important point is that payment plans will draw market share away from the market offering the best quote and subsequently, those exchanges quoting most aggressively, offering tight and liquid markets, will eventually give up if that market is unfairly not getting the orders due to them because of these back room payment deals.

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 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?

<u>Answer 4.</u> Current exchange rules guaranteeing specialists a portion of orders do not negatively effect quote competition because intramarket quote competition is healthy on the AMEX. Currently market makers are rewarded when they quote aggressively as they can better the market in the auction market place and take the whole trade themselves. In the larger crowds on the AMEX the specialist is only entitled to 25% of the order and only when a bid is hit or an offer is taken. The specialist is guaranteed nothing when orders trade in between markets. Furthermore the specialist's guaranteed 25% if far less than the 50% that an internalizing firm currently demands or the 40% that they are legally allowed in today's skewed firm facilitation rules. This leaves the general market place with less than 38% of the order after the specialist 25% and the firms 50%. This is the true worry as an internalizing firm or any firm for that matter should not be allowed to do more than 40% of a trade as is suggested by the Commission itself. It is imperative that no one

party is automatically guaranteed more than 40% of an order and that's why on the AMEX when crowds are greater than just 1 market maker and a specialist the guaranteed minimum that a specialist is given decreases with added market makers in the crowd.
All increased competition is good competition. Auto quoting by market makers empowers them to compete effectively and rewards them by ensuring that their markets will be published to the world. This is likened to the days when only preferred market makers registered with NASDAQ were able to get their stock quotes published while non affiliated market makers who placed orders on Instinet were not reflected in the national bid/offer market of NASDAQ stocks. It is imperative to allow all market participants the right to not only quote markets in individual option series but further to have the ability to trade on them unimpeded.

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?

<u>Answer 5.</u> A market makers ability to quote is severely hampered by upstairs firms internalizing orders. The reason is that the market makers incentive to give tight, deep, and liquid quotes is premised on the expectation that he will be allowed to trade on those tight markets. If he is watching trades print on his market and he is only allowed to participate when it is disadvantageous to him (i.e. at the beginning of a big order) then he will be less aggressive in giving tight markets and will instead widen with the hopes of doing a few high profit, wide spread trades rather than numerous tight spread trades, therefore diminishing liquidity. Again, if firms are allowed to internalize orders then the market makers will not quote aggressively and the depth and liquidity of the published market in equity derivatives will greatly suffer.

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?

Answer 6. The American Stock Exchange has the strictest policy of treating all orders equally. Currently the AMEX specialist doesn't even know whom he is trading with until after the trade is consummated, so on the AMEX we treat everyone equally. Conversely on other exchanges they see the "give up" of the order and fade non advantageous option originated orders such as linked trades from the AMEX and other firms trying to compete fairly. On the AMEX if a quote is crossed, the away bidding firm is automatically given a fill on the offer that the away firm is or exchange is bidding in to, as opposed to on the CBOE where they honor our linked orders with merely a 10 lot if a customer or none if a principal and then trade through at will by issuing a hard cancel to our sent linkage order. It is most unfair that the CBOE have a public order to sell 100 at let's say $1.00 on their book and see the AMEX send a proprietary bid, through linkage of $1.00 for 100 then give the AMEX 10, hard cancel the 90 remaining bid for and then print the trade either minutes later at $1.00 giving the trade to the second bidding CBOE members or even worse buying these options at $.90 when the customer drops his limit, never telling the customer that he could have been filled at $1.00 from the incoming AMEX proprietary bid. This happens on a regular basis, but since it happens on the CBOE we on the AMEX seem not to have any way of policing this flagrant violation.

Question 6.2 Some may argue that specialists in the options markets establish the prices and sizes of their quotes based in part on the assumption that their counter parties will be other professional traders. The desirability of trading with uninformed order flow due to the lower risks of trading with non-professionals should translate into those orders, on average, receiving better prices than the specialist's quote.[62] *Under this argument, specialists may use payment for order flow as an indirect way of providing a better execution to uninformed or* *non-professional orders.*

Answer 6.2 Untrue. In this environment our exchange is fiercely competing for order flow and since we have no way of knowing whether an order is originating from a firm who collects payment for order flow, or not, we quote the same to all customers, as should any legitimate market place. Any argument that a specialist or any other market participant on the AMEX would favor one customer over another, regardless of payment agreements or level of sophistication, is not only illegal but immoral. In summary it is the position of the AMEX as well as the SEC to honor all customer orders with fair and equitable execution, unlike many of our competitors.

Question 7. 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?

Answer 7. No, on the AMEX our published quote is the quote that the market is willing to trade an option and any market participant who sends an order to the AMEX will be executed immediately if his order is marketable. Furthermore, as previously stated it is irrelevant who the other side of a trade is and further it could be argued that professional market makers are just hedgers and are less informed than the big customers such as hedge funds and other truly smart money players that have customer status.

Question 8. 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?

Answer 8. The commission must make a distinction between small lot investors (orders of 10 or less, generated from small retail accounts) and large customer orders being generated by hedge funds and otherwise informed customers. In order to be eligible to trade with the small retail order an exchange must show an aggressive quote and therefore those quotes will be good for small retail lots and large customer orders. Furthermore with the fierce intramarket competition on the AMEX, as opposed to other less capitalized floors, size builds up in a crowd and therefore all market participants benefit from tight, deep, and liquid markets. This though is all predicated on a fair and level playing field which does not include *any payment for order flow plan*.

Question 9. Are market makers willing to trade with non-professional orders at prices better than their quote?

Answer 9. When a competent floor broker presents an order to the auction market he has many options in front of him. If he makes the decision to get a better price for his customer rather than take an immediate fill he can bid or offer close to the posted bid or offer and then allow the competitive processes that occurs in a trading crowd to work. This in most instances will garner his customer price improvement therefore getting his customer filled at a better price than the posted market.

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

Answer 10. If the Commission were to eliminate payment for order flow, non-professional orders as well as some professional orders would absolutely get better prices. Market makers would be incentivized to tighten their markets because they would be assured that the order would be routed to the best bid and/or the best offer as opposed to the best bribe. Furthermore, any reduction in market makers' cost will enable market makers to tighten their spreads and quote more aggressively.

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?

Answer 11. It is a fact that customer orders that are internalized in whole or in part on an exchange receive less favorable executions than orders that are not internalized. This is the case because internalized orders are never opened to the auction market so they can never receive price improvement.

Furthermore it can be argued that firms who internalize look for opportunities to internalize orders when the price is most advantageous to themselves and conversely most disadvantageous to their customer. Without open and competitive pricing, market integrity will lapse back to forgone days of wide spreads and the mere existence of internalization removes the beneficial forces of competition.

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?

Answer 12. The exchange rules requiring that an auction occur prior to a trade do not ensure that internalized orders are executed at the best available price. The current exchange rules are wholly ineffective in protecting the customer from his broker's avarice. Firms who wish to internalize play each marketplace against the other in an attempt to internalize more of the order. Furthermore, the internalizing firm presents the order in a hostile manor and bullies the market makers into not improving the marketplace for their customer. If the market maker were to make a more competitive bid on the order the internalizing firm is angered and cancels the order for he is currently under no obligation to consummate the trade. What ends up happening is that the order is crossed away, at that better price for the customer, but the internalizing firm diverts order flow away from the market place that improved the bid in order to punish that floor for getting in the way of the firms profitability and that floor soon learns not to quote aggressively when an order is presented by an internalizing firm.

The floor willing to do the least size and offer the widest spreads is an internalizer's best place to go. Obviously the AMEX is not that place while the P Coast survives on just this sort of business.

Furthermore the auction between exchanges as to how much they are to concede in order to be "allowed" to participate on a trade virtually guarantees that the customer order not only will get no price improvement but that the customer order will get the worst acceptable price within the confines of the existing market.

Question 13. 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?

Answer 13. The SRO is fully aware of its fiduciary responsibility and polices its members aggressively but since it has no authority over what happens on other exchanges each SRO panders to the order flow provider. The rules are therefore slanted toward what benefits the order providing firm and offer no protection to the actual customer or to on floor market participants.

Question 14. To what extent do 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?

Answer 14. The conflict is irrelevant for although the SRO polices its on floor members well, it has no ability to police the upstairs firms who can play each SRO, from each exchange, off each other with ease, and is currently enjoying a free hand in dictating how, when, and what rules they wish to follow. As of today firms query the marketplace in order not to fall under any exchange rules or guidelines. This use of asking a question instead of presenting an actual order allows the order providing firms protection against their fiduciary obligation to fill their customer's orders quickly and at the best possible price

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?

Answer 15. This insidious practice does not differ at all from the more general form of payment for order flow, but allowing one form of this noxious practice to remain and not another is unfair and places to great a burden on the independents and the honest. In fact it can be argued that exchange based payment for order flow plans are less seedy than other types of payment for order flow plans because they are codified and out in the open for all market participants to see, rather than just a secret agreement between to self serving parties.

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?

Answer 16. Since we as an exchange have no power to regulate firms with originating orders from off floor this may be a good idea. Holding an on floor broker responsible for policing his upstairs customer, (who is the ultimate order flow provider) is not possible since the order flow provider will use the broker who best serves his purposes and not those of his client's. It may be the job of the upstairs firms' compliance departments or the job of internal auditors of the upstairs firms to accomplish this but they have behaved poorly in recent times. We applaud the Commission in its foresight for having recognized this problem and if the Commission would create some governing body to police upstairs firms and hold them accountable to meet their best execution obligations it would be a welcome protection for the customer and the on-floor market maker.

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

Answer 17. Recent regulatory changes have had little or no recognizable effect on order providing firms and any action the Commission can take to help protect the public from order flow providing firms who act in their own best interest instead of in the best interest of their customer would be welcome. If the SEC does not act to check the abuses wrought by order flow providing firms' ability to internalize order flow by allowing firms to trade against their own customers, in secret, and without opening up to the general marketplace, then there will be no one left who doesn't have his own customers and markets will eventually widen as there are no independent minded market participants fighting competitively through aggressive market making to quote tight markets. Furthermore it is our belief that a failure to act on this immediately will jeopardize the recent competitive gains that have occurred since the Commission so wisely acted by forcing multiple listing of equity options.

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?

Answer 18. There is a more likely chance that pigs will fly than there is that a market trend toward silent, secret execution, and internalization, will fix itself and eventually cease to exist. It is apparent that market spreads have tightened due to fierce competition between competing market places and not from any payment plans or internalization schemes. Competition needs to be able to work and in order to do this all orders must be aired in some competitive market place with many market participants vying for execution based on price and size not through under the table payments and silent executions in back office areas.

Question 19. Should brokers that receive payment for order flow be required to rebate all or a certain portion of those payments to their customers or demonstrate that the economic benefit of payment for order flow has been passed on to customers? If so, how should the amount of any such rebate be determined, and how would a firm demonstrate that it passed the payment for order flow benefit to customers?

Answer 19. There is such a simple answer to this and that is that all payments are charged per contract and should be wholly reimbursed per contract in a like manner. If order flow providing firms passed the savings directly along to their customers these agreements would not exist. It would be interesting to note how large brokerage firms would replace the obvious bribe, of payment for order flow, with a more discreet form of "I'll slap your back if you slap mine" form. We have full faith that the SEC is capable of governing the marketplace in such a way that the only market determinant will be price and quantity given that the equity derivatives market is such a standardized marketplace.

Question 20. How would any non-cash inducements to route order flow be valued for purposes of any such rebate?

Answer 20. There should be no payment plans whether in cash or in kind.

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?

Answer 21. The effect of the banning of all payment for order flow arrangements in the options market would be to strengthen the ability of the market makers to quote aggressively. If the SEC were to ban payment for order flow arrangements then customer orders would once again be subject to the benefits of competition and subsequent price improvement. We feel that the SEC is fully capable of policing and banning all forms of payment for order flow and would have the support and the gratitude of the AMEX in its attempt to root out all illicit payment plans. Furthermore although some payment for order flow arrangements would be driven underground, and take on new and more devious forms, there widespread negative impact on the options markets would be greatly diminished.

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?[93]

Answer 22. If the Commission were to ban all payment for order flow, but continue to permit firms to internalize their customers' orders, it would provide an unfair advantage to integrated firms that have customer order flow they can internalize. It is imperative that the Commission revisit the legality of a broker acting as both agent and principal. It is our opinion that a broker never act as both agent and principal, for how can a broker truly put the customers needs ahead of his own desire to turn a profit, knowing that he will be the counter party on the trade and will profit form the customer paying the worse possible price? It is the tenet of any good market place that a broker be compensated for acting in the best interest of his client and the current system blurs this fundamental distinction. This creates the incentive for the broker not to compete for a good price for his client but rather to have his customer trade his options at a non competitive price. It further incentivizes the broker to convince that client to accept the worse price possible because the broker himself benefits form a poor price to the customer and conversely a good price for the broker.

Answer 22a. Banning payment for order flow is necessary but so is banning internalization. If a firm loses the pure profits that it generated unfairly charging other market participants then it will accelerate the need for said firms to generated profits by internalizing orders at disadvantageous prices to its customers and at advantageous prices to itself to recoup such losses.

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?

Answer 23. The commission should definitely ban internalization. As previously discussed at length a broker should never act as agent and principle because the broker profits when he does not get the best price for his customer. Conversely, a specialist is competing with other markets to offer order flow providing firms a fair and orderly market and therefore the customer has a broker looking out for his best interest against the specialist's need to make a profit when he is only acting as the customer's broker and not profiting from trading against his own customer. If the Commission were to ban internalization then it follows logically that the Commission should ban payment for order flow programs as well. Payment for order flow plans are the ying while internalization is the yang. They are two insidious practices that lead to a breakdown of the basic function of the marketplace where two parties meet in an adversarial manner to negotiate a deal between two informed parties. Internalization and payment for order flow plans corrupt the broker by taking away his incentive to singularly fight for his customer's best interest.

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?

<u>Answer 24.</u> The Commission should act on each issue as though each were singularly important. Internalization is the most insidious as it blurs the line between agent and customer. Payment for order flow, being secondary by the smallest margin, since it challenges the basic elements of open and fair markets. And least problematic and possibly innocuous the minimum guarantee given specialists given that in those market where specialist are giving a minimum guarantee there already exist fierce, open, and transparent price discovery.

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?

<u>Answer 25.</u> A ban on payment for order flow would energize any and all market participants to compete with the guarantee that best price, depth and liquidity dominate. A further ban on internalization would give the market place back its credibility as a place where fair and open competition rewards those willing to commit capital and take risk as opposed to rewarding those who

have advanced knowledge of customer orders, who try to internalize the orders quickly and quietly, in secret, and without price discovery. Market makers and specialist would quote more aggressively in order to win order flow from competing exchanges and would be rewarded for their aggressive quoting. The long term benefit would be the health of the market place in 5 years. If the commission fails to act then all market participants without their own customer base will eventually go out of business. Acting to ban PFOF plans and internalization schemes would benefit specialists and market makers only if those particular specialists and market makers quoted the best markets. If they had survived on anything other than good performance then they too would falter under the more fair system. There is no economic benefit to being a floor participant in today's market place as order flow providers use the floor to price their options and then sell off there execution to the highest bidder and then cross the end of the order for themselves all to the detriment of the originating customer. There would be no harm to smaller market making participants if these bans were enacted as best price would dominate, which as we know from experience, fosters diverse competition.

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.[94] *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?*

<u>Answer 26.</u> The commission should act nobly in accord with its duty to uphold fair and competitive securities markets by banning all payment for order flow provisions as there is no difference between bribing one constituency or another. Such a practice would not be allowed in the world of commerce at large and it certainly has no place in the securities business.

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?

Answer 27. Clearly the intent of the PHLX is duplicitous. The plan to allow the largest specialist units to pay for order flow but not allow a competing exchange to more fairly spread the cost evenly among its members who would otherwise not have the ability to negotiate separately to pay for order flow is preposterous. Payment for order flow is wrong but allowing one form that favors a few large firms and outlaws the more egalitarian version of exchange sponsored payment for order flow programs is anti-competitive and restrictive.

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?

Answer 28. There is no possible reason to believe that exchange sponsored programs are worse than other payment for order flow plans. They are all equally onerous but if the commission is truly looking to avoid the possibility of a return to the days of wider spreads and poorer execution it should ban all types of payment for order flow plans.

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?[102]

Answer 29. This is a difficult issue. We recognize that order flow providing firms add liquidity to the marketplace when they take the other side of their customer's orders, and this is to be encouraged. Customers can and do receive price guarantees from their brokers. However, this creates an uneven playing field, which is ultimately to the customer's detriment. The firm, by seeing the order first, is at a competitive advantage. If the firm is to be allowed to take the other side of the order it must be certain that there is a mechanism in place which will detect any attempt at hedging before the order is shown to the floor. The current lack of oversight prevents other market participants from competing affectively, who otherwise would be willing to trade the option order at a better price to the customer.

Another issue, which has been addressed elsewhere in these responses, is that when the firm has the right to take a large percentage of an order, there is little incentive for it to seek price improvement for its customer. The effect is that firms set the price of a trade and execute it on the exchange which permits it to do the largest percentage. This could not happen if there were a requirement to expose the order to the auction marketplace first. This is less of a problem in simple trades involving one option class, than in complex spread trades, where it has been packaged by the firm entirely to trade at given parameters, never having been opened to any price discovery, and when printed on one exchange it remains unclear to other market participants what has happened.

There are certainly many cases in which a firm is willing to trade at a price at which no one else will, either because it is receiving a commission, or to maintain its relationship with its customer. This is not an excuse for the firm to gauge the customer on trades where others would improve the price.

In conclusion there is a need to expose every order to the market for price improvement. It is in the best interest of the order flow provider NOT to get the best fill for his customer if he has a chance to take the other side of the trade, " to internalize it" at a favorable price to himself. Opening the order to the marketplace at one price but reserving the firm's right to trade the customer order with its own firm trader at a different price is still problematic. It is inconceivable that an order providing firm can act as broker and agent when upstairs firms aren't subject to even the slightest amount of scrutiny when compared with the superior order tracking capabilities of the exchange when regulating its own members.

Answer 29a. A reasonable amount of time is one in which the floor had at least 5 seconds to respond to a simple order and 30 -60 seconds to respond to a complex trade that has more than one component. Furthermore the order flow providing firm has to be carefully scrutinized for the probability that its advanced knowledge of the order either benefited the firm trader or disenfranchised the customer from getting the best price.

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?

Answer 30. Absolutely not! Under current exchange rules firms who wish to internalize orders are not held accountable to any rules and furthermore discourage price improvement on those orders they wish to internalize. The reason is that firms try to bully the floor into not caring at a price better to the customer by asking "questions" such as, does the floor care to sell any at $1.20 when the market is $1.10 bid at $1.25. If the floor says yes, they try to trade it away in order to internalize the trade, therefore discouraging the market maker from giving price improvement. Furthermore the internalizing firm plays each exchange off the other shaking them down to get a larger and larger percentage of the trade. This should be illegal as no single market participant should ever get more than 40% of the trade and if it is over subscribed then the firm should get less if there are many market participants willing to do the trade at said price.

Question 31. What improvements could be made to the current framework for cross-market surveillance in the options markets to improve the ability of SRO's 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?

Answer 31. Anything is better than the current non existent system. The head regulator on the AMEX reportedly said," what do you want me to do. I have a hard enough time policing my own guys. If you get robbed in Paris and then fly back to New York what is the point in reporting the crime to us in New York." We need cross market surveillance that is effective.

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?

Answer 32. It is the fiduciary responsibility of the upstairs firm to consummate a trade that fills his customer immediately if he can fill the order. By continuing to shop the order and pitting exchange against exchange to get a higher facilitation percentage for the firm trader, the firm fails to act in the best interests of the customer. For example if the market moves violently and the customer's limit is now outside the market place then the customer can not be filled when he would have been filled if the order was brought to the floor immediately. This happens when the market moves significantly away from him and then the customer order cannot trade because it is outside the now current bid-ask spread. Ultimately the customer is disenfranchised from receiving a timely fill at a competitive price all due to the fact that his broker wanted to shop the order and bill both sides of the trade in order to receive more commission dollars off the original customer 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?

Answer 33. The exchanges facilitation rules were implemented due to the fear that upstairs firms would internalize order flow in backroom arrangements away from public and transparent market places if the exchanges didn't give them facilitation guarantees. For the exchanges to rescind these nascent rules, the commission must outlaw firms from acting both as broker and as principal (firm trader).

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

Answer 34. The presumption that upstairs firms are at all concerned with filling customer orders at the best price would give them too much credit. Any rule that forces order flow providers to uphold their fiduciary responsibility to their customer would be a positive for customers and the market place in general. It is easily identifiable to all, which markets are showing the best bid and best offer. All professionals route their own orders to the best marketplace without exception. To believe that professional brokers are somehow unable to, or lack the information to do the same is foolhardy.

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?

Answer 35. The existing technology is more than sufficient as anyone who looks at the NBBO immediately knows where the best bid and best offers are. It is their ability to shop orders to others for commission dollars and their ability to internalize the trade themselves without opening the trade up to the marketplace that foster this perceived and non-existent problem of identifying the best bids and best offers.

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?

Answer 36. As far as we are concerned anything that forces firm's to best represent their customer's right to get the best execution without having to worry that the upstairs firm is profiting from that customer order by charging commission to solicited parties, buy collecting payment for order flow payments and not reimbursing the originating customer, or trading against his own client which is a gross fiduciary conflict, is good for the customer and for free, open, and transparent markets.

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

Answer 37. Payment for order flow will exist in some form unless outlawed in its entirety. Penny increments will just give firms with inside knowledge of customer limits the ability to trade ahead of other market participants decreasing their incentive to quote and creates a situation like on the NYSE where those with inside information trade ahead of whomever they want. It is imperative that a firm not be able to trade against its own order unless no other firm is willing to trade that option at that price.

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)?

Answer 38. Penny quoting will diminish the ability to show size and depth and would unduly tax existing exchange systems as well as, as well as the systems of other venders and broker dealers. It would further decrease the independent market participant from ever being able to trade with a customer without getting run-over as the firm would always do the last trade at the best price for himself which conversely is the worst price for the customer while surely running over the market maker on the first part of the order and then leaving him off the "clean up" print. This activity saps the ability and desire of other market participants, such as market makers, from quoting aggressively.

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?*

<u>Answer 39.</u> It is this body's belief that penny increments will weaken markets by diluting market size and market depth, and give too much power to order handlers who have advance knowledge of customer's true price limits. On the other hand if firms are not allowed to trade against their own customer or at least would be forced to query the marketplace to see if other market participants would trade against their clients at that given price then penny increments eventually might be possible given technological advances and if they prove not to dilute the existing size and depth of the marketplace.

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")?

<u>Answer 40.</u> Flickering quotes would add a degree of uncertainty, by draining depth and liquidity, and would give too much pricing power to order flow providers with advanced knowledge of the order. Furthermore, on a more practical note, penny increments will be used when an order provider wants to cross or facilitate an order. If penny increments come into existence then firms should be forced to attempt to make a legal crossing market, one penny wide, thus giving all market participants the opportunity to trade on either side of their quote. In today's world a firm will never lay down a proper cross without first making 100 percent sure that they will not be broken up.

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?

<u>Answer 41.</u> Any charges for quoting would lessen the incentive for market makers to update and compete aggressively to make quicker and tighter markets.

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

Answer 42. If the Commission's intent is simply the enforcement of displaying customer orders or any market participant's bid or offer when better than the published quote of the dominant market maker or specialist then it is a necessity. Any bid or offer that is better than the prevailing quote must be shown. This practice of showing all bids and offers that make up the true picture of an option quote is currently mandatory on the AMEX. We take pride in reflecting all bettering quotes to the general market place.

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

Answer 43. Uniform display requirements are a welcome addition in the options marketplace but will remain ineffective if order flow providing firms remain out of reach of all or most of exchange's SRO's enforcement divisions. Again we fail to see any reason why a market place wouldn't show all possible bids and offers that can improve the market place.

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?

Answer 44. It is our understanding that on the AMEX we reflect all customer orders when they better the market, as there is no reason to do otherwise.

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?

Answer 45. Further review needs to be taken to answer this question.

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?*

Answer 46. Customer orders should be displayed when they better the market or when they join an existing market.

VII. Solicitation of Additional Comments

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address relating to the options markets. Please be as specific as possible in your discussion and analysis of any additional issues. Where possible, please provide empirical data or observations of market trends to support or illustrate your comments.

Problem 1: The firm quote rule is less reasonable and maybe unreasonable when you are dealing with a derivative product since said product's value is derived from the whimsy of the reporting of the underlying security. It is therefore imperative that one trade clears the floor and allow the Specialist or market maker the right to reset his quotes.

This is important because in a given option class a market maker might be showing 100 up in all series of an equity option. This means that if a trade doesn't clear the floor and does not allow the market maker to change his market then he could potentially be bidding or offering millions of shares of stock through his option bids. Holding market makers to the firm quote rule is advisable as long as one trade clears the floor. If this is not done then market makers who were 100 up in all series will be forced to reduce there size in order to accommodate the possible risk of being hit on all his bids simultaneously.