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OFFICE OF THE SECRETARY

February 3, 2003

FEB 05 2003

4-474

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

Re: Options Exchange Payment for Order Flow Programs; Petition for Rulemaking

Dear Mr. Katz:

The Philadelphia Stock Exchange ("Phlx") hereby petitions the Securities and Exchange Commission ("Commission")¹ to adopt new Rule 19c-6 pursuant to Section 19(c) of the Securities Exchange Act of 1934 ("Exchange Act"), to ban exchange-sponsored options payment for order flow programs. Specifically, the Phlx requests that the Commission propose and adopt the attached Rule 19c-6, or a substantially similar rule, to eliminate the practice of exchanges organizing or sponsoring options payment for order flow programs. Individual payment for order flow arrangements between options specialist units and order flow providers would not be affected by the proposed rule.

As the Commission is aware, the Phlx has long held the view that exchange-sponsored options payment for order flow programs are deleterious to the quality of the market for exchange-traded options and reduce competition among market makers, thereby imposing a burden on competition that is not justified by furthering the purposes of the Exchange Act. The Phlx, therefore, was pleased by Chairman Pitt's recent call to the nation's options exchanges to end the practice.² However, past experience with exchange-sponsored payment for order flow programs indicates that not all of the options exchanges are willing to eliminate such programs voluntarily. Indeed, in a market where options exchanges fiercely compete for customer orders, individual exchanges cannot be

¹ The Phlx submits this petition pursuant to Rule 192 of the Commission's Rules of Practice, 17 C.F.R. 201.192.

² See e.g., Letter from Harvey L. Pitt, Chairman, SEC, to Meyer Frucher, Chairman, Phlx, dated January 24, 2003.

expected to voluntarily give up their payment for order flow programs if the other options markets are not willing to do the same. Moreover, because the Commission in the past has either approved these programs or permitted them to become effective upon filing, Chairman Pitt's recent request to eliminate them represents a significant departure from the Commission's previous approach with respect to these programs. As a result, the Phlx believes that the Commission now must take action to ban the programs through rulemaking or other appropriate action. A Commission rule also would provide clarity as to the scope of permissible and impermissible arrangements.

I. Exchange-Sponsored Options Payment for Order Flow is Anticompetitive

Although exchange-sponsored payment for order flow programs vary somewhat among the exchanges, in the typical arrangement an exchange will assess the specialist³ and market makers in the trading crowd a "marketing fee" or "payment for order flow fee" on each options transaction.⁴ The specialist will then use the funds collected by the exchange to attract orders, typically by paying broker-dealers for options orders they direct to the exchange or, in the case of the Phlx program, the specialist unit may draw upon funds collected to reimburse itself for qualifying payments made by them to purchase order flow.

Although the Commission has criticized payment for order flow in the past, it was not until this most recent request by Chairman Pitt,⁵ that a Commission representative has called for the abolition of exchange-sponsored options payment for order flow. The Phlx believes there are strong economic arguments against exchange-sponsored payment for order flow programs because such programs prevent market forces from setting the prices that specialists pay for order flow. Such programs also reduce competition in ways that traditional payment for order flow arrangements do not, by, in effect, regulating prices. This, in turn, has the effect of increasing the costs of many market maker firms and individuals and, thereby, reducing liquidity and increasing spreads.

³ We use the generic term "specialist" to refer to American Stock Exchange LLC and Phlx Specialists, Chicago Board Options Exchange, Incorporated Designated Primary Market Makers, Pacific Exchange, Inc. Lead Market Makers, or International Securities Exchange, Inc. ("ISE") Primary Market Makers. We use the term "market maker" to refer to all non-specialist securities dealers on the five options exchanges.

⁴ We note that the ISE has both a payment for order flow fee and a separate marketing fee. The ISE marketing fee is paid by market makers on customer contracts to fund general ISE marketing efforts to increase order flow from Electronic Access Members. The ISE is currently waiving the marketing fee through June 30, 2003. *See* Securities Exchange Act Release No. 46976 (December 9, 2002), 67 FR 77116 (December 16, 2002).

⁵ *See supra* note 2.

A. Interference with Market Forces

Payment for order flow arrangements are made by individual negotiation between exchange specialists and order flow providers. This is one basis on which specialists in the same options on different exchanges compete with each other. Even though exchange-sponsored options payment for order flow programs do not generally, themselves, establish the rate at which order flow providers are paid, they do establish the rate at which the specialist's arrangements with order flow providers are subsidized. The Exchange believes that this may interfere with market forces by, in effect, creating a known and stable price point (the exchange-mandated fee) that affects payment for order flow negotiations. In this regard, exchange-sponsored payment for order flow may cause distortions in the market similar to those found in the presence of price regulation. That is, price regulation can cause market participants to provide their output in an inefficient manner, or can cause firms to provide an inefficient level of quality with respect to the services provided.⁶ Therefore, in addition to potentially affecting quote competition (as described in Chairman Pitt's January 24, 2003 letter), exchange-sponsored programs may affect the non-price dimensions of competition among specialists and market makers, including, but not limited to customer service or research. As such, exchange-sponsored programs may impose an inappropriate burden on competition by interfering with the operation of the marketplace.

B. Adverse Impacts on Market Makers

Exchange-sponsored payment for order flow may also have detrimental effects on market makers. Prior to the development of exchange-sponsored programs, options exchange specialists would individually fund payments for order flow. This is both logical and equitable in that it is the specialist who presumably reaps the greatest benefit from the arrangement. Under exchange-sponsored payment for order flow programs, however, market makers effectively subsidize the specialist's order flow payments. This "wealth transfer" raises costs for market makers, who may have to widen their spreads to cover those increased costs, reduce the level of liquidity they provide, or go out of business altogether. All of these outcomes would be harmful to investors. In this regard, exchange-sponsored payment for order flow is inconsistent with Section 11A of the Exchange Act, which requires, among other things, "fair competition among brokers and dealers."

⁶ The classic example of this is the "Averch-Johnson effect" where regulated firms overinvest in capital relative to the optimum level. See H. Averch and L.L. Johnson, "Behavior of the Firm Under Regulatory Constraint," *American Economic Review*, 1962, vol. 52, pp. 1052-1069.

II. Exchange-Sponsored Options Payment for Order Flow Has the Potential to Call Into Question an SRO's Discharge of its Regulatory Obligations

As noted in Chairman Pitt's January 24, 2003 letter, economic inducements to order flow providers also create potential conflicts of interest that can compromise a broker's fiduciary obligation to achieve best execution. Indeed, since its growth in the 1980's in the equities markets, the Commission has made clear its concern about the practice of payment for order flow and the potential impact on best execution duties and other obligations of broker-dealers, and that it may present a threat to aggressive quote competition. Exchange-sponsored payment for order flow programs may be viewed as exacerbating this conflict of interest because they provide a potential disincentive for a self-regulatory organization ("SRO") to police its members in complying with their regulatory obligations.

Under our system of self-regulation, it is primarily the responsibility of SROs to police their members' compliance with exchange rules and the federal securities laws. Although the Phlx takes very seriously its self-regulatory obligations, when any exchange is permitted to sponsor and promote a payment for order flow program, the exchange's regulatory objectivity may be questioned. The Phlx is fully committed to ensuring that its members meet their best execution obligations. Nonetheless, banning exchange-sponsored payment for order flow would completely eliminate any perceived conflict of interest in this regard.

III. Proposed Rule 19c-6

For all of the above reasons, the Phlx believes that the Commission should exercise its authority under Section 19(c) of the Exchange Act to adopt a rule that effectively bans exchange-sponsored options payment for order flow. Section 19(c) provides that the Commission may amend the rules of an SRO as the Commission deems necessary or appropriate in furtherance of the purposes of the Exchange Act. Pursuant to Section 6(b)(8) of the Exchange Act, the rules of an exchange must not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. We believe that proposed Rule 19c-6 meets this standard. In addition, exchange-sponsored options payment for order flow programs effectively require market makers to subsidize specialists, which is inconsistent with one of the primary goals of Section 11A of the Exchange Act – ensuring fair competition among brokers and dealers. We believe that eliminating exchange-sponsored programs will further the purposes of the Exchange Act by increasing competition among markets and market makers, enhancing the depth and liquidity of options exchange markets, and promoting fair and orderly options markets.

Proposed Rule 19c-6 would require the options exchanges to adopt rules: (1) prohibiting an options exchange from organizing, sponsoring, or administering a payment for order flow program in connection with the routing of options orders; (2) prohibiting an options exchange from imposing fees or assessments to fund payment for order flow payments in connection with the routing of options orders; and (3) prohibiting options exchange

members from participating in any options payment for order flow program that is organized, sponsored, or administered by an options exchange or by any group or association of unaffiliated members. The proposed definition of "payment for order flow" refers to any monetary payment to a broker-dealer in return for the routing of customer orders to any exchange or exchange member, regardless of whether such payments are collected by the exchange as "marketing" or other fees.

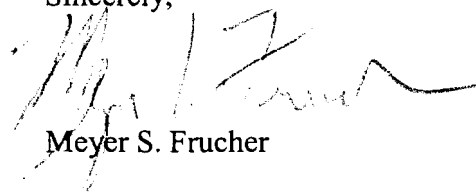
Specifically excluded from the above prohibitions are payment for order flow arrangements made directly between individual members or between an individual member and a non-member broker-dealer. The Rule also excludes programs or arrangements whereby an exchange provides its members with volume discounts or rebates or programs in which the exchange shares market data revenues with its members.

We believe that proposed Rule 19c-6 is drafted in a manner to effectuate its intended purpose. Of course, we would be happy to discuss the proposed language or its intent with the Commission staff.

* * * * *

We appreciate the Commission's consideration of our request and urge the Commission to take prompt action to propose and adopt this rule as quickly as possible. If you have any questions or wish to discuss this matter in greater detail, please contact the undersigned at (215) 496-5193, or Lanny A. Schwartz, Executive Vice President and General Counsel, at (215) 496-5406.

Sincerely,



Meyer S. Frucher

cc: The Honorable Harvey L. Pitt, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmidt, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
Annette L. Nazareth, Director, Division of Market Regulation
Lori A. Richards, Director, Office of Compliance Inspections and Examinations
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Elizabeth K. King, Associate Director, Division of Market Regulation
Nancy J. Sanow, Assistant Director, Division of Market Regulation

Attachment: Draft of Proposed Rule 19c-6

Attachment

Proposed Rule 19c-6.

Governing Options Exchange Payment for Order Flow Programs

Reg. § 240.19c-6. The rules of each national securities exchange that provides a trading market in standardized put or call options shall provide as follows:

- (a)(1) On and after [insert date of effectiveness of this Rule], no rule, stated policy, practice, or interpretation of this exchange shall permit this exchange to organize, sponsor, or administer payment for order flow to or from members or other brokers or dealers in connection with the routing of options orders.
- (2) On and after [insert date of effectiveness of the Rule], no rule, stated policy, practice, or interpretation of this exchange shall permit this exchange to impose or collect any fee or assessment for the purpose of making payment for order flow payments, or for the purpose of reimbursing members for making such payments, in connection with the routing of options orders.
- (3) On and after [insert date of effectiveness of this Rule], no member of this exchange may participate in any options payment for order flow program or arrangement organized, sponsored, or administered by this exchange or by any group or association of unaffiliated members.
- (b) Nothing in this Rule shall prohibit a member acting alone from making payment for order flow arrangements directly with other members or other brokers or dealers in connection with the routing of options orders.
- (c) Nothing in this Rule shall prohibit this exchange from (i) providing members a discount or rebate based on the number or size of options transactions executed on the exchange, or (ii) sharing with members market data revenues received by the exchange in connection with options transactions.
- (d) For purposes of this Rule, the term “payment for order flow” shall mean any monetary payment to a broker or dealer from any exchange or exchange member in return for the routing of customer orders by such broker or dealer to any exchange or exchange member for execution.
- (e) For purposes of this Rule, the term “exchange” shall mean a national securities exchange, registered as such with the Securities and Exchange Commission pursuant to Section 6 of the Securities Exchange Act of 1934, as amended.
- (f) For purposes of this Rule, the terms “standardized put or call options” and “options” shall have the same meaning as the term “standardized options” provided in Rule 9b-1 under the Securities Exchange Act of 1934, as amended, 17 C.F.R. § 240.9b-1.