publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

A. By order approve the proposed rule change, or

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW, Washington, D.C. 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NYSE. All submissions should refer to the File No. SR–NYSE–00–19 and should be submitted by [insert date 21 days from date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[10]

Jonathan G. Katz,

Secretary.

[FR Doc. 00–20098 Filed 8–8–00; 8:45 am]

BILLING CODE 8010–01–M

[10] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–43100; File No. SR–Phlx–00–01]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. To Amend its Current Enhanced Specialist Participation Provisions and Adopt Two New Programs in Phlx Rule 1014(g); Commission Request for Comment

July 31, 2000.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 31, 2000, the Philadelphia Stock Exchange, Inc. (''Phlx'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On March 17, 2000, the Phlx filed with the Commission Amendment No. 1 to the proposed rule change, and on July 7 and July 18, 2000, the Phlx filed Amendment Nos. 2 and 3, respectively, substantively amending its proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

[2] 17 CFR 240.19b–4.

[3] The substance of these amendments has been incorporated in the description of the proposal below.

Commission's Introduction

The Commission has serious concerns as to whether the proposed rule change is consistent with the Act and the rules and regulations thereunder. Accordingly, it is considering whether to approve the proposed rule change or to institute proceedings pursuant to Section 19(b)(2)(B) of the Act[4] to determine whether the proposed rule change should be disapproved. In Section IV below, the Commission elaborates on the nature of its concerns, and asks for comment on them.

I. Statement of the Terms of Substance of the Proposed Rule Change[5]

The Phlx is proposing to amend its current enhanced specialist participation provisions as codified in Phlx Rule 1014(g), primarily by adopting two new programs that would entitle a specialist to a higher participation in ''Top 100 Options.''[6] These programs would:

- Entitle a specialist on parity to an enhanced participation of 80% in Top 100 Options allocated to a Phlx specialist after January 1, 1997. This 80% Enhanced Participation would be effective for a six month pilot period.
- Entitle a specialist on parity to an enhanced participation of 50% in Top 100 Options allocated to a Phlx specialist before January 1, 1997.

The proposal would establish a ''Performance Requirement'' for specialists entitled to the 80% participation. If an average of 10% of the daily consolidated Options Clearing Corporation (''OCC'') volume in a particular specialist's option is not transacted on the Phlx over a six-month period, an Exchange committee would be authorized to reallocate the option.

The proposal would also modify the manner in which orders executed through AUTO–X, the Phlx's automatic execution system, are allocated, specifically with regard to the application of enhanced specialist participations to AUTO–X trades.

The full text of the proposed rule change appears as Exhibit A appended

[4] 15 U.S.C. 78s(b)(2)(B).

[5] The Phlx proposal has been condensed and edited for clarity, with some changes based on a series of telephone conversations with the Exchange, the most substantive of which are annotated below.

[6] As defined below, ''Top 100 Options'' are those equity options with the highest total year-to-date option volume across all options markets as of the date specified in the proposed rule.

to this notice. The Phlx's more detailed statement of the terms of substance of the proposed rule change has been incorporated into Section II below.

II. Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Phlx included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries of the most significant aspects of such statements, set forth in edited form in Sections A, B, and C below.[7]

A. Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Phlx Rules 119 and 120 and Rule 1014(g) specifically direct members in the establishment of parity and priority in the execution of orders on the options floor. These rules provide that when bids or offers at the same price are made simultaneously, or when it is impossible to clearly determine the order of time in which they were made, all such bids and offers will be on parity.[8] Although not specifically stated in the Phlx rules, the Phlx represents that member son parity receive equal shares of the contra-side participation, except where otherwise set forth in the rules.

An ''enhanced specialist participation''—sometimes called an ''enhanced parity split''—is one type of exception to the general parity rules, allocating to the specialist a greater than pro-rata share of the portion of an order that is divided among the specialist and any ''controlled accounts'' [9]—*e.g.,* Registered Options Traders (''ROTs'')—that are on parity. The Exchange currently has several enhanced participation programs, embodied in Rule 1014(g) and described below. These programs establish specified percentages as the specialist's enhanced participation, depending on the category of option.

When an incoming order arrives on the floor and only the specialist and controlled accounts are on parity, the specialist is entitled to the specified percentage of the order before the controlled accounts divide the rest. However, when a customer order is also being represented in the crowd at the same bid or offer as the specialist and controlled accounts, other rules must be taken into account. Specifically, Phlx Rule 1014(g)(i) provides that orders of controlled accounts must yield priority to customer orders, but that specialists and ROTs closing in person are not required to yield priority to customer orders. Nonetheless, a customer may not receive a smaller participation than any trading crowd participant, including the specialist and an ROT closing in person.

Thus, a specialist and an ROT closing in person are considered to be on parity with the customer, according to the Phlx, while other controlled accounts are not.[10] As a result, when an incoming order arrives on the floor, and a customer order, the specialist, an ROT closing in person, and other ROTs are all competing to fill it at the same price, the customer order, the specialist, and the ROT closing in person are all entitled to equal portions of the order and are allocated those portions first. If the size of the incoming order is sufficient, each will receive up to the number of contracts sought by the customer. Any remaining portion of the order will then be divided among the specialist and the other ROTs, with the specialist receiving his greater than pro-rata share of that remainder, *i.e.,* the enhanced specialist participation.

a. *Current Enhanced Specialist Participation Programs:* (i) Enhanced Specialist Participation of Rule 1014(g)(ii): The enhanced specialist participation provided under Rule 1014(g)(ii) [11] currently allocates to the specialist 30% of the portion of an order divided among the specialist and controlled accounts when three or more controlled accounts are on parity and more than five contracts are to be bought or sold.[12] If two controlled accounts are on parity, the specialist is allocated 40%, and if only one controlled account is on parity, the specialist is allocated 60%.[13] If a customer order is on parity, the customer may not receive a smaller participation than any other crowd participant, including the specialist.[14]

(ii) New Specialist Unit/New Options Enhanced Specialist Participation: Another enhanced participation program on the Phlx, originally adopted in May 1994 and embodied in current Rule 1014(g)(iii), is designed to encourage the establishment of new specialist units to trade options classes that have never been listed on the Exchange.[15] For a period of six months following the commencement of trading in such a new options class, the new specialist unit is entitled to 50% of an order when one controlled account is on parity, and 40% when two or more controlled accounts are on parity.[16] As in the Phlx's other enhanced participation programs, if a customer order is on parity, the customer may not receive a smaller participation than any

[7] See *supra* note 5.

[8] *See infra* notes 68–71 and accompanying text for additional illustrations of parity.

[9] A ''controlled account'' for the purpose of Phlx Rule 1014(g) includes any account controlled by or under common control with a member broker-dealer of the Exchange. Phlx Rule 1014(g)(i).

[10] Telephone conversation between Edith Hallahan, Deputy General Counsel, Phlx, Nandita Yagnik, Counsel, Phlx, and Robert H. Miller III, KRJ Securities, Phlx on-floor Governor; and Ira L. Brandriss, Attorney, the Division of Market Regulation (''Division''), the Commission, July 14, 2000 (''Telephone conservation with the Phlx, July 14, 2000''). *See also* Amendment No. 3 to the proposed rule change.

[11] Rule 1014(g)(ii) applies to both equity and index options.

[12] The 30% enhanced participation when three or more controlled accounts are at parity was approved by the Commission on April 18, 2000. *See* Securities Exchange Act Release No. 42700, 65 FR 24246 (April 25, 2000). The enhanced specialist participation in Rule 1014(g)(ii) was originally approved by the Commission as a one-year pilot program for equity options. *See* Securities Exchange Act Release No. 34606 (August 26, 1994), 59 FR 45741 (September 2, 1994). It was later expanded to include index options. *See* Securities Exchange Act Release No. 35028 (November 30, 1994), 59 FR 63151 (December 7, 1994). The pilot rule provided for a ''two-for-one'' split when the specialist was on parity with any number of controlled accounts, allocating to the specialist two contracts for every one allocated to a controlled account. The program was later revised to provide for the current 40% allocation when two controlled accounts are on parity and 60% allocation when one is on parity. *See* Securities Exchange Act Release No. 35429 (March 1, 1995), 60 FR 12802 (March 8, 1995). The pilot was renewed unaltered on three occasions. *See* Securities Exchange Act Release No. 36122 (August 18, 1995), 60 FR 44530 (August 28, 1995); 37254 (August 5, 1996), 61 FR 42080 (August 13, 1996); and 38924 (August 11, 1997), 62 FR 44160 (August 19, 1997). It was thereafter extended for another period with certain modifications. *See* Securities Exchange Act Release No. 39401 (December 4, 1997), 62 FR 65300 (December 11, 1997). The pilot was approved as a permanent program on July 1, 1999. *See* Securities Exchange Act Release No. 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999).

[13] The Commission notes that the enhanced participation program of Rule 1014(g)(ii) is mandatory. The specialist may not decline the enhanced allocation.

[14] As explained above, *see supra* note 10 and accompanying text, when a customer order is on parity, the customer, specialist, and any ROT closing in person are first allocated an equal number of contracts. Any remaining portion of the order is then allocated among the specialist and the controlled accounts, with the specialist receiving 30% or 40% or 60% of the remaining contracts, depending on the number of controlled accounts on parity.

[15] *See* Securities Exchange Act Release No. 34109 (May 25, 1994), 59 FR 28570 (June 2, 1994). *See also* Securities Exchange Act Release No. 35028 (November 30, 1994), 59 FR 63151 (December 7, 1994) (extending the new specialist unit/new options program to index options).

[16] The enhanced participation is renewable for one additional six-month period.

other crowd participant, including the specialist.[17]

(iii) *New Products Enhanced Specialist Participation:* On July 1, 1999, still another enhanced participation program, the ''New Products Split,'' was adopted.[18] Under Phlx Rule 1014(g)(iv), a specialist who develops and trades a new product is entitled to 40% when three or more controlled accounts are on parity, and 60% if fewer than three controlled accounts are on parity. In either of these situations, if a customer is on parity, the customer may not receive a smaller participation than any other crowd participant, including the specialist.[19]

b. *Proposed 80% Enhanced Specialist participation:* (i) Parameters: The Phlx is now proposing to adopt Rule 1014(g)(vi) on a six-month pilot basis. The proposed rule would entitle a specialist allocated a Top 100 Option after January 1, 1997[20] to participate in 80% of an incoming order where the specialist is on parity with one or more controlled accounts and no customer order is present (''80% Enhanced participation'').[21] If a customer order is on parity, the customer would not receive a smaller participation than any other crowd participant, including the specialist. For example:

- If there is a market order to sell 500 contracts of XYZ option, and the specialist and the ROTs in the trading crowd are at the same price on parity, the specialist would be allocated 400 contracts (80% of 500) and the floor broker would allocate the remaining 100 contracts (20% of 500) to the ROTs.
- If however, a customer order to buy 250 contracts is also represented in the trading crowd at the same price, the ROTs who are not closing in person must yield priority to it. The specialist and any ROTs closing in person are not required to yield to the customer order, but may not receive a greater participation than the customer. Therefore, the customer order would first be allocated 250 contracts, and the specialist would receive an equal allocation of 250 contracts. The ROTs would receive no participation.[22]
- If, however, there is a market order to sell 525 contracts, the customer and the specialist would each receive 250 contracts. Then, the specialist would be entitled to the 80% Enhanced Participation in the remaining 25 contracts (*i.e.,* 20 additional contracts), and the other five contracts would be divided among the ROTs.[23]

As defined in proposed Rule 1014(g)(vi)(A), the Top 100 Options for the pilot period would be those equity options with the highest total year-to-date option volume as of November 30, 1999.[24] The initial list of Top 100 Options would remain in effect for at least the length of the pilot period. If the pilot is extended, the options constituting the Top 100 Options would be re-determined as of May 30 and November 30 of each year. The 80% Enhanced Participation would then become effective for those options on the following July 1 and January 1, respectively.

Proposed Phlx Rule 1014(g)(vi)(B) provides that a specialist eligible for the 80% Enhanced Participation would not be eligible for any other enhanced specialist participation program under Rule 1014(g).

Proposed Rule 1014(g)(vi)(C) provides an exception to the 80% Enhanced Participation, stating that it would not apply when an ROT is closing in person, provided that the ROT announces to the trading crowd that he is doing so. In such case, the proposed 50% Enhanced Participation of proposed Rule 1014(g)(v), as described below, would apply. The purpose of this exception is to better enable an ROT to trade out of a position in its entirety, which could be inhibited by the 80% Enhanced Participation. The following examples illustrated how the exception in proposed Rule 1014(g)(vi)(C) would apply:

- A market order to sell 500 contracts of XYZ option arrives on the floor, and the specialist, a customer order to buy 100 contracts, an ROT closing for 200 contracts, and other ROTs in the trading crowd are at the same price. The customer, the specialist, and the ROT closing are on parity. Each is entitled to 100 contracts. With respect to the remaining 200 contracts, the 80% Enhanced Participation does not apply, because there is an ROT closing. Instead, the 50% Enhanced Participation would apply. Thus, the specialist would be entitled to 100 contracts (50% of 200), and the remaining 100 contracts would be allocated among the ROTs in the crowd, including the ROT closing.
- However, if, in the above example, the customer order was for 300 contracts, the customer would receive 168 contracts, the specialist would be entitled to 166 contracts, the ROT closing would receive 166 contracts, and the other ROTs would receive no participation.

the Phlx believes that by recognizing the additional responsibilities of specialists, the 80% Enhanced Participation would help to attract and retain highly capitalized specialists who would be able to attract sufficient order flow to the Exchange. Because the specialist unit is the key party responsible for marketing to attract order flow in particular options, the Exchange seeks to provide the appropriate encouragement to specialists to plan, invest in, and effect marketing strategies. Therefore, the Exchange believes that an 80% Enhanced Participation would provide the specialists with the appropriate incentive to create more depth and liquidity in applicable options in order to attract greater order flow to the Exchange. The Exchange's reasons for the proposal are outlined more fully in Section II.A.2 below.

(ii) *Performance Requirement:* The Exchange is also proposing to adopt new Rule 511(d)(3), which would require the Exchange's Allocation, Evaluation and Securities Committee (''Committee'') to conduct a ''Special Review''[25] of each specialist assigned a Top 100 Option to which the 80% Enhanced Participation applies. The

[17] *See supra* note 10 and accompanying text illustrating application of this rule.

[18] *See* Securities Exchange Act Release No. 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999).

[19] *See supra* note 10 accompanying text illustrating application of this rule.

[20] An option that was listed on the Phlx before January 1, 1997, but was reallocated or transferred to a new specialist after that date, would be subject to the 80% Enhanced Participation. *See* proposed Rules 1014(g)(vi)(A) and 511(d)(3)(B).

[21] Unlike the enhanced participation under Rule 1014(g)(ii), the proposed 80% Enhanced Participation would be voluntary, allowing the specialist to decline the allocation. In addition, the Commission notes that the proposed 80% Enhanced Participation, unlike the enhanced specialist split of Rule 1014(g)(ii), is not limited to orders for more than five contracts.

[22] The Phlx states, however, that if the customer order was not represented in the trading crowd, but was on the specialist's limit order book with the specialist acting as agent, the specialist could not be considered on parity with the customer order, due to various restrictions relating to specialist trading ahead of customer orders as well as agency-principal restrictions. In such case, the customer order for 250 contracts would first be executed, and then the 80% Enhanced participation would apply to the remainder, with the specialist entitled to 200 contracts (80% of 250) and the ROTs dividing the remaining 50 contracts.

[23] The Phlx notes that allocating the specialist the same number of contracts as the customer and then adding an enhanced participation of 80% in the remainder of the order might on first impression appear to result in a total specialist participation exceeding 80%. However, the Exchange does not believe it to be mathematically possible that, in such an allocation scheme, a specialist would ever receive more than 80% of the original incoming order.

[24] Volume here refers to the aggregate of trading on all options exchanges. Telephone conversation between Nandita Yagnik, Counsel, the Phlx, and Ira L. Brandriss, Attorney, Division, the Commission, March 15, 2000.

[25] Phlx Rule 511, ''Specialist Performance Evaluation,'' provides for reviews of specialists on the Exchange based on criteria enumerated in Phlx Rule 515. Rule 511(c)(2) provides for ''Routine Reviews'' of options specialists, while Rule 511(d) provides for ''Special Reviews'' addressing specific situations. The proposed rule change would add a new category of Special Review specifically designed for specialists in the 80% Enhanced Participation program. Notwithstanding the Special Review, however, specialists in the program would also be subject to Routine Reviews. Telephone conversation between Edith Hallahan, Deputy General Counsel, and Nandita Yagnik, Counsel, the Phlx; and Ira L. Brandriss, Attorney, the Division, the Commission, May 1, 2000 (''Telephone conversation with the Phlx, May 1, 2000'').

rule would direct the Committee to solicit new specialist applications when a defined ''Performance Requirement'' has not been met by the current specialist in that option.

Specifically, if the Committee finds that an average of 10% of the daily consolidated OCC volume in any Top 100 Option in the 80% Enhanced Participation program has not been transacted on the Exchange for each six month period commencing with the effective date of the rule, the Committee would be authorized to solicit specialist applications to reallocate such option pursuant to Phlx Rule 506.

The intent of this provision, the Phlx states, is to allow a search for another specialist. However, a failure to meet the Performance Requirement would not mean the automatic loss of the book. The current specialist would be permitted to apply and be considered by the Committee. As an applicant, the current specialist would be evaluated as a whole, using the current allocation criteria, such as staffing and expertise.[26] Thus, the Performance Requirement becomes a factor in triggering a process to reevaluate the current specialist's role.

The Exchange is also proposing to amend Rule 515 and Rule 511(e) to reflect that Top 100 Options in the 80% Enhanced Participation program would be subject to different procedures, and that current reallocation and hearing procedures described in Rule 511(e) would not apply to reviews conducted pursuant to Rule 511(d)(3).[27]

Proposed Rule 511(d)(3)(B) provides that if any Top 100 Option is reallocated under this rule, or allocated or transferred after the effective date of the rule, the new specialist would be entitled to 80% Enhanced Participation. It would also require the new specialist to meet the Performance Requirement every six months commencing on the business day following allocation, reallocation, or transfer and continuing until the end of the current six month test period operating for the other options (which originated with the effective date of the rule).[28] If the Performance Requirement is not met, the Committee would again solicit specialist applications.

The Performance Requirement is intended by the Phlx to establish volume criteria that will encourage new business and a viable, active marketplace in Top 100 Options. The Exchange believes that in order to compete, highly capitalized, qualified specialists are needed who are willing to attract order flow to the Exchange. Thus, the Phlx believes that if a specialist unit cannot attract the order flow to meet the Performance Requirement, then its specialist privileges should be reevaluated (by comparing other applicants) to seek out the best specialist unit—to ensure that it does have the capability to attract that order flow. The Exchange believes that Top 100 Options, due to their volume, present both the need for a highly capitalized specialist as well as the opportunity to attract more of this volume to the Exchange.

c. *Proposed 50% Enhanced Specialist Participation:* The Exchange also proposes to adopt Rule 1014(g)(v), to apply to Top 100 Options that were allocated to a Phlx specialist prior to January 1, 1997.[29] The proposed rule change would entitle a specialist in these options to 50% of an incoming order when the specialist is on parity with more than one controlled account (and no customer order is on parity).[30] When one controlled account is on parity, the specialist would be entitled to 60% of the incoming order. If a customer order is on parity, the customer would not receive a smaller participation than any other crowd participant, including the specialist.[31]

Because the 50% Enhanced Participation would not be a pilot program, specialists receiving it would be subject to the enhanced specialist participation review of Phlx Rule 509.[32] The purpose of this review is to monitor all specialists benefiting from an enhanced split.[33] Specifically, the Committee would be permitted to reduce the 50% Enhanced Participation if the specialist performs below any minimum standards or fails to satisfy any conditions established pursuant to the rule, which also includes provisions for reinstatement.[34]

Proposed Phlx Rule 1014(g)(v)(D) provides that a specialist eligible for the 50% Enhanced Participation would not be eligible for any other enhanced specialist participation program under Rule 1014(g).

The 50% Enhanced Participation is intended by the Phlx to create a performance incentive to encourage specialists to attract additional order flow. The Exchange believes that this incentive is reasonable in light of specialists' added responsibilities in updating and disseminating quotations as well as in maintaining the limit order book. In addition, the Exchange proposes to increase the specialist participation to 50% in order to remain competitive with other exchanges.[35] These reasons are outlined more fully in Section II.A.2 below.

d. *Wheel Trades:* The Exchange proposed to modify Option Floor Procedure Advice F–24 (''Advice F–24''), ''AUTO–X Contra-Party Participation (the Wheel),'' to give the specialist whatever split the specialist would receive pursuant to Rule 1014(g)(ii) (v) or (vi). AUTOM is the Exchange's electronic order routing and delivery system for option orders.[36] AUTO–X is the automatic execution feature of AUTOM, which provides customers with automatic executions of eligible option orders at displayed markets. The Wheel is an automated

[26] Allocation criteria are set forth in Phlx Rule 511(b).

[27] Because 80% Enhanced Participation would be a pilot program, the Phlx proposes to provide for specialist evaluations, aside from Routine Reviews, only through the 10% Performance Requirement it is proposing as a Special Review under Rule 511(d)(3). If the current specialist fails the review, the Committee would be authorized to solicit applications for a new specialist without needing to comply with the relevant procedural requirements embodied in Rule 511(e).

Accordingly, the enhanced specialist participation review of Phlx Rule 509 would not apply to specialists in the proposed 80% Enhanced Participation program. Rule 509 generally sets a performance standard for specialists who receive enhanced participations, providing, among other things, that if the Phlx does not maintain a minimum of 10% of market share in a multiply-traded issue listed on five exchanges (or up to 25%, if the issue is traded on fewer exchanges) the specialist may lose the enhanced participation for that option. Telephone conversation with the Phlx, May 1, 2000.

[28] For example, if the effective date of the rule was March 1, 2000, then the first review date would be September 1, 2000, and the following review date would be March 1, 2001. However, if a Top 100 Option was allocated on June 1, 2000, the first review date for that option would be December 1, 2000, and the next review date would be March 1, 2001.

[29] This date differentiates those Top 100 Options in which the Phlx has already achieved a significant market share, such that it believes that an 80% Enhanced Participation incentive is less important for them. In addition, the Exchange recognizes with this differentiation that ROTs are also responsible for having achieved and retained market share in these options.

[30] *See supra* note 10 and accompanying text.

[31] Like the 80% Enhanced Participation, the proposed 50% Enhanced Participation would be voluntary, allowing the specialist to decline the allocation. Similarly, the 50% Enhanced Participation would not be limited to orders of more than five contracts.

[32] Thus, the Phlx proposes to amend Rule 509 to refer to the 50% Enhanced Participation, and Rule 1014(g)(v)(B) to refer to Rule 509.

[33] *But see supra* note 27.

[34] Specialists receiving the 50% Enhanced Participation would also be subject to the Routine Reviews of Phlx Rule 511(c)(2) and the related provisions of Rule 515. Telephone conversation with Phlx, May 1, 2000.

[35] *See, e.g.,* Pacific Exchange Rule 6.82(d)(2), which provides the Lead Market Maker on that exchange with a 50% guaranteed participation similar to the enhanced participation proposed by the Phlx.

[36] AUTOM is an acronym for Automated Options Market System.

mechanism for assigning trade participation among specialists and ROTs on a rotating basis, as contra-side participants to AUTO–X orders. The Exchange's detailed Wheel provisions appear as Advice F–24.[37] The purpose of the Wheel is to increase the efficiency of order execution through AUTO–X by including all floor traders, on a voluntary basis, in the automated assignment as contra parties to incoming AUTO–X orders.

Currently, as detailed in Advice F–24(e), ''Wheel Rotation/Assigning Contracts, Exception to the Normal Rotation,'' the Wheel operates with a different trade participation and allocation process than Rule 1014.[38] At this time, the Exchange proposes to amend Advice F–24(e) so that specialists are allocated the same enhanced participation in Wheel trades that they receive under Rule 1014(g)(ii), (v) and (vi) for non-Wheel trades. Thus, a specialist that receives a 30% enhanced participation in the trading crowd under Rule 1014(g)(ii) would receive a 30% enhanced participation on the Wheel; a specialist that receives a 50% Enhanced Participation under Rule 1014(g)(v) would receive a 50% enhanced participation on the Wheel; and a specialist that receives a 80% Enhanced Participation under Rule 1014(d)(vi) would receive an 80% enhanced participation on the Wheel.[39] The Exchange does not propose, at this time, to extend the new specialist/new option enhanced participation of Rule 1014(g)(iii) or the new product enhanced participation of Rule 1014(g)(iv) to the Wheel.

e. *Relationship Among the Various Enhanced Participation Programs:* For purposes of clarity, the Phlx is proposing to codify a reference to all its enhanced participation programs at the beginning of Rule 1014(g)(i). The Exchange further makes clear in its proposal that all equity and index options that do not qualify under any other enhanced participation program of Rule 1014(g)—*i.e.,* the new specialist unit/new option split, the new product split, or either of the two Top 100 Option splits—would continue to be eligible under the proposal for the enhanced participation of Rule 1014(g)(ii).

Finally, the Phlx is proposing to amend Rules 1014(g)(ii) (the standard 30% enhanced participation) and (iii) (new specialist/new options enhanced participation) to make clear that these programs exclude options subject to the 50% and 80% Enhanced Participations of Rule 1014(g)(v) and (vi),[40] and to amend Option Floor Procedure Advice B–6 (''Advice B–6'') to reflect corresponding modifications.

2. Statutory Basis

Enhanced participation programs are generally intended to create incentives to retain and attract specialist units. The Phlx believes that the proposed enhanced specialist participation programs for Top 100 Options are necessary and important to create such incentives, which are reasonable in light of the increasing responsibilities of specialists. With respect to prior proposals, the Commission has acknowledged the need for well capitalized specialist units, burdens and costs borne by specialists, and how enhanced participation is intended to compensate specialists for these costs and burdens. For the reasons stated below, the Phlx believes the proposal is consistent with the Act.

The Phlx believes that the incentives afforded to specialists by this proposal are justified by the particular responsibilities, burdens, and costs borne by specialists as compared with other market participants. Although both specialists and ROTs perform market making functions, specialists, as the principal market maker, have more responsibilities than ROTs. For instance, various Exchange rules impose higher affirmative and negative market making obligations on specialists.[41] In addition, Rule 11b–1(a)(2)(iii) under the Act, provides that ''the rules of a national securities exchange permitting a member to act as specialist shall include provisions restricting his dealings so far as practicable to permit him to maintain a fair and orderly market.'' [42] Thus, the Phlx states, the specialist is considered the market maker of last resort who must not only step in when no other market participant will, but must refrain from trading when others are willing to do so. ROTs, it states, are required to make markets only when called upon by either the specialist, floor broker, or a floor official.

The Phlx notes that in addition to these responsibilities, specialists are faced with certain unique costs associated with being a specialist, including higher capital requirements,[43] staff and risk related costs associated with continually updating and disseminating quotes, as well as reflecting all markets in the displayed quote.[44] Further, specialists market to upstairs firms in order to attract order flow to the Exchange, entailing efforts that require expenditures for appropriate staff to plan and implement strategies. In addition, specialists must also monitor markets on other exchanges. These costs and burdens are exacerbated by today's current increases in options volume, the number of options traded by each specialist, quotation activity, and market volatility. Although specialists might address some of these burdens directly or the Exchange might attempt to offset them differently, the Phlx has determined that it is again appropriate to address these increasing burdens and costs with enhanced trade participation in order to attract and retain specialist units.

The Exchange believes that this proposal should not unreasonably burden competition, and should, in fact, serve as an incentive for market performance. Currently, in Top 100 Options, the Exchange has not benefited

[37] *See* Securities Exchange Act Release No. 35033 (November 30, 1994), 59 FR 63152 (December 7, 1994).

[38] Advice F–24(e) currently entitles the specialist the substantial equivalent of a two-for-one split on the Wheel for options covered by Rule 1014(g)(ii), provided that Wheel participants unanimously consent and the Options Committee Chairman or his designee approves. *See* Securities Exchange Act Release No. 42699 (April 18, 2000), 65 FR 24248 (April 25, 2000).

[39] The size of orders guaranteed execution through AUTO–X varies according to the option being traded. Floor Advice F–24 provides that the Wheel rotates and assigns contracts to participants in the system depending on the size of the guarantee for that option. When the guarantee is between 1 and 10 contracts, the Wheel assigns 2 contracts to the first participant in line, rotates and assigns 2 contracts to the next participant in turn, and continues rotating and assigning in this manner. For guarantees between 11 and 25 contracts, the Wheel rotates every 5 contracts. For guarantees of more than 26 contracts the Wheel rotates every 10 contracts. Under the proposal, if the AUTO–X guarantee is 10 contracts, and an order for five contracts that is subject to the 80% Specialist Participation enters the system, the specialist would receive four contracts and the Wheel would assign the remaining one to the Wheel participant next in the line in the rotation. If the next order is again for five, four would be assigned to the specialist and the remaining one to the next Wheel participant in the rotation. Telephone conversation with the Phlx, May 1, 2000.

[40] The Phlx is also proposing a related amendment to clarify that options qualifying for the new products category of Rule 1014(g)(iv) are also excluded from Rule 1014(g)(ii) and (iii).

[41] *See* Phlx Rule 1020(d), which states that it is ordinarily expected that the specialist will engage, to a reasonable degree under existing circumstances, in dealings for his own account in options when lack of price continuity or lack of depth in the options market exists or is to be reasonably anticipated.

[42] *See* 17 CFR 240.11b–1(a)(2)(iii).

[43] Specialists are subject to a minimum net capital requirement of $100,000; ROTs, on the other hand, must meet an initial net capital requirement of $25,000 and thereafter must maintain positive net assets. *See* Rule 15c3–1 under the Act and Phlx Rule 703(a)(iii).

[44] *See* Phlx Rule 1080. *See also* Securities Exchange Act Release No. 34606 at 13 (August 24, 1994), 59 FR 45741 (September 2, 1994).

from significant order flow.[45] To the extent that the proposed enhanced participant programs should provide incentives for specialists to provide tighter markets and attract order flow to the Exchange, all market participants in the crowd, including ROTs, should benefit. This benefit would come in the form of increased depth of markets as well as increased liquidity, both of which are important market performance elements. The Phlx expects that specialist efforts to reach the 10 Performance Requirement should also result in deeper, more liquid markets and tighter spreads. Thus, the Phlx believes that competition should be enhanced, and important auction market principles preserved.

The Exchange believes that the proposal should not materially disadvantage ROTs and other controlled accounts. Specifically, because these accounts have not historically transacted significant volume in Top 100 Options, based on Exchange analysis of certain data, the Exchange believes that if it is successful in attracting order flow to these options, ROTs and controlled accounts should benefit in absolute terms from that enhanced flow. The Phlx notes that, in the past, the Commission has refuted assertions that the enhanced specialist participation programs may harm ROTs by noting that the ''ROTs may in fact benefit from the enhanced parity split, if the specialists are successful in attracting order flow to the Exchange.'' [46] Specifically, more order flow may benefit ROTs, even if they receive a lesser percentage of such order flow when they are on parity. The Exchange believes that this reasoning is still applicable whether the enhanced participation is 80% or 50%.

The Phlx believes that the proposal is narrowly crafted to apply to certain options in certain situations, minimizing the potential negative impact and preserving opportunities in other options. For instance, both the 80% and the 50% Enhanced Participation would only apply when the specialist is on parity with a least one controlled account.[47] Because the specialist must be on parity with another controlled account, that controlled account, such as an ROT, can either establish a better price (improve the market) or establish a market first. In either case, the enhanced participation would not apply. The Phlx notes that an ROT's ability to quote a better price may soon be enhanced by the advent of decimalization, which reduces the cost of improving markets by narrowing minimum increments. In the Phlx's view, the proposal provides an incentive for ROTs to better markets and thus should promote competition. Therefore, the Exchange believes that this proposal should encourage tighter markets and attract order flow to the Exchange.

In addition, the proposal is limited to certain Top 100 Options, in which the Exchange has not received significant order flow. Furthermore, the 80% Enhanced Participant program is being proposed as a six-month pilot program which the Exchange believes should enable both the Exchange and the Commission to evaluate its actual impact and whether is purposes were achieved.

The Exchange also believes that the proposal protects investors and the public interest, because it specifically addresses the situation of a customer order on parity with any other crowd participant. Under the 80% Enhanced Participation, no customer order on parity may received a smaller participation than any other crowd participant including the specialist. If the proposal is successful in attracting order flow, customers should benefit from the additional liquidity and tighter markets. Thus, the proposal contains safeguards to ensure that customers are protected.

The Exchange has also analyzed whether specialists could be encouraged by the proposal to pay for order flow (as opposed to tightening spreads) to meet the Performance Requirement. The Phlx notes that following extensive public policy debate and Commission study of the practice in the equities markets, payment for order flow was not banned, but rather was addressed with enhanced disclosure requirements for broker-dealers and reliance on the duty of best execution. The Exchange does not believe that the proposal would be inconsistent with the Act or that it is necessary for payment for order flow in the options markets to be addressed in the proposal's current, limited context.

For these reasons, the Phlx believes that the proposed rule change is consistent with Section 6 of the Act [48] in general, and with Section 6(b)(5) [49] in particular, because it is designed to promote just and equitable principles of trade and protect investors and the public interest, by rewarding specialist units for their cost and responsibilities which, in turn, should attract and retain highly capitalized specialist units, thereby attracting additional order flow and resulting in increased competition and tighter markets. The Exchange believes that in crafting its proposal and presenting its justification, it has addressed and remained consistent with certain principles on which the Commission has focused in approving past enhanced participation programs, including the belief that such incentives encourage specialists to make deep, tight markets, enhance their ability to compete for order flow, address their heightened responsibilities, protect investors, and enhance competition.

B. Phlx's Statement on Burden on Competition

The Phlx does not believe that the proposed rule change will impose any inappropriate burden on competition.

C. Comments on the Proposed Rule Change Received by the Phlx from Members, Participants, or Others

No written comments were solicited with respect to the proposed rule change. The Phlx received one letter commenting on the proposal, which it has submitted to the Commission and is available for inspection in the Commission's Public Reference Room.[50]

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

Section 19(b)(2) of the Act[51] provides that within 35 days of the date of publication of notice of a proposed rule change in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization that filed the proposal consents, the Commission will:

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

[45] The Phlx represents that its share of volume across the options markets in the Top 100 Options that would be eligible for the 80% Enhanced Participation was approximately 5% in November 1999. Also, for top 100 Options traded on the Phlx in November 1999—69 issues—trading volume was 1,463,477 contracts out of a total Phlx trading volume of 2,368,300 contracts, a percentage of 61.79%.

[46] *See* Securities Exchange Act Release No. 34109 at note 19 (May 25, 1994) 59 FR 28570 (June 2, 1994). The Commission notes that the quotation is cited from an order approving the 40% participation right granted to new specialist units trading new options classes when two or more controlled accounts are on parity, and 50% when one is on parity.

[47] *See* Options Floor Procedure Advice A–10. The Phlx represents that the specialist may establish his market and be on parity either verbally or by electronic means.

[48] 15 U.S.C. 78f.

[49] 15 U.S.C. 78f(b)(5).

[50] *See* Letter from Tim D. Lobach, General Partner, Keystone Trading Partners, to Members of the Board, Phlx, dated December 22, 1999.

[51] 15 U.S.C. 78s(b)(2).

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

The Commission finds it appropriate to designate a period of 90 days from the date of publication of this notice within which to approve the Phlx proposal or institute proceedings to determine whether to disapprove it. As detailed below, the proposed rule change raises several complex issues on which the Commission is seeking public comment to assist it in its decision whether to institute disapproval proceedings.

IV. Commission's Solicitation of Comments

The Commission believes the proposed rule change could result in a significant alteration to the current structure of the options markets and, as noted in the introduction, has serious concerns as to whether such changes are consistent with the Act and the rules and regulations thereunder. The Commission is concerned specifically about the potential impact that specialist guarantees of up to 80% could have upon competition in the options markets and, consequently, upon the quality of prices that investors receive in those markets.

Section 6(b)(8) of the Act[52] requires that the rules of a national securities exchange ''not impose any burden on competition not necessary or appropriate'' in furtherance of the Act. Section 6(b)(5) of the Act,[53] moreover, requires that the rules of a national securities exchange be designed to, among other things, ''remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.'' Assuring that price competition remains vigorous is crucial in ensuring that investors receive the best execution possible. Finally, in considering whether any proposed rule change of a national securities exchange is in the public interest, the Commission is required by Section 3(f) of the Act[54] to consider whether the change will ''promote efficiency, competition, and capital formation.''

The Commission believes it will be helpful to provide some background regarding the context of the proposal and the issues it raises, and to pose a number of specific questions concerning its potential ramifications, so that commenters will better be able to assist the Commission in deciding whether to approve the proposed rule change or to institute proceedings to determine whether it should be disapproved.

A. Background

The proposed rule change arises against a backdrop of increasingly intense completion over the past year among the options exchange—the American Stock Exchange (''Amex''), the Chicago Board Options Exchange (''CBOE''), the Pacific Exchange (''PCX''), and the Phlx—to attract the flow of options business to their respective markets.

Prior to August 1999, the great majority of the most actively traded options in this country was listed on only one exchange. Thus, broker-dealers receiving orders from customers to buy or sell these options had only one place to send them for execution. Since then, the number of options that are ''multiply traded''—*i.e.,* traded on more than one exchange—has vastly expanded.[55] In addition, the anticipated entry of the International Securities Exchanges (''ISE'') into the arena as the first fully electronic options exchange[56] increased the demand upon the existing exchanges to compete vigorously for order flow. The ISE, which began operating on May 26, 2000, by trading three options classes, plans to list standardized equity options on 600 of the most actively traded stocks, and is widely considered to be a catalyst for the increase of multiple trading among the existing exchanges. As a result of these ongoing changes in the options market, the exchanges have felt intense pressure to compete with each other for the flow of customer orders that are represented by brokerage firms.

Investors have benefited measurably from the increased competition. Since multiple trading began in earnest, bid-ask spreads have narrowed significantly.[57] The options exchanges have also reduced their transaction fees.[58] The Phlx proposal is another response to these developments. By proposing changes to the Exchange's priority rules, the Phlx believes it would be able to better attract or retain business in the new competitive environment.

To evaluate the proposal's potential impact and determine whether it is consistent with the Act, we must consider it in the context of how options are traded today and the impact on the markets if similar proposals were implemented on all options exchanges.[59]

B. Price Discovery on the Options Markets

An options exchange, like any exchange, is a marketplace where buyers and sellers of a product—in this case, standardized options contracts—come together in the hope of finding a party ready to take part on the opposite side of the transaction at a favorable price.

The buyers and sellers include: (a) Floor brokers, who represent orders to buy and sell sent to the exchange by broker-dealers (''order entry firms'' or ''upstairs firms'') on behalf of customers; (b) market makers, *i.e.,* dealers trading for their own accounts who stand ready to buy and sell contracts on a continuous basis[60] and (c) in many markets, the specialist, who is a market maker that assumes additional leadership responsibilities in assuring fair and orderly markets, is authorized to represent certain types of customer orders as a broker, and may manage the public customer limit order book. On the CBOE and the PCX, market participants serving in a role similar to that of the specialist are called ''Designated Primary Market Makers'' (''DPMs'') and ''Lead Market Makers'' (''LMMs''), respectively.[61] On the ISE, the role is filled by ''Primary Market Makers'' (''PMMs''). These various participants all congregate at a designated ''trading station,'' an

[52] 15 U.S.C. 78f(b)(8).

[53] 15 U.S.C. 78f(b)(5).

[54] 15 U.S.C. 78c(f).

[53] 15 U.S.C. 78f(b)(5).

[54] 15 U.S.C. 78c(f).

[55] Between mid-August and mid-September 1999, for instance, 131 equity options classes that were previously listed on only one market became multiply-listed. Although in number these options represent a small percentage of the approximately 3000 options classes that trade, as a result of their addition to the multiple trading category, the volume of trading in multiply-listed options across the markets rose in the same period from 39% to 76% of all options trading.

[56] The ISE's application to become a registered national securities exchange was submitted in February 1999 and was approved in February 2000. *See* Securities Exchange Act Release Nos. 41439 (May 24, 1999), 64 FR 29367 (June 1, 1999) and 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000).

[57] *See, e.g.,* ''Best Execution: Promise of Integrity, Guardian of Competition,'' Remarks of Commission citing an analysis of trading in 81 options that had recently become multiply listed, which found that spreads had been narrowed by 15% or more in 76% of the cases.

[58] *See* Exchange Act Release Nos. 41270 (April 9, 1999), 64 FR 19395 (April 20, 1999) (SR–CBOE–99–08); 41307 (April 16, 1999), 64 FR 20349 (April 26, 1999) (SR–PCX–99–09); 41317 (April 24, 1999), 64 FR 23144 (April 29, 1999) (SR–Phlx–99–09); 41370 (May 5, 1999), 64 FR 25931 (May 13, 1999) (SR–Amex–99–12) (reducing options transactions fees).

[59] The Commission notes that in many cases options exchanges adopt similar rules when a rule proposal has been approved by the Commission. Particularly when rules are designed to provide benefits to order flow providers, and therefore create incentives for order flow providers to send their customers' orders to a particular exchange, other exchanges frequently adopt similar rules to compete. The Commission, of course, does not approve or disapprove rules based on which exchange submits them, but instead must base

assigned spot on the exchange floor, to buy and sell options contracts in each particular options class.[62]

1. The General Rules: Priority and Parity

When a customer order arrives at the trading station and the floor broker representing it asks for the current price (*i.e.,* calls for a market), members of the crowd respond with their bids and offers in public outcry.[63] The trade is executed at the best price that emerges from the auction to meet the customer order.[64] To participate in the trade, therefore, market participants at the station compete with each other to provide the best price for the customer order. Among the competitors may be floor brokers representing customer orders to fill, as well as the specialist and the market makers, who must always be prepared to buy and sell at prices reasonably close to the last sale.

In addition, the floor broker who brought the order to the floor may compete to fill the order he is holding. He may, on behalf of the firm that sent it to the floor, propose to cross it at a superior price with the order of another of the firm's customers. Alternatively, he may propose to cross it with an order submitted by the firm itself, seeking to trade with the firm's customer as principal at a better price than that offered by others—in what is called a ''facilitation cross.'' [65]

When more than one market participant is bidding or offering the best price, depending on the circumstance, in general the rules of the exchange grant any one of several different participants the right to fill the order—either entirely, or a certain percentage of it—before anyone else.

As a general rule, the first person to quote the price at which the option is ultimately traded is entitled to ''priority''—the right to fill the order before anyone else.[66]

''Parity,'' by contrast, means that none of the market participants competing to fill the order has rights over any other based on quoting the best price first. Parity is established on the Phlx, for example, when an order arrives on the floor to sell 100 contracts, and three market makers—A, B, and C—all bid to fill it at $3 per contract, but, in the public outcry, no one can determine which of A, B, or C called out the $3 bid first. Generally, in a situation of this kind, participation in the order must be divided up equitably among the crowd participants who simultaneously bid to fill the order at the best price.[67]

According to the Phlx, as a practical matter, in the pace of trading on its options floor today, it is often difficult to determine who cried out the best price first, and therefore crowd participants are frequently on parity on this basis.[68] Moreover, it is common for the members of a trading crowd to be all simultaneously committed to the bid and offer of the Exchange's publicly disseminated quotation,[69] and thereby considered at parity.[70]

In addition, even if one member of the trading crowd is the first to bid or offer at a particular price, if others indicate their willingness to trade at that price, too, then the first member bidding or offering at the price has priority only for the first trade executed at that price. Afterward, all who remain willing to trade at the same price are considered to be at parity for subsequent trades.[71]

In practice, a large majority of trades on the Phlx take place where all participants are at parity.[72]

Although, in its purest form, an auction should treat all participants equally, to create incentives for various market participants, the exchanges have enacted rules that in certain circumstances guarantee a portion of an order to a particular participant even when that participant is on parity.

In a similar vein, but for a different purpose, the exchanges have established automatic execution (''auto-ex'') systems, discussed below, to fill smaller customer orders quickly and efficiently, but without the benefit of an auction on the trading floor. Each of the floor-based options exchanges' auto-ex systems allocate orders to market makers on a rotational basis to execute at the exchange's disseminated quotation.[73]

Allocations of this kind represent exceptions from pure competitive principles. The Commission has approved them when it has believed that vigorous competition would be preserved and the overall price-discovery mechanism of the market would not be substantially affected.

2. Exceptions to the Rule

a. *Specialist Guarantees:* Historically, most of the options exchanges have adopted rules that under certain circumstances guarantee a specialist the right to trade ahead of others in the crowd with a certain percentage of every order, even when the specialist has not otherwise established priority. Of course, the specialist must also be quoting the best price available to the customer to receive such a guarantee. When the specialist is entitled to these special guarantees varies somewhat among the exchanges.

More specifically, a DPM on the CBOE and an LMM on the PCX is entitled to a percentage of each order only when the trade takes place at its previously established ''principal bid or offer'' [74] or ''previously disseminated'' quote.[75] The DPM does not receive its guaranteed portion of the fill if the auction improves the price.

The Phlx's version of the specialist guarantee, the ''enhanced parity split,'' applies, by contrast, when the specialist is ''on parity'' as defined and illustrated above.[76]

These exceptions to the general priority and parity rules, which would otherwise require the equitable division of an order among market makers on a par with the specialist, are intended to provide an incentive for market makers to assume the extra responsibilities assigned to the specialist to supply liquidity and attract order flow to the market.

[62] This description applies, of course, to a floor-based exchange. The Amex, CBOE, PCX, and Phlx, operating on this floor-based model, have installed various systems to route many orders electronically to the trading station. However, the essential process of trading at these exchanges is conducted through open auction outcry of bids and offers and the finalization of transactions by brokers and market makers in person on the floor of the exchange. The ISE substantially replicates the auction process of the floor-based exchange in a fully electronic format.

[63] Often, the trade takes place at the disseminated quotation, which is a posting by the exchange of the best bid and offer currently being quoted on its market. Frequently—in the absence of better-priced customer orders or market maker quotes—the disseminated quotation will be generated by an exchange's ''autoquote'' system, which calculates the price for an option based on variables, including the price of the underlying stock.

[64] Order routed to an exchange's automatic execution system, which is discussed in Section IV.C.2.c below, are executed pursuant to different rules.

[65] *See, e.g.,* Amex Rule 950(d), Commentary .02; CBOE Rule 6.74; PCX Rule 6.47; Phlx Rule 1064.

[66] The rule is not absolute, however. The order of a public customer on the limit order book, on some exchanges, takes priority over the quote of any member of the crowd. *See* CBOE Rule 6.45(a); PCX Rule 6.75(a). Market makers in the trading crowd, for their part, generally have a degree of priority over a bid or offer submitted on behalf of the proprietary account of an upstairs broker-dealer firm. *See* Amex Rule 950(d), Commentary .02; CBOE Rule 6.74; PCX Rule 6.47; Phlx Rule 1064. *But see also infra* Section IV.C.2.b.

[67] *See* Phlx Rule 119(b). *See also* Amex Rule 126(e), applied to options trading by Amex Rule 950(d).

[68] Telephone conversation with the Phlx, May 1, 2000.

[69] *See supra* note 63.

[70] Telephone conversation with the Phlx, July 14, 2000.

[71] Telephone conversation with the Phlx, July 14, 2000.

[72] Telephone conversation with the Phlx, July 14, 2000.

[73] *See supra* note 63.

[74] *See* Securities Exchange Act Release No. 42190 (December 1, 1999) 64 FR 68706 (December 8, 1999) (concerning CBOE Rule 8.80(c)(7)(ii)).

[75] PCX Rule 6.82(d).

[76] *See supra* notes 8 and 67–71 and accompanying text.

The following specialist guarantees are operative on the options exchanges today:

- On the Amex, a specialist is not currently entitled by rule to a participation guarantee. However, the Amex recently filed a proposal to codify the specialist allocation practices that have developed on its trading floor.[77] The proposal would guarantee the specialist approximate 60% of an order when one registered trader is on parity, 40% when two to four are on parity, 30% when five to seven are on parity, 25% when eight to fifteen are on parity, and 20% when 16 or more are on parity. Amex rules provide that a customer will not receive a lesser amount than the market makers or specialist.[78]
- On the CBOE, after all public customer orders in the book have been filled, a DPM is guaranteed to trade with 30% of each order filled at its principal bid or offer.[79]
- On the ISE, after all public customer orders have been filled, a PMM is allocated 60% of an order if only one other participant is quoting at the best price, 40% if two other participants are at the best price, and 30% if more than two other participants are at the best price. A PMM also has precedence to execute orders of five contracts or fewer.[80]
- On the PCX, after all public customer orders in the book have been filled, an LMM is generally guaranteed the right to participate in 50% of each transaction occurring at its disseminated quote.[81] However, the Commission understands that with the expansion of multiple exchange trading of options last summer, LMM guarantees have been reduced on the PCX to between 25% and 35% of each trade in some of the most actively traded issues.
- On the Phlx, as discussed in Section II of this Notice, a specialist is currently allocated 30% of an order when three or more controlled accounts are on parity, 40% when two are on parity, and 60% when one is on parity.[82] A specialist on the Phlx is not required to yield to a customer order on parity, but a customer order may not receive a smaller participation than the specialist.[83]

Specialist guarantees, generally, have been found by the Commission to be consistent with the Act as a reasonable means for an exchange to attract and retain well capitalized specialists who will attract order flow to the exchange, as long as the granting of such guarantees does not unreasonably restrain competition and harm investors.[84]

b. *Guarantees to Upstairs Firms: Facilitation and Customer Crosses:* Until recently, upstairs—or order-entry—firms seeking to cross the order of one customer with that of another, or to trade as principal with a customer order, were required to yield priority to members of the trading crowd for the full size of the order.[85] Even if the cross were proposed at a better price than that given by the crowd in its response to a floor broker's call for a market, if members of the crowd then decided they wanted to trade with the original customer order at the new best price, they could do so, and thus "break up the cross."

The options exchanges have made exceptions to this general rule, however. As an incentive to improve market liquidity in FLEX options, for instance, the exchanges guarantee upstairs firms the right to cross or trade with a certain percentage of each order they bring to the floor when the firm improves or matches the best bid or offer supplied by the crowd in response to the floor broker's call for a market.[86]

In addition, most of the options exchanges have adopted rules to permit such crossing and/or facilitation guarantees in the case of standardized options. A trading mechanism on the ISE, for instance, guarantees an Electronic Access Member the right to trade with 40% of its own customer order.[87] New Amex, CBOE, and PCX rules, approved by the Commission in May and June, 2000, similarly give order entry firms the right to trade as principal with up to 40% of each of their customers' orders above a certain size.[88] These rules provides, however, that if the trade takes place at a price at which the specialist too, is entitled to a guarantee, the combined total percentage of an order allocated to the upstairs firm and the specialist may not exceed 40%.

The Commission believes that these new rules and proposals reflect, in part, the increased competition among the options exchanges to attract the flow of customer orders to their respective markets since August 1999, when multiple trading was vastly expanded. By guaranteeing order entry firms the right to participate in the execution of their customers' orders, exchanges allow these firms to profit from the spread. Effectively, these types of guarantees allow order entry firms to internalize a portion of their own customers' order flow through the facilities of the exchange. Multiple trading has meant that order entry firms have more leverage to demand that exchanges provide them these participation rights because they now have more of a choice where to execute their customer orders.

c. *Automatic Execution Allocations:* All the exchanges have systems that automatically execute orders of public customers below a certain size—currently up to 50 contracts[89] without exposing them to the auction on the floor. Auto-ex systems are designed to give investors speed, efficiency, and accuracy in the execution of their small orders. These orders are executed at the exchange's disseminated quotation on a rotational basis against the accounts of specialists and market makers who sign up for the system.

Auto-ex orders are thus not executed according to auction principles and priority rules, but are allocated to market makers on the system by turn, regardless of who was first to bid or offer the disseminated price. Although a

[77] *See* Securities Exchange Act Release No. 42964 (June 20, 2000), 65 FR 39972 (June 28, 2000).

[78] A specialist cannot be on parity with a customer order for which he is acting as agent, however, and a registered trader cannot be on parity with a customer when either establishing or increasing his position in the option. *See id.*

[79] *See* Securities Exchange Act Release No. 42190 (December 1, 1999), 64 FR 68706 (December 8, 1999) (establishing pro-rata percentage pursuant to CBOE Rule 8.80(c)(7)(ii)).

[80] *See* Securities Exchange Act Release No. 42808 (May 22, 2000), 65 FR 34515 (May 30, 2000) (establishing allocation procedures pursuant to ISE Rule 713(e)). The PMM is entitled to a larger allocation if its quotation size in proportion to the total size of quotations on the market is greater than these percentages. This larger allocation recognizes the superiority of larger sized quotes, and is not based merely on the PMM's status as PMM.

[81] *See* PCX Rule 6.82(d). For more heavily traded options, this guarantee may be reduced based on LMM performance to 40% under certain conditions when PCX market share falls in the case of multiple-traded issues; and to 25% in the case of non-multiple-traded issues.

[82] New specialist units introducing new options and specialists developing and trading new products receive different percentages, as discussed in Section II.

[83] However, orders of controlled accounts—except for orders of ROTs closing inperson—must yield priority to customer orders. Phlx Rule 1014(g)(i).

[84] *See, e.g.,* Securities Exchange Act Release Nos. 34109 (May 25, 1994), 59 FR 28570 (June 2, 1994); 34606 (August 26, 1994), 59 FR 45741 (September 2, 1994). These orders, approving specialist guarantees, are cited above by the Phlx in support of the current proposed rule change.

[85] *See, e.g.,* Amex Rule 950(d), Commentary .02; CBOE Rule 6.74; PCX Rule 6.47; Phlx Rule 1064.

[86] *See* Amex Rule 904G(e)(iii); CBOE Rule 24A.5(e)(iii); PCX Rule 8.103(c)(3); Phlx Rule 1079(f)(6).

[87] ISE Rule 716(c). *See also* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000).

[88] *See* Securities Exchange Act Release Nos. 42894 (June 2, 2000) (File No. SR–Amex–99–36), 65 FR 36850 (June 12, 2000); 42835 (May 26, 2000), 65 FR 35683 (June 5, 2000) (File No. SR–CBOE–99–10); 42848 (May 26, 2000), 65 FR 36206 (June 7, 2000) (File No. SR–PCX–99–18).

[89] *See* Securities Exchange Act Release Nos. 36601 (December 18, 1995), 60 FR 66817 (December 26, 1995) (SR–Phlx–99–35); 41821 (September 1, 1999), 64 FR 50313 (September 16, 1999) (SR–CBOE–99–17); 41823 (September 1, 1999), 64 FR 49265 (September 10, 1999) (SR–PCX–99–04); and 42094 (November 3, 1999), 64 FR 61675) (November 12, 1999) (SR–Amex–99–43). Proposals by the exchanges to increase the maximum size of orders eligible for auto-ex to 75 or 100 contracts are currently pending before the Commission. *See* Securities Exchange Act Release Nos. 42930 (June 13, 2000), 65 FR 38618 (June 21, 2000) (SR–CBOE–99–51); 42931 (June 13, 2000), 65 FR 38615 (June 21, 2000) (SR–Amex–99–45); 42932 (June 13, 2000) 65 FR 38621 (June 21, 2000) (SR–Phlx–99–32); and File Nos. SR–PCX–00–18 and 99–19.

market maker can change the disseminated quote and thereby directly affect the price at which orders will be automatically executed, that market maker will receive no larger an allocation of auto-ex orders as a result, and hence has no incentive to better prices for this purpose. On the other hand, auto-ex prices are not totally isolated from competitive forces. The disseminated quote may be narrowed or widened by the specialist or the market makers to compete with other exchanges in atracting customer orders.

Some exchanges' rules governing their auto-ex systems incorporate a specialist guarantee. On the PCX, the LMM is required to either participate in every other auto-ex trade, or participate in every trade to the extent of the LMM's guaranteed percentage for non-auto-ex orders.[90] On the Phlx, as discussed above in this Notice, the Wheel currently assigns specialists in certain options approximately twice the number of contracts as it assigns every ROT with the unanimous consent of Wheel participants.[91] Under the proposed rule change, Phlx specialists would be guaranteed 30% of each auto-ex order in non-Top 100 options covered by Rule 1014(g)(ii), 50% of each auto-ex order for Top 100 Options assigned to a Phlx specialist before January 1, 1997, and 80% of each auto-ex order for Top 100 options assigned to a Phlx specialist before that date.[92]

C. Special Guarantees as an Exchange's Competitive Strategy

Paradoxically, while the special allocations raise concerns about inhibiting price competition within an exchange, they are often conceived—from the perspective of the exchange and its members—as necessary strategies to compete with other exchanges.

For any market center to survive, it must compete with other, similar centers to attract the flow of customer orders to buy and sell through its own facility. Many of these competitive efforts are designed to appeal to brokers, who play a critical role in deciding where to route their customer orders. [93] These efforts can take many forms, such as providing faster and more reliable execution of orders, lowering transaction fees, initiating innovative trading services, and providing economic inducement to brokers to send their customer order flow to the market center.

The special allocations for specialists, for example, enable an exchange to recruit market makers to serve in the specialist role, which is critical to operating an effective marketplace. Specialists provide the liquidity and offer the services that assure the smooth functioning of today's exchanges. Some exchange rules and policies explicitly oblige the specialist to promote the exchange's standing as a marketplace.[94]

In addition, through their automatic execution systems, exchanges assure brokers that their smaller customer orders will be executed with certainty, speed, and efficiency. The exchanges can provide this assurance only when market makers agree to execute those orders. Exchanges provide market makers with an incentive to participate in these auto-ex systems through rotational allocation.

In addition to competing for orders solely on the strength of their specialists' services, automatic execution facilities, and other services, the exchanges also increasingly rely on providing order entry firms with economic inducements to attract order flow.

1. Offering Internalization Opportunities

One such type of inducement is allowing members to ''internalize''—*i.e.,* trade on a proprietary basis with—at least a portion of the customer order flow they control. Internalization allows the member who brought the customer's order to the exchange to make profit as a dealer, rather than simply act as agent and change the customer a brokerage commission. One way in which an exchange allows its members to internalize is by adopting the kind of facilitation guarantee described above, whereby a broker-dealer is entitled to trade ahead of the crowd with a certain percentage of any customer order it sends to the floor.

A second way in which exchange rules may set the stage for firms to internalize is through the specialist guarantee. When a broker-dealer is affiliated with the specialist in a particular option at a particular exchange, it has the incentive to route its customer orders to that exchange, knowing that its affiliated specialist will have priority, by virtue of the specialist guarantee, to trade with a significant portion of them.

2. Payment for Order Flow and Preferencing

Another economic inducement used by market centers to attract business is ''payment for order flow,'' an arrangement in which a market center or one of its members pays brokers who agree to route their orders to it for execution—in other words, to preference their order flow.[95] For example, the specialist firm in a given option, responsible for attracting order flow in that option to the exchange, may consider paying, or in some other form compensating brokerage firms who choose to send their customer orders to its own market over another. The specialist firm can earn extra profits when those orders are executed, by virtue of its guaranteed right to participate in a significant portion of every transaction at the disseminated price. The higher the specialist firm's percentage, the more contracts it can trade with and the more it can afford to pay for order flow. In this way, the rules by which exchanges provide guarantees can directly impact their specialists' ability to implement this strategy.

The Commission has expressed the views that internalization and payment for order flow, while not unlawful in themselves, can present conflicts between the interests of brokers and the investors they represent. Moreover, internalization and payment for order flow agreements diminish the need for exchange participants to quote competitively. The latter concern is discussed further in Part D below.

D. Specialist Guarantees and Exchange Act Requirements

As discussed above, the Exchange Act requires the Commission to consider the impact on competition in evaluating proposed rules of self-regulatory organizations.[96]

Thus, in approving exchange rules that provide for special guarantees—be they guarantees to specialists, market makers on the automatic execution Wheel, or firms seeking to cross or facilitate customer orders—the

[90] *See* Securities Exchange Act Release No. 41823 (September 1, 1999), 64 FR 49265 (September 10, 1999).

[91] *See supra* note 38.

[92] *See supra* Section II.A.1.d.

[93] For amplification on this theme, *see* Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2000) (notice of filing of SR–NYSE–99–48, including Commission request for comment on issues relating to market fragmentation) (''Market Fragmentation Release'').

[94] *See, e.g.,* PCX Rule 6.82(c)(8); CBOE Rule 8.80(b)(2), Interpretations and Policies. 01.

[95] Payment for order flow, a common practice in the equities markets, began to appear in the options markets as a result of the competition for order flow engendered by multiple trading. *See, e.g.,* ''Payment for Order Flow has Entered the Options Markets,'' Dow Jones Business News, November 4, 1999. In a recent development in this area, the CBOE, followed by the Amex, submitted rule changes to the Commission—which became effective upon filing—that allow them to collect a fee of 40 cents per contract from their market makers for certain transactions on the exchange. The collected monies are then given to the DPM or specialist in each options class to use, among other things, to pay for options order flow. *See* File Nos. SR–CBOE–00–28 and SR–Amex–0038.

[96] *See supra* notes 52–54 and accompanying text.

Commission has been always mindful that, if too great, guarantees will negatively impact the competitive auction process that lies at the heart of exchange trading.[97] This is because, while such strategies are a competitive response by markets to attract order flow, if a guarantee becomes too large it could significantly discourage another type of competition: Price competition.

Because these guarantees ''lock up'' a certain portion of each affected order, they reduce the number of contracts for which the market making crowd can compete. The concern is that locking up a percentage or the order—for whatever the purpose—may so tilt the playing field that the opportunities available to the crowd are reduced and its members are unable to compete in some or all options.[98]

In its recent approval of the ISE's application for registration as a national securities exchange, the Commission discussed this concern with respect to the ISE's proposed ''facilitation mechanism,'' a system designed to effect a form of facilitation guarantee in an electronic context. The Commission wrote:

> It is difficult to assess the precise level at which guarantees may begin to erode competitive market maker participation and potential price competition within a given market. In the future, after the Commission has studied the impact of guarantees, the Commission may need to reassess the level of these guarantees. For the immediate term, the Commission believes that 40% is not clearly inconsistent with the statutory standards of competition and free and open markets.[99]

With respect to specialist guarantees, it is similarly difficult to predict the potential effects on the market of a particular proposed rule change. At some certain point it becomes clear, however, that if the percentage of each order allocated to the specialist rises too high, the members of the trading crowd will be left with too little with which to trade to sustain their competitive market making activity.

When only a small percentage of each order is left to the market makers to trade with, not only are their potential profits reduced, their costs of doing business on a per-unit basis—*e.g.*, their clearing expenses—also rise. This is particularly true when the remaining portion of an order must be divided among several market makers. By the same token, the specialist firm is in a better position to lower its clearing costs, enabling it to compete even more aggressively against the crowd.

If market makers cannot make sufficient profits by trading, for instance, at the spread determined by auto-quote— normally an approximation of the realistic best price, at which the specialist will also be quoting—they will scarcely be able to compete by offering still better prices. Although any market maker can capture an order entirely anytime he chooses if he alone improves the specialist's quote, it is likely that he will not be able to long sustain his business by constantly reducing the spread. Moreover, the specialist firm can use its position and its greater economies of scale to match or continuously best the improving market maker at the auction.

The Phlx argues that a large specialist percentage will encourage the specialist to draw more order flow to the Phlx, so that the absolute amount of volume received by the competing market makers will grow, even though their percentage volume may decrease. But this assumes that other markets do not imitate the Phlx and offer similar specialist guarantees. If they do, the Phlx may not attract any greater volume, while the competing market makers' share will have been reduced.

If the market makers leave the market, the specialist firm will be left as the only one determining the spread. Even if some market makers remain, they may be forced to recognize the specialist firm as the price leader, enabling it to establish the best bid and offer on its own. In either case, the spread is likely to widen, to the detriment of customers.

In addition to the concern over price competition dwindling or disappearing on one market, if other exchanges adopt similar guarantees, the end result could be one price-setter left on each exchange.

Theoretically, the absence of competition on one exchange need not mean that customer orders sent to that exchange will receive inferior prices. In order to attract customer orders, a specialist firm left as the sole price-setter on an exchange would still need to compete with other exchanges to provide the best price. At a minimum it would need to at least match the best price available elsewhere—the national best bid or offer (''NBBO'')—or, if it cannot match that price, agree to send it to another exchange that will.

Several concerns remain, however. Because there is currently no prohibition against trade-throughs,[100] the specialist who is not prepared to match the NBBO can execute an order at an inferior price. Moreover, even the adoption of a rule prohibiting trade-throughs would not necessarily inspire intermarket competition to improve prices if the market makers on one market can match a better price quoted by another market. Such competition might be fostered by a system of ''peer/time priority,'' which would reward the first exchange to offer the best price by requiring that any order received across the country be sent to that exchange for execution, and possibly strengthen the incentives to display competitive quotes. The Commission, however, recently concluded that it does not have sufficient information, at this time, to satisfy itself that the potential benefits of a mandatory price/time priority requirement justify the potential drawbacks.[101]

Further, with one price-setter left on each exchange, the potential grows for payment for order flow and internalization arrangements to interfere with order interaction and discourage the display of aggressively-priced quotations. The preferencing of orders based on factors unrelated to the quality of the market to which they are sent, raises the concern that price spreads may not remain narrow over time. At least one academic study has concluded, for example, that while preferencing to some market centers may not have significant negative effect when competition reigns in the market as a whole, ''once preferencing becomes the norm in a market, there is little question that market performance can deteriorate.'' The authors observe: ''The results [of the study] that shows that the scale of preferencing can be detrimental suggest an active role for regulators in limiting the dominance of preferencing in markets.'' [101] The Commission must consider the potential impact of any proposed rule change in light of these concerns.

In evaluating proposals that increase specialist guarantees, the Commission

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[97] *See e.g.,* Securities Exchange Act Release Nos. 34109 (May 25, 1994) 59 FR 28570 (June 2, 1994); 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999); 42455 (February 24, 2000), 65 FR 11388; 42845 (May 26, 2000), 65 FR 35683 (June 5, 2000).

[98] For a discussion of the role dealers and market makers play in the overall structure of the securities markets, see Market Fragmentation Release.

[99] *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000).

[100] A ''trade-through'' occurs where a customer's order is executed on one exchange at a price inferior to that available on another exchange.

[101] *See* Securities Exchange Act Release No. 43086 (July 28, 2000) (Order approving options intermarket linkage plan submitted by the Amex, CBOE, and ISE). *See also* Securities Exchange Act Release No. 43084 (July 28, 2000) (proposing new rules under the Act concerning disclosure of order routing and execution practices).

[101] Robert Bloomfield and Maureen O'Hara, Does Order Preferencing Matter?, 50 Journal of Financial Economics 3, 35 (1998). The study, which conducted experiments based on a market design patterned after the Nasdaq, related to the debate over the potential effects of preferencing in the securities markets.

must consider the provisions of Section 6(b)(5) of the Act that require, in addition to the standards cited above that exchange rules be designed to ''promote just and equitable principles of trade'' and not to permit ''unfair discrimination between customers, issuers, brokers, or dealers.'' [103] It must further consider Section 11A(a) of the Act,[104] which sets as one of its objectives ''fair competition among brokers and dealers and among exchange markets.'' [105]

Specialist guarantees, which afford specialists the ability to attract increased order flow to an exchange, may, on the one hand, benefit market markers in the exchange's trading crowd by enabling them to interact with a larger number of customer orders. On the other hand, the larger the specialist guarantee, the less of each order the crowd in left to trade with, raising the question of whether the guarantee is too high and thus unfairly discriminatory.

The Commission must also consider in this context whether an increased guarantee is consistent with Rule 11b–1(a)(2)(iii) under the Act, which requires that the rules of a national securities exchange include provisions restricting the dealings of a specialist ''so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market * * *'' [106]

E. The Phlx Proposal

The proposed rule change would dramatically increase guarantees on the Phlx, to 80% for active options allocated to specialists after January 1, 1997. Among the purposes cited by the Exchange for the proposals is that this enhanced guarantee would provide added incentive for specialists to attract order to flow to the Exchange.

As indicated above, specialist guarantees on the options markets currently rise to more than 40% of an order in only several instances. One exception is on the PCX, where 50% is the general rule, but the trend has been downward since the advent of multiple exchange trading.[107] Otherwise, specialist allocations on the options exchanges generally are 40% or less.[108] Thus, the proposed rule change by the Phlx to establish an 80% specialist guarantee represents a significant increase in the amount of order flow that would be guaranteed to one market participant.

The Phlx believes that allocating this large percentage is warranted as an incentive for specialists in view of the particular responsibilities, burdens, and costs they bear compared to other market participants. The Commission is concerned, one the other hand, with the effect that such a high specialist guarantee will have on the ability of market makers in the crowd to quote competitively or even to continue making markets at all.

In its rule filing, Phlx argues that because the Exchange until now has not benefited from significant order flow in the Top 100 Options in question, its ROTs in these options will not be disadvantaged. To the contrary, the Phlx maintains, the ROTs will benefit by the depth and liquidity the specialists in these options will being to the Exchange. ''Specifically,'' the Phlx writes, ''more order flow may benefit ROTs, even if they receive a lesser percentage of such order flow * * *'' [109]

The Phlx further argues that ROTs indeed will have an incentive to improve prices under the proposed rule change, because by its provisions, the specialist's enhanced participation applies only when the specialist is on parity. If an ROT or other controlled account improves the market or establishes a market first, the specialist's enhanced participation does not apply. ''Thus,'' the Phlx maintains, ''the proposal provides an incentive ROTs to better markets and thus should promote competition.'' It adds: ''Therefore, the Exchange believes that this proposal should encourage tighter markets and attract order flow to the Exchange.''

The Commission is concerned, however, that because the market makers are reduced to so small a percentage of the spread when they are at the best bid or offer in parity with the specialist, they will not be able to continue market making and compete to establish better prices at all. The Commission notes in this regard that the proposal would entitle the specialist to an 80% participation in all eligible trades executed through the Exchange's auto-ex system.

Moreover, the Commission is concerned that under the proposed rule change, a specialist could, for the short term, tighten its quote to the extent that no potential competitor could afford to improve prices any further. Unable to make profits on the 20% left to them, the potential competitors would be forced to follow the specialist's lead, allowing the specialist to widen spreads again.[110]

Further, the Commission believes it is reasonable to expect that, if the Phlx proposal is approved, other exchanges will also propose specialist guarantees of 80% in order to remain competitive. Thus, the increased order flow and benefits for its ROTs that the Phlx anticipates as the result of a higher specialist guarantee may not, in the end, be sustainable.

The Commission is requesting therefore that commenters address the merit of the Phlx's arguments, in addition to any other comments they may wish to submit on the potential impact of the proposed rule on competition. Specifically, the Commission is requesting comments on the following questions:

- Will enhanced specialist entitlements of up to 80% discourage competition and price improvement on the part of market makers in the crowds of individual options exchanges, such as the Phlx, that choose to adopt them?
- If enhanced specialist entitlements of these sizes were approved by the Commission, and other exchanges also adopted them, what would be the

[103] 15 U.S.C. 78f(b)(5).

[104] 15 U.S.C. 78k–1(a). Section 11A(a) sets forth findings and objectives that are intended to guide the Commission in its oversight of the national market system. As the Commission has recently noted, these findings and objectives can be summed up in two fundamental principles: (1) the interests of investors (both large and small) are preeminent, especially the efficient execution of their securities transactions at prices established by vigorous competition; and (2) investor interests are best served by a market structure that, to the greatest extent possible, maintains the benefits of both an opportunity for interaction of all buying and selling interest in individual securities and fair competition among all types of market centers seeking to provide a forum for the execution of securities transactions. *See* Market Fragmentation Release.

[105] Section 11A(a)(1)(C)(ii), 15 U.S.C. 78k–1(a)(1)(C)(ii).

[106] 17 CFR 240.11b–1(a)(2)(iii).

[107] On the Phlx itself, the specialist is entitled in one case to more than half the fill (60%) when only one other controlled account is parity. Also, 50% guarantees are allowed for new products and new specialist units on the Phlx.

[108] The 60% specialist guarantees on some exchanges, described above, apply when only one market besides the specialist is on parity. In this case, as one of two participants, the specialist would receive 50% of the order even without an enhanced allocation. Thus, the 60% allocation entitles the specialist to only 10% more than he would otherwise have received. Moreover, if additional market makers choose to compete, the specialists guarantee is reduced to 40% or less.

[109] While the Phlx cites a statement by the Commission itself to this effect, we note that this statement appeared in the approval order for a rule change instituted by the Phlx in 1994 that provided for only a 40% guarantee when two or more ROTs were on parity with the specialist and 50% when only one ROT was on parity.

[110] The Commission notes that the proposal includes no limitation on the number of option classes that could be allocated to a specialist under the 80% Enhanced Participation program. The Commission also notes that allocations of options classes to specialists as mandated by Phlx Rule 511(b) may be based on, in addition to specialist evaluation results, ''such other factors as the Committee deems appropriate,'' among them capital resources and order flow commitments. The Commission is thus concerned about the proposal's potential to strengthen the position of specialists still further.

ultimate effect, if any, on price competition and the width of bid-asks spreads across the options markets as a whole?

• Would enhanced specialist entitlements of up to 80% be unfairly discriminatory and induce the exit of market makers?

• How have existing specialist entitlements on the options exchanges affected competition and market quality?

• What is the likelihood of the Phlx proposal leading to preferencing as a norm and in turn creating a risk to overall market quality?

• The Commission has elsewhere asked for comment on the alternative of requiring greater disclosure by market centers and brokers concerning their trade executions and order routing as a means of addressing market fragmentation. Would this alternative impact any of the concerns raised above? If so, how?

Interested persons are invited to submit written data, views, and arguments concerning the foregoing questions and other issues raised by this notice, including whether the proposed rule change is consistent with the Act or whether the Commission should institute proceedings to determine if it should be disapproved as inconsistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of the filing will also be available for inspection and copying at the principal offices of the Phlx. All submissions should refer to File No. SR–Phlx–00–01 and should be submitted by August 30, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[111]

Jonathan G. Katz,

Secretary.

Exhibit A

Text of Proposed Rule Change

Additions are italicized and deletions are in brackets.

Rules

Obligations And Restrictions Applicable To Specialists And Registered Options Traders

Rule 1014

(a)–(f) No change.

(g) Equity Option and Index Option Priority and Parity

(i) Exchange Rules 119 and 120 direct members in the establishment of priority of orders on the floor. In addition, equity option and index option orders of controlled accounts are required to yield priority to customers orders when competing at the same price, as described below.

For the purpose of paragraph (g) of this Rule, an account type is either a controlled account or a customer account. A controlled account includes any account controlled by or under common control with a member broker-dealer. Specialist accounts of PHLX Option Specialists, however, are not subject to yielding requirements placed upon controlled accounts by this Rule. Customer accounts are all other accounts.

Orders of controlled accounts must yield priority to customer orders, except that PHLX ROTs closing in-person are not required to yield priority to orders of customer accounts.

Orders of controlled accounts are not required to yield priority to other controlled account orders, except that when both an order of a PHLX ROT closing in-person and some other order of a controlled account are established in the crowd at the same price, and then a customer order is established at that price, the order of the controlled account must yield to the customer order while the order of the PHLX ROT closing in-person does not have to so yield.

Orders of controlled accounts, other than ROT's and Specialists market making in person, must be:

(1) verbally communicated as for a controlled account when placed on the floor and when represented to the trading crowd and

(2) recorded as for a controlled account by appropriately circling the "yield" field on the floor ticket of any such order.

Several programs described below provide an enhanced participation (or split) to specialists, which refer to the portion of an options trade available for allocation to the specialist on parity, including a 30% enhanced specialist participation, new unit/new option enhanced specialist participation, new product enhanced specialist participation, 50% enhanced participation, and 80% enhanced participation.

(ii) Enhanced Specialist Participation—*Except as provided in (g)(iv), (g)(v) and (g)(vi) below, i*[I]n equity and index option classes, when the registered specialist is on parity with a controlled account as defined in subparagraph (i) above, in accordance with Exchange Rules 119 and 120 and the number of contracts to be bought or sold is greater than five, the specialist is entitled to receive an enhanced participation of 30% *when there are three or more controlled accounts on parity* ("Enhanced Specialist Participation"), except in the following circumstances: (1) Where there is one controlled account on parity, the specialist is entitled to 60%; or (2) where there are two controlled accounts on parity, in which case the specialist is entitled to 40%. Further, no customer order which is on parity may receive a smaller participation than any other crowd participant including the specialist. Enhanced Specialist Participation will be effective for: (a) All newly listed issues and issues, (b) all index options and (c) such issues selected by the specialist and approved by the Allocation, Evaluation and Securities Committee pursuant to section (A) below.

(A)–(C) No change.

(iii) New Unit/New Option Enhanced Specialist Participation—*Except as provided in (g)(iv), (g)(v) and (g)(vi) below, t*[T]o encourage the establishment of new specialist units to trade equity and index option classes that heretofore have never been listed on the Exchange ("New Options Classes"), when such units are on parity with controlled accounts in such classes, the new specialist units will be entitled, for a period of six months following commencement of trading in New Option Classes, to the following enhanced specialist participation in a any such parity trade: (1) Fifty percent (50%) where there is one controlled account on parity; and (2) Forty percent (40%) where there are two or more

[111] 17 CFR 200.30–3(a)(12).

controlled accounts on parity, except that no customer order which is on parity may receive a smaller participation than any other crowd participant including the specialist. The Allocation, Evaluation and Securities Committee may extend such enhanced parity split for each applicable option beyond the initial six month period for one additional six month period upon petition by the specialist unit and a determination by the Committee that such extension is consistent with the promotion of just and equitable principles of trade and the public interest. Additionally, the Committee after granting such extension may at any time terminate with enhanced parity split for any particular options class if the Committee determines that such action is consistent with the promotion of just and equitable principles of trade and the public interest.

(A)–(D) No change.

(iv) No Change.

(v) 50% Enhanced Participation—in 50% Enhanced Participation Options (defined in (A) below), when the registered specialist is on parity with more than one controlled account as defined in subparagraph (i) above, in accordance with Exchange Rules 119 and 120, the specialist is entitled to 50% when there are two or more controlled accounts on parity (''50% Enhanced Participation''. Why there is one controlled account on parity, the specialist is entitled to 60% participation. No customer order which is on parity may receive a smaller participation than any other crowd participation including the specialist.

(A) *50% Enhanced Participation Options are the Top 100 Options, defined in Rule 1014(g)(vi)(A) below, which were allocated to Phix specialist before January 1, 1997.*

(B) *Pursuant to Exchange Rule 509, the Allocation, Evaluation and Securities Committee may reduce the 50% Enhanced Participation authorized under this Rule to a parity level in accordance with Rules 119 and 120. The reduction shall be in accordance with the provisions of this rule if the specialist in such class is determined to be performing below any minimum standards or not satisfying any conditions that the Exchange may establish with respect to any 50% Enhanced Participation Options. The Committee may reinstate the 50% Enhanced Participation for a particular option if it determines that the specialist in such class is performing at or above all established minimum standards and is satisfying all established conditions.*

(C) *50% Enhanced Participation Options that are reallocated or transferred to a Phlx specialist after January 1, 1997, are eligible to be 80% Enhanced Participation Options, as defined in Rule 1014(g)(vi)(A) below.*

(D) *A 50% Enhanced Participation Option is not eligible for any other enhanced specialist participation programs provided in Rule 1014(g).*

(vi) 80% Enhanced Participation—When the registered specialist in 80% Enhanced Participation Options (as defined in (A) below) is on parity with a controlled account(s) (as defined in subparagraph (i) above), the specialist is entitled to 80% participation (''80% Enhanced Participation''). No customer order which is on parity may receive a smaller participation than any other crowd participant including the specialist. This 80% Enhanced Participation will be in effect for a six-month pilot period commencing on a date determined by the Exchange (''Effective Date'').

(A) *Initially, Top 100 Options are those equity options with the highest total year-to-date option volume as of November 30, 1999. The initial Top 100 Options will remain in effect for at least the length of the initial pilot period and until the next evaluation date as follows: subsequent Top 100 Options will be evaluated and established on May 30 and November 30 of each year; the 80% Enhanced Participation will become effective for those options on July 1 and January 1 of each year.*

Top 100 Options allocated, reallocated or transferred to a Phlx specialist after January 1, 1997 are eligible to be an 80% Enhanced Participation Option.

(B) *An 80% Enhanced Participation Option is not eligible for any other enhanced specialist participation programs provided in Rule 1014(g).*

(C) *Exception: The 80% Enhanced Participation does not apply to orders when there is a Phlx ROT closing in-person on parity, provided that the ROT must announce to the trading crowd that he is closing. 50% Enhanced Participation, as defined in subparagraph (g)(v) of this Rule, may be applicable to such order.*

(D) *The volume requirement for 80% Enhanced Participation Options appears in Rule 511(d)(3).*

Enhanced Specialist Participation Review

Rule 509

(a) A Quality of Markets Subcommittee shall be established as a permanently standing subcommittee of the Committee. The purpose of the Subcommittee will be to monitor and evaluate the performance of equity and index option specialists to determine if they will retain an enhanced participation as defined in Rule 1014(g)(ii) *and Rule 1014(g)(v),* to strengthen the equity option floor, and to oversee the specialists' performance respecting multiply traded issues. The Chairman of the Subcommittee will be a floor broker who shall be a member of the Committee. The Other members of the Subcommittee may be anyone that the Chairman of the Committee finds to be qualified and there must be an equal number of specialists and ROTs on the Subcommittee. The Subcommittee also may assist the Committee in conducting informal reviews of specialist units which do not meet minimum standards on specialist evaluations pursuant to Rule 515.

(b)–(e) No change.

Specialist Performance Evaluation

Rule 511

(a)–(c) No change.

(d) Special Reviews.

(1)–(2) No change.

(3) 80% Enhanced Participation Options. The Committee will conduct special reviews for 80% Enhanced Participation Options. Specifically, if the volume transacted on the Exchange for each 80% Enhanced Participation Option does not exceed an average of 10% of the daily consolidated volume compiled by The Options Clearing Corporation (''Performance Requirement'') in each such option for the six month period commencing on the Effective Date or any six month period thereafter, the Committee, pursuant to rule 506, will solicit specialist applications to reallocate such option. This subparagraph (3) will be in effect for a six-month pilot period commencing on a date determined by the Exchange (''Effective Date'').

(A) *Initially, Top 100 Options are those equity options with the highest total year-to-date option volume as of November 30, 1999. The initial Top 100 Options will remain in effect for at least the length of the initial pilot period and until the next evaluation date as follows: subsequent Top 100 Options will be evaluated and established on May 30 and November 30 of each year; and will become effective for those options on July 1 and January 1 of each year.*

(B) *For each Top 100 Option reallocated to a new specialist pursuant to Section (A) above, or transferred or allocated after the Effective Date (which now qualifies as an 80% Enhanced Participation Option), the new specialist* *is entitled to receive the 80% Enhanced Participation as described in Rule 1014(g)(vi), and the Performance Requirement must be met with the initial six month period commencing on the next business day following allocation, reallocation or transfer and continuing until the end of the next six month period operating for the other options in (A) above (that originated with the Effective Date.).*

(C) *Reviews conducted pursuant to this subsection (3) will not be subject to the hearing procedures described in Section (e) below.*

(e) Hearing Procedures. Prior to a final determination with respect to any proceedings instituted under Sections (c) and (d) *(1) and (2) above,* the Committee shall notify the Registrant in writing of the Committee's preliminary evaluation and proposed action and inform the Registrant of its right to a hearing on this matter. If the Registrant elects to receive a hearing, the information supporting the Committee's evaluation of the Registrant's performance shall be presented. The Registrant shall have the opportunity to comment on the Committee's evaluation and present any information that it believes is relevant. The Registrant may question members of the Committee and Exchange staff with respect to the evaluation of its performance. Formal rules of evidence shall not apply. The Registrant and the Committee shall have the right to have present at the hearing one or more technical consultants for the purpose of answering questions about trading techniques and procedures and shall not otherwise participate in the Committee's final evaluation of the Registrant's performance. The Registrant may be represented by legal or other counsel. A transcript shall be kept of the hearing and copies will be furnished to the Registrant upon request and payment of the costs of reproduction. Based on the entire hearing record, the Committee shall prepare and deliver to the Registrant a written decision setting forth its conclusions regarding the Registrant's performance and the action, if any, to be taken with respect to removing and reallocating securities and the basis therefore. The decision also shall describe the Registrant's appeal rights. In the event of such appeal, the Committee's action shall be stayed pending the conclusion of the Registrant's appeal. If, after receiving notice of the Committee's preliminary evaluation and right to a hearing, the Registrant refuses to appear at a scheduled hearing or otherwise fails without reasonable justification or excuse to attend a scheduled hearing, he shall have waived his rights to such hearing.

Supplementary Material:

.01–.04 No change.

Specialist Evaluations

Rule 515

(a) No Change.

(b) Review Frequency and Weight of Evaluations. Routine reviews will be conducted quarterly for equity specialist units and every six months for option specialist units. Special reviews shall be commenced where a specialist unit's performance in a particular market situation was so egregiously deficient as to call into question the Exchange's integrity or impair the Exchange's reputation for maintaining efficient, fair and orderly markets, where a material change in the specialist unit has occurred, within 760 days after a transfer of one or more equity books or option classes has become effective pursuant to Rule 511(d0(2) or within 90 days after a new allocation and will cover such time periods as are deemed appropriate. Special reviews may incorporate the same review methodology and procedures as established for routine reviews, although special reviews may instead or in addition, examine such other matters related to a Registrant's performance as the Committee deems necessary and appropriate. The Committee may seek input from members, customers and Exchange staff and consider any other information the Committee deems relevant in making a final determination to initiate a reallocation proceeding pursuant to Rule 511(c). *The reallocation proceedings described in Rule 511(c) do not apply to the 80% Enhanced Participation Review described in Rule 511(d)(3).*

Option Floor Procedure Advice F–24

AUTO–X Contra-Party Participation (The Wheel)

(a)–(d) No change.

(e) Wheel Rotation/Assigning Contracts—The AUTO–X participation shall be assigned to Wheel Participants on a rotating basis, beginning at a random place on the rotational Wheel each day, from those participants signed-on in that listed option at that time. The Wheel shall rotate and assign contracts depending upon the size of the AUTO–X guarantee, as follows:

1–10 contracts every 2 contracts;

11–25 contracts ever 5 contracts

26 and more every 10 contracts

The Options Committee, or its designees, may approve a Wheel rotation in a size larger than the minimum stated above, if requested by the specialist and Wheel participants. However, the Wheel may not rotate in a size larger than ten contracts. Each remaining portion shall be successively assigned to individual Wheel Participants on that same basis. The specialist shall receive the first execution of the day; thereafter, if four or less ROTs are participating on the Wheel, the specialist shall participate in a normal rotation. However, if an average of five to 15 ROTs have signed-on the Wheel, the specialist shall receive every fifth execution; of an average of 16 or more ROTs have signed-on the Wheel, the specialist shall receive every tenth execution, unless Wheel participation falls below ten participants at any time, then the specialist shall automatically participate in a normal rotation.

Execution to the normal rotation: [With the unanimous consent of Wheel participants in an option and approval of the Options Committee Chairman or his designee, t] *T*he specialist shall receive [an enhanced participation substantially equivalent to twice the number of contracts as other crowd participants where the Enhanced Specialist Participation of Rule 1014(g)(ii) applies.] *the same enhanced participation on the Wheel as such specialist should receive under the enhanced specialist participation programs of Rule 1014(g)(ii), the 30% Enhanced Specialist Participation, Rule 1014(g)(v), 50% Enhanced Participation, or Rule 1014(g)(vi), 80% Enhanced Participation.*

(f) The provisions of section (e) above will be reviewed and evaluated by the Options Committee, on a six-month basis.

FINE SCHEDULE

F–24 Fine not applicable, except paragraph (c). Matters subject to review by the Business Conduct Committee.

Option Floor Procedure Advice B–6

Priority of Options Orders for Equity Options and Index Options by Account Type

Exchange Rules 119 and 120 direct members in the establishment of priority of orders on the floor. In addition, equity option and index option orders of controlled accounts are required to yield priority to customer orders when competing at the same price, as described.

For the purpose of this Advice, an account type is either a controlled account or a customer account. A controlled account includes any account controlled by or under common control with a member broker-dealer. Specialist accounts of PHLX Option Specialists, however, are not subject to yielding requirements placed controlled accounts by this Advice. Customer accounts are all other accounts.

Section A

No change.

Section B

Orders of controlled accounts, other than ROTs and Specialists market making in-person, must be

(1) verbally communicated as for a controlled account when placed on the floor and when represented to the trading crowd, and

(2) recorded as for a controlled account by appropriately circling the ''yield'' field on the floor ticket of any such order.

In any instance where an order is misrepresented in this fashion due to factors which give rise to the concern that it was the result of anything other than an inadvertent error, the Exchange may determine to bypass the fine schedule below and refer the incident to the Business Conduct Committee for possible disciplinary proceedings in accordance with those procedures set forth under the Exchange's Disciplinary Rule 960.

Several programs described below provide an enhanced participation (or split) to specialists, which refers to the portion of an options trade allocated to the specialist on parity, including a 30% enhanced specialist participation, new unit/new option enhanced specialist participation, new product enhanced specialist participation, 50% enhanced participation, and 80% enhanced participation.

Section C

Enhanced Specialist Participation—*Except as provided sections D–F,* [i[I]n equity and index option classes, when the registered specialist is on parity with a controlled account, as defined above, in accordance with exchange Rules 119 and 120 and the number of contracts to be bought or sold is grater than five, the specialist *is entitled to received an enhanced participation of 30% when there are three or more controlled accounts on parity (''Enhanced Specialist Participation''),* except in the following circumstances:

(1) where there is one controlled account on parity, in which case the specialist is entitled to 60%; or

(2) where there are two controlled accounts on parity, in which case the specialist is entitled to 40%.

Further, no customer order which is on parity may receive a smaller participation than any other crowd participant including the specialist. Enhanced Specialist Participation will be effective for:

(a) all newly listed issues,

(b) all index options, and

(c) such issues selected by the specialist and approved by the Allocation, Evaluation and Securities Committee.

Section D

No change.

Section E

50% Enhanced Participation—In 50% Enhanced Participation Options (defined in (a) below), when the registered specialist is on parity with more than one controlled account as defined in subparagraph (i) above, in accordance with exchange Rules 119 and 120, the specialist is entitled to 50% participation when there are two or more controlled accounts on parity. When there is one controlled account on parity, the specialist is entitled to 60% participation. No customer order which is on parity may receive a smaller participation than any other crowd participant including the specialist.

(a) 50% Enhanced Participation Options are the Top 100 Options, defined in Section F below, which were allocated to a Phlx specialist before January 1, 1997.

(b) Pursuant to Exchange Rule 509, the Allocation, Evaluation and Securities Committee may reduce the 50% Enhanced Participation authorized under Rule 1014(g)(v) to a parity level in accordance with Rules 119 and 120. The reduction shall be in accordance with the provisions of this rule if the specialist in such class is determined to be performing below any minimum standards or not satisfying any conditions that the Exchange may establish with respect to any 50% Enhanced Participation Options. The Committee may reinstate the 50% Enhanced Participation for a particular option if it determines that the specialist in such class is performing at or above all established minimum standards and is satisfying all established conditions.

Section F

80% Enhanced Participation—When the registered specialist in 80% Enhanced Participation Options (as defined in (a) below) is on parity with a controlled account(s), the specialist is entitled to 80% participation (''80% Enhanced Participation''). No customer order which is on parity may receive a smaller participation than any other crowd participant including the specialist. The 80% Enhanced Participation will be in effect for a six-month pilot period commencing on a date determined by the Exchange (Effective Date).

(a) Initially, the Top 100 Options are those equity options with the highest total year-to-date option volume as of November 30, 1999. The initial Top 100 Options will remain in effect for at least the length of the initial pilot period and until the next evaluation date as follows: subsequent Top 100 Options will be evaluated and established on May 30 and November 30 of each year; the 80% Enhanced Participation will become effective for those options on July 1 and January 1 of each year.

Top 100 Options allocated, reallocated or transferred to a Phlx specialist after January 1, 1997 are eligible to be 80% Enhanced Participation Options.

(b) An 80% Enhanced Participation Option is not eligible for any other enhanced specialist participation programs provided in Rule 1014(g).

(c) Exception: The 80% Enhanced Participation does not apply to orders when there is a Phlx ROT closing in-person on parity, provided that the ROT must announce to the trading crowd that he is closing. 50% Enhanced Participation, as defined in subparagraph (g)(v) of Rule 1014(g), may be applicable to such order.

(d) The volume requirement for 80% Enhanced Participation Options appears in Rule 511(d)(3).

FINE SCHEDULE (Implemented on a one year running calendar basis)

No change.

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SOCIAL SECURITY ADMINISTRATION

Agency Information Collection Activities: Proposed Request and Comment Request

In compliance with Public Law 104–13, the Paperwork Reduction Act of 1995, SSA is providing notice of its information collections that require submission to the Office of Management and Budget (OMB). SSA is soliciting comments on the accuracy of the agency's burden estimate; the need for the information; its practical utility; ways to enhance its quality, utility and clarity; and on ways to minimize burden on respondents, including the use of automated collection techniques or other forms of information technology.

I. The information collections listed below will be submitted to OMB within 60 days from the date of this notice. Therefore, comments and