Securities Industry Association

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October 31, 2000

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

Re: Securities Exchange Act Release; No. 43085; File No. 57-17-00

Dear Mr. Katz:

The Options Committee ("Committee") of the Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on Securities Exchange Act Release No. 43085, which proposes two rules that would apply to exchange-listed options. Under proposed Rule 11Ac1-7 ("The Trade-Through Disclosure Rule"), broker-dealers would be required to disclose to a customer when the customer's order to buy or sell a listed option was executed at a price inferior to the best quote published at the time of execution of the customer's order. Separately, it is proposed that Rule 11Ac1-1 ("Quote Rule") be amended to require options exchanges and options market makers to publish firm quotes. The Committee generally supports the goals of both proposed rules insofar as they are intended to increase market transparency and further best execution in the options markets. Nevertheless, both proposals raise important issues that need to be addressed prior to further Commission action.

Options Linkage

As a preliminary matter, the Committee applauds the Commission on its approval of the CBOE/AMEX/ISE linkage plan. We are also very pleased that the Pacific Exchange and Philadelphia Stock Exchange have joined the plan. We believe this is an

[1] The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals.

important step toward ensuring that broker-dealers can access the best available markets for their customer option orders. It will also help increase customer confidence in listed options and improve the overall integrity of the marketplace. Moreover, we believe it is imperative in the current options market environment that any new options exchange join the SEC-approved plan. At the same time, however, the Committee agrees with the need for flexibility to accommodate more advanced linkage systems as technological enhancements develop. Such flexibility will help to encourage new exchange participants as well as promote healthy competition among existing exchanges.

Trade-Through Disclosure Rule

The proposed Trade-Through Disclosure Rule generally would require broker-dealers to disclose every option trade-through occurrence to affected customers, subject to a significant exception. The exception provides that the disclosure would not be required if the order is sent to an exchange that participates in an approved linkage plan. We observe that this exception creates a tremendous incentive for exchanges to join the plan. For example, as a practical manner, it is unrealistic to believe that most broker-dealers would choose to route orders to an un-linked exchange, given that an inadvertent trade-through would be subject to the SEC' "red badge" disclosure requirement. Given that PCX and PHLX have joined the CBOE/Amex/ISE linkage plan, there is little reason to believe, at least in the short term, that broker-dealers will be posed with the choices offered by this rule. Nevertheless, we offer the following specific comments on the proposed rule.

The Committee generally supports enhanced disclosure of order routing and execution practices[2] but respectfully disagrees with the Commission that the Trade-Through Disclosure Rule will facilitate an investor's ability to monitor and determine whether their broker is fulfilling best execution requirements. The mere fact that a trade-through has occurred does not provide a complete snapshot of the circumstances surrounding the handling and execution of a particular order. It ignores, for example, other factors that often come into play in representing customer orders, such as speed of execution, liquidity, anonymity, service and transaction costs. These are all legitimate factors that, in addition to price, are considered in determining whether best execution has been met. The proposal would potentially put brokers in the position of having to "defend" each and every trade-through. We believe this result is unreasonable and unwarranted.

We believe that the goal of improving the execution quality of options transactions is best served by moving ahead aggressively on implementing the approved options linkage plan. In other words, we believe the focus of the Commission and

[2] The comment letter submitted by the SIA Board-level Market Structure Committee expressed the same view in response to the companion proposal for disclosure of order routing and execution practices by market centers and broker-dealers (Exchange Act Release No. 43084). See letter to Jonathan G. Katz, Secretary, SEC, from Mark B. Sutton Chairman, SIA Market Structure Committee, dated September 26, 2000.

options industry should be on preventing the occurrence of trade-throughs rather than disclosing them after the fact. We believe the approved linkage plan provides significant protections against trade-throughs, both in deterring their occurrence and in providing remedies to customers in the rare instances where they occur.

As a technical matter, the Committee supports the seven proposed exceptions to the trade-through disclosure rules, including stale markets, trading rotations, and complex orders. In addition, we note that the size of an order is an extremely important factor in determining whether a trade-through involving such an order is meaningful. Because, large orders are far more dependent on liquidity than smaller orders, the ability to get a block off on a timely, efficient basis may be severely impacted by strict adherence to a trade-through rule. We therefore support an exception for block trades from the trade-through rule.

Quote-Rule

The Committee supports the extension of the Quote Rule to the options market. While the options markets currently require that quotes be firm for non-broker dealer orders, no similar guarantee is required for broker dealer proprietary orders. We believe that extending firm-quote treatment to broker-dealer orders will promote greater market transparency and ensure that the prices displayed to the market are real.

The Commission has proposed two alternative approaches to determining the extent of the guarantee for broker dealer orders. One approach (Alternative A) requires that an exchange's best bid or offer be firm to broker dealers to the same extent as customers of the broker dealer. The alternative approach (Alternative B) allows an exchange to establish different firm quote sizes for customer orders than for broker-dealer orders. The Committee generally supports Alternative B. More specifically, we support a minimum size for which market makers' quotes must be firm for broker-dealer and public customer orders alike. This minimum should not fall below one contract per option series, with market makers retaining the ability to increase their firm quote size limits for either customer or broker dealer orders. Under our preferred approach, an exchange could establish different firm quote sizes for customer orders than for broker-dealer orders, but the disseminated quote would always have to be good for at least one contract for broker-dealer orders. As to Alternative A, the Committee has a significant concern that mandating the same guarantee for customer and broker dealer orders alike could cause market makers to limit their exposure to professional traders by widening their spreads or limiting their guaranteed size.

As you are aware, a number of significant technological limitations exist today that prevent the wide-scale dissemination of size of all options quotes occurring on U.S. options exchanges. Efforts to expand the system capacity of the Options Price Reporting Authority ("OPRA") are currently underway, however, the additional message traffic expected from the conversion to decimals could exceed the OPRA system's capacity. Accordingly, the Committee strongly believes that the Commission should refrain from mandating that size be disseminated with each quotation until such limitations have been remedied.[3] In recognition of the current limitation, the rule proposal would not require broker-dealers and options exchanges to publish on a quote-by-quote basis the size associated with each quotation in listed options. Instead, exchanges would furnish market participants with information relating to the size associated with the quotes in particular options series. The Committee believes that, under the circumstances, this is an appropriate solution. However, we think it is important to note that it will be extremely difficult for market participants to keep track of the potentially huge number of different size guarantees permitted by this approach. Of course, this leads us back to what should be the main goal – developing the ability to disseminate actual size with all options quotes. In this regard, we urge the Commission to continue to exercise its authority to address the current capacity constraints of the OPRA and other entities that prevent the wide-scale dissemination of quote size at this time.[4]

The Committee appreciates the opportunity to provide comments on this important Release. If we can provide further information, or clarification of the points made in this letter, please contact Scott Kursman, Assistant General Counsel, at 212-618-0508.

Sincerely,

William McGowen
Chairman
Options Committee

cc: The Honorable Arthur Levitt, Chairman
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Paul R. Carey, Commissioner
The Honorable Laura S. Unger, Commissioner
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Belinda Blaine, Associate Director, Division of Market Regulation

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[3] Chairman Levitt noted the same concern in a speech expressing his support for quote size dissemination. "Now I know that the current capacity crisis in the options markets prevents a prompt removal of this impediment. But quotes without size are simply an intolerable fog surrounding today's options prices and restricts competition among orders on the basis of price. Clearing this fog should be a top priority for the options markets the moment the present capacity crunch is resolved." Remarks of SEC Chairman Arthur Levitt at the Annual Options Industry Conference by Chairman Arthur Levitt Palm Beach, Florida May 5, 2000.

[4] During the past year, the Options Committee worked closely with the SEC and the exchanges developing proposals to mitigate quote traffic to address the ongoing capacity issues facing OPRA. The Committee reiterates its willingness to assist the SEC and exchanges with this issue going forward.