



Securities Industry Association

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February 20, 2001

Ms. Annette Nazareth
Director
Division of Market Regulation
U.S. Securities & Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: SEC Rule 11ac1-7: Trade Through Disclosure Rule for Options

Dear Ms. Nazareth,

The Securities Industry Association¹ (“SIA”) is writing to urge the SEC to postpone the effective date of the Trade-Through Disclosure Rule.² As you know, the rule requires firms to begin disclosing options trade-throughs on customer confirmations by April 1, unless the transaction was effected on a market that is a part of an approved intermarket linkage plan. The SEC has stated that it would consider granting exemptive relief from the rule if the options exchanges have made “substantial progress” toward implementing a linkage that meets the SEC’s requirements. While we understand the need to bring the linkage issue to a prompt resolution, we believe that the rule imposes an unfair regulatory burden on firms for a problem that they did not create and cannot solve. Accordingly, we ask the Commission to postpone the effective date of the rule.

SIA commends the Commission for urging the options exchanges to implement a linkage plan and commends the options exchanges for agreeing to build it. We believe that an effective linkage plan is in the best interests of investors. SIA understands that the exchanges

¹ The Securities Industry Association (SIA) brings together the shared interest 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 in excess of \$300 billion of revenues yearly in the U.S. economy and employs approximately 700,000 individuals.

² Firm Quote and Trade-Through Disclosure Rules for Options, Securities Exchange Act Release No. 43591(November 17, 2000).

have made substantial progress towards making the linkage a reality. We continue to urge the options exchanges to complete work on a linkage as expeditiously as possible.

But no matter how much pressure the firms apply to the exchanges to resolve the linkage issue, we understand that there will not be a functioning linkage in place by April 1. Moreover, we understand that the exchanges are currently unable to supply firms with the information about trade-throughs in the short time frame and format required to disclose it on confirmations. Finally, the firms do not know how the Commission is defining or measuring “substantial progress.” SIA’s member firms are unable to solve these problems themselves, but will be forced to make confusing disclosures to customers, suggesting that the firms are not doing their job. Penalizing the firms for circumstances beyond their control is simply unfair. SIA is calling on the Commission either to find that substantial progress has been made, or to otherwise delay effectiveness of the rule.

BACKGROUND

The recent SEC study on payment for order flow in the options markets³ highlights the critical market structure issues that must be resolved before a complete and accurate assessment of best execution in the options market is possible. For example, the SEC and exchanges need to immediately address the existing structural impediments to best execution that have plagued investors in recent years. Recent initiatives of the SEC have focused on building a market structure that will allow for more vibrant competition to occur.⁴ SIA commends the Commission for recognizing the problems that have affected this market and taking the necessary action to correct them.

It is without question that firms have a duty of best execution in handling customers’ options orders. It is just as true that since the advent of multiple trading in 1989, firms have been handicapped in their exercise of this duty by the inability of the options markets and regulators to come to agreement on very basic market structure and investor protection measures. The absence of a linkage, a disseminated consolidated quote, a firm quote rule and an effective exchange trade-through rule have negatively impacted firms in two meaningful ways. First, firms are limited in their ability to obtain reliable information needed to make order-routing determinations pursuant to best execution. Second, the inability of specialists and market makers to route orders in their possession to the best market means that exchanges are unable to supplement the best execution efforts of the firms that route them orders.

³ Special Study: Payment for Order Flow and Internalization in the Options Markets (December 2000).

⁴ Joint Industry Plan: Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC, Securities Exchange Act Release No. 43086 (August 4, 2000); 65 FR 48023; Firm Quote and Trade-Through Disclosure Rules for Options, Securities Exchange Act Release No. 43591 (November 17, 2000). Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000). Decimals Order, Exchange Act Release No. 34-42914 (June 8, 2000); 65 FR 38010.

CUSTOMERS AND FIRMS CONTINUE TO BEAR THE COSTS OF THE LACK OF AN EXCHANGE LINKAGE

The lack of an inter-exchange order routing capability has been the single greatest obstacle when seeking best execution in the options markets. Prior to 1989, there was no choice of where to route an option orders. With the adoption of Rule 19c-5 in 1989, a choice of market centers listing the same options product became available for the first time.⁵ However, this choice was not meaningful, primarily because key elements required for an effective integrated options market were missing. Most notably absent was (and still is) a linkage. Since the decision where to route cannot be based on price alone, a linkage ensures that a market center that is not quoting the best price when an order is received has the means to transmit that order to the market that does. Thus, regardless of which exchange an order is routed to, best execution will prove elusive if that exchange cannot access a better quote away.

The SEC originally took the view that the development of a market integration facility such as a linkage should *not* be a prerequisite to the expansion of multiple trading.⁶ However, in 1990 the SEC called on the exchanges to build a linkage, maintaining that it would increase opportunities to ensure best execution for customer orders.⁷ The SEC further warned that it would take action against any exchange that attempted to stall efforts aimed at building a linkage.⁸ The GAO also recommended in 1990 that the SEC direct the construction of a linkage system if it determined that the exchanges are not making sufficient progress.⁹ Subsequent SEC efforts to introduce market integration facilities met with resistance from the exchanges or were abandoned. For example, a 1992 linkage proposal was not approved despite having the support of four out of the five options exchanges.¹⁰ There were no further attempts to create a linkage until 1999 when the Commission ordered the options exchanges to develop a linkage and ultimately approved the linkage plan submitted by the CBOE, AMEX and ISE.¹¹ SIA believes that a linkage, once built, will provide for meaningful price competition and opportunities for price improvement at the exchange level.

The failure to have a functioning linkage in place, however, is not the fault of the firms. SIA is very concerned that the recently approved trade-through disclosure rule would require firms to disclose trade-throughs to customers if the linkage is not operating by April 1, 2001. It would be grossly unfair for firms to have to suffer the cost and potential liability associated with detecting and disclosing possible trade-throughs because of the failure of others to build a linkage that has been promised for over 10 years. Moreover, notice that a particular exchange

⁵ Securities Exchange Act Release No. 26870 (May 26, 1989), 54 FR 23963.

⁶ Id.

⁷ Letter from Chairman Breedren to the Registered Options Exchanges (January 9, 1990).

⁸ Id.

⁹ SEC Action Needed to Address National Market System Issues, (GAO/GGD 90-52).

¹⁰ Securities Exchange Act Release No. 30187 (January 22, 1992); 57 FR 2612.

¹¹ Securities Exchange Act Release No. 42029 (October 19, 1999); 64 FR 57674 .

may have traded through an unverifiable and unreachable quote on another exchange will prove confusing to investors, and may indiscriminately undermine investor confidence in this market. Finally, any expenditure of systems capital in pursuit of a compliance solution will ultimately be wasted once an operating linkage is in place since firms will then fall under the safe harbor. Surely, there are enough critical projects confronting the industry – i.e., Nasdaq decimalization, OATS, T+1, etc... - without adding another that will soon be obsolete.

It is not clear how a firm would even know that a trade-through had occurred on a particular options exchange. The exchanges have their own SEC-approved rules for identifying and investigating trade-throughs and do not notify firms of their final determinations (if at all) until after the exchanges send the execution reports to the firms. Broker-dealers generate confirmations using the execution reports and would have to delay printing confirmations, thereby postponing settlement of the trade, until a trade-through report was received. Even if firms could revise their own confirmation procedures to accommodate the required disclosure in a timely manner, they will still not be able to comply with the rule if the exchanges cannot supply the data in the format and time frame required for information to appear on a confirmation.

In the adopting release, the Commission said it would consider granting temporary exemptive relief from the rule if “the markets continue to make substantial progress towards implementing the linkage plan.”¹² The Commission has not enunciated the standard as to what would constitute “substantial progress” in the eyes of the Commission. These standards need to be clearly articulated and realistic. For example, requiring amendments to the current linkage plan to require market makers and specialists to take account of quotes on an unlinked market would undermine the purpose of the linkage by rewarding those that choose not to participate. The firms cannot be expected to play a role in achieving substantial progress if they do not know what the Commission’s goals are and are not present at the linkage discussions between the exchanges and the SEC.

Moreover, the selection of the April 1 deadline is ill-conceived in light of the OCIE Report’s conclusion that “the Commission expects that the exchanges will have made substantial progress towards implementation of the linkage by October 1, 2001.”¹³ (emphasis added). If the Commission already knows that substantial progress will not be achieved until October, it is unclear how the Commission can at the same time expect there to be substantial progress by the earlier April 1 date. With this statement, the Commission appears to have undercut the basis for the April 1 benchmark in the approval order.

The Commission could find ample evidence for the achievement of substantial progress by virtue of the long-term linkage discussions that it has held with the exchanges. SIA understands that the process of selecting a general contractor to build the linkage is ongoing and that a final decision is expected by mid-March. Substantial progress could also be found in the

¹² Supra Note 2 at p.12

¹³ Supra Note 3, at p. 8.

interim linkage solution currently being discussed. SIA is strongly urging the other exchanges to join the CBOE and ISE in that linkage plan, which has already received the Commission's approval. The Commission should let it be known immediately whether the interim plan represents substantial progress or what further steps need to be taken.

CONCLUSION

As our letter and the OCIE Report point out, these linkage questions have lingered since the advent of multiple trading over 10 years ago. Brokerage firms have always been the major proponents of previous and current attempts to provide a linkage for this market. To link the exchange's progress on the linkage to a firm's compliance with a new and unrealistic trade-through requirement now ignores the positive role that firms have played in this debate and incorrectly presumes that firms can speedily resolve it on their own. Given the SEC's own experience attempting to mandate a linkage, it should not now expect brokerage firms to be able to force a solution.

Nevertheless, our firms will continue to lend their voices to the debate and we have publicly called on the options exchanges to expeditiously resolve all outstanding issues relating to the long-term linkage solution and for those that have not done so, to join the interim linkage plan (see attached letter). Moreover, we urge the specialists, market makers and other members of the floor community to participate in the interim linkage plan.

Finally, we believe the SEC should work to guide the current linkage effort to a successful conclusion. To address the urgent matter of the April 1 date for the trade-through disclosure rule, SIA is appealing to the Commission to postpone the effectiveness of the trade-through disclosure rule. We respectfully suggest that the Commission has access to all of the information it needs right now to make a decision, and that delay will only serve to perpetuate anxiety about compliance with a rule that is impossible to satisfy.

Our purpose in submitting this letter is to describe for the SEC the context in which to consider the role of the broker in seeking best execution in the options market. That role we believe has been constrained and obstructed by structural and regulatory defects for too long. We are confident that the new initiatives, once implemented, will give all the parties - firms, exchanges and regulators - the necessary tools to ensure best execution and customer protection.

If we can answer any questions or be of any further assistance, please contact me or Stuart Kaswell, Senior Vice President and General Counsel at 202-296-9410.

Very truly yours,

Marc E. Lackritz

Cc: The Honorable Laura Unger, Commissioner, SEC
The Honorable Isaac Hunt, Commissioner, SEC
The Honorable Paul Carey, Commissioner, SEC
Lori Richards, Director, Office of Compliance, Inspections and Examinations, SEC
Robert L.D. Colby, Deputy Director , Market Regulation, SEC
Belinda Blaine, Associate Director, Market Regulation, SEC
Elizabeth King, Associate Director, Market Regulation, SEC
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