

an account in which he has an interest. However, the requirements of this Rule shall not apply to those option orders which are not executable because of the restrictions of Securities Exchange Act Rule 11a1-1, the two tick requirement of Rule 111 and the procedures for the handling of percentage orders pursuant to Rule 154.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Amex 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 Amex has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

The Amex is proposing to amend Amex Rule 950 for the purpose of revising the obligation of specialists in representing options orders. Currently, Amex Rule 950(a) incorporates and applies Amex Rule 155 to options so that a specialist is required to give precedence to orders entrusted to him as an agent in any option in which he is registered before executing at the same price any purchase or sale in the same option for an account in which he has an interest.³ This amendment to paragraphs (a) and (d) of Amex Rule 950, and the addition of new paragraph (q) to Amex Rule 950, would revise the obligation of options specialists so that such specialists are obligated to accord priority only to public customer orders. The term "public customer of a member organization" is defined as an order which, if executed, results in the purchase or sale for an account in which no member or broker-dealer has an interest.⁴

Amex represents that a number of developments in the options industry and at the Amex in recent years have resulted in an increasing number of options orders left with specialists for representation. In particular, the

consolidation of firms and changing economics have resulted in a decline in the number of independent floor brokers who formerly represented orders in trading crowds at the Amex.⁵ In addition, the enhanced use of electronic order routing systems by firms has further increased the number of options orders that specialists represent. Therefore, a larger percentage of all options orders traded in a particular trading crowd are now being electronically routed and either automatically executed via the Amex's automatic execution system or placed in the specialist's order display book, the Amex Options Order Display Book ("AODB"),⁶ for execution.

The introduction of the Booth Automated Routing System ("BARS")⁷ at the Amex further permits member firms to manage their order flow more efficiently by providing members a choice of sending orders electronically to their floor broker booths for further action or using existing electronic order routing systems to send orders directly to the specialist. With the advent of a reduction in floor broker operations and the speed of electronic order routing, such orders increasingly are routed electronically to the specialist for handling. Accordingly, the Amex does not believe that it is appropriate for a specialist to be denied the opportunity to compete for orders merely because it is representing such orders that have in the past been represented by floor brokers.

The Amex believes it will become increasingly difficult for specialists to compete against Registered Options Traders ("ROT's") and other members in the trading crowd given the preference for electronic order routing. As the percentage of electronically routed orders increases, the incentive to assume the affirmative obligations and exposure in managing a specialist unit decrease. Therefore, the Amex believes this proposal is justified in light of the particular responsibilities, burdens and costs borne by specialists as compared to other market participants. For example a specialist unit has greater

market making responsibilities than ROT's and other non-specialists, higher capital requirements, and other costs such as staffing in connection with brokerage quote updating and quote processing.

The Amex offers the following example to help illustrate how the current order precedence rule works at the Amex. A specialist who had been bidding \$2 as dealer receives an order for a broker-dealer that has been electronically routed by an unaffiliated floor broker via BARS. The broker-dealer is seeking to buy 50 contracts of XYZ at a limit of \$2 at a time when the market is 2 (bid) – 2.25 (offer). A Registered Options Trader ("ROT") now walks into the trading crowd to sell 100 contracts of XYZ at \$2. The specialist must represent the order of the floor broker and, in addition, may bid as dealer to compete against other non-specialists to trade against the ROT order for 100 contracts. The specialist, however, must, when bidding as dealer, accord priority to the order of the floor broker and cannot compete to trade against that order. If competition in the trading crowd is such that the specialist is allocated 20 contracts (or less) in the trade of 100 contracts, the specialist will have no chance to participate, as principal, in the trade. If the specialist did not have to accord priority to the order of the broker-dealer, the specialist would be able to compete equally with the other trading crowd participants and assert its participation right if the trade occurred at the specialist's previously established principal bid or offer.

The Amex believes this proposal is substantially similar to a proposal by the Chicago Board Options Exchange, Inc. ("CBOE") that was approved by the Commission.⁸ Pursuant to the CBOE proposal, the designated primary market makers ("DPMs"), when representing an order as agent, would be required to accord priority only to public customer orders over their own principal transactions.⁹ The Amex represents that it has based the instant proposal on the CBOE rule change, and therefore, submits it is identical to the CBOE's approved rule. Amex therefore believes that approval of the proposal would place Amex specialists on an equal footing with DPMs so that a specialist when representing an order accords priority only to public customer orders.

The Amex, notes, however, that although Commission approval of this

⁵ For example, Amex "spread" brokers no longer exist because of the inability to profitably remain in business. These specialized floor brokers at the Amex focused on executing options spread orders. See File No. SR-Amex-2001-48.

⁶ The AODB is the electronic options specialist book that receives and stores both market and limit orders directed to the Amex through its electronic order routing system or given to the specialist by traders.

⁷ BARS is an order routing system permitting brokers to manage and route orders for Amex traded securities. See Securities Exchange Act Release No. 45782 (April 18, 2002), 67 FR 20559 (April 25, 2002).

³ According to the Amex, the specialist does not have to give precedence to those orders which are not executable because of the restrictions of Rule 11a1-1(T) under the Act or because of the two-tick requirement of Commentary .01(b) to Amex Rule 950(c).

⁴ See Commentary .02 to Amex Rule 950(d).

⁸ See Securities Exchange Act Release No. 45103 (November 26, 2001), 66 FR 63083 (December 4, 2001) (notice of SR-CBOE-00-42) and 45341 (January 25, 2002) 67 FR 5016 (February 1, 2002) (approval order of SR-CBOE-00-42).

⁹ *Id.*