

## II. Complex Orders

Current exchange rules permit floor brokers to represent complex options orders, including, among others, spread,<sup>13</sup> straddle,<sup>14</sup> and combination orders.<sup>15</sup> According to two exchanges, there are fewer floor brokers today on the exchange floors than there were in the past. As a result, there may be times when, under current rules, such orders may not be able to be represented or executed on a national securities exchange. As a result of these concerns, on July 19, 2001, the Amex filed a proposal with the Commission, pursuant to Section 19(b)(1) of the Exchange Act<sup>16</sup> and Rule 19b-4 thereunder,<sup>17</sup> to amend its rules to permit Amex options specialists to accept spread orders.<sup>18</sup> The Commission determined that consideration of the Amex proposal required addressing issues related to Exchange Act Section 11(b).

According to the Amex, the Amex floor brokers who focused primarily on executing spread orders ("spread

2,000 shares and the aggregate number of shares as to which stops are in effect may not exceed 5,000 shares. The 5,000-share limit is designed to ensure that the amount of stopped stock does not become so large that there would, in effect, cease to be an imbalance on the opposite side of the market from the order being stopped (*i.e.*, less likelihood of price improvement for the order being stopped). See Amex 1995 Order and NYSE Order, *supra* note 6. With regard to the rules of the Chicago Stock Exchange ("CHX") and the BSE, the Commission concluded that because stopped orders would be elected automatically after a transaction takes place on the primary market at the stopped price, the requirements imposed on specialists under the CHX and BSE rules provided sufficient guidelines to ensure that a specialist would implement the rules for stopping stock in minimum variation markets in a manner consistent with his or her market making duties and Section 11(b). See BSE 1996 Order and CHX 1995 Order, *supra* note 6.

<sup>13</sup> A spread order is an order to buy a stated number of option contracts and to sell the same number of option contracts, or contracts representing the same number of shares at option, in a different series of the same class of options.

<sup>14</sup> A straddle order is an order to buy (sell) a number of call option contracts and to buy (sell) the same number of put option contracts on the same underlying security, which contracts have the same exercise price and expiration date.

<sup>15</sup> A combination order is an order involving a number of call option contracts and the same number of put option contracts on the same underlying security and representing the same number of shares at option. In the case of adjusted option contracts, a combination order need not consist of the same number of put and call contracts if the contracts both represent the same number of shares at option. A adjusted option contract is a contract whose terms are changed to reflect certain fundamental changes to the underlying security. For example, after an adjustment for a 2 for 1 stock split, an investor who held an option on 100 shares of XYZ stock with an exercise price of \$60 may hold two options, each on 100 shares of XYZ stock and with an exercise price of \$30.

<sup>16</sup> 15 U.S.C. 78s(b)(1).

<sup>17</sup> 17 CFR 240.19b-4.

<sup>18</sup> See File No. SR-Amex-2001-48.

brokers") were unable to remain in business and the loss of the spread brokers has reduced spread order executions on the Amex.<sup>19</sup> Other exchanges have also expressed concern that the disappearance of floor brokers has meant a shift in business to the over-the-counter ("OTC") market.<sup>20</sup>

As noted above, the Commission previously has permitted specialists to accept percentage orders and to stop orders in part because the exchange rules allowing specialists to accept percentage orders and to stop orders sufficiently limited a specialist's discretion and ensured that a specialist's handling of those orders was consistent with his or her market making duties and Section 11(b) of the Exchange Act. Similarly, the Commission believes that it is appropriate in the public interest and consistent with the protection of investors to exempt, subject to certain conditions, options specialists from the provisions of Section 11(b) of the Exchange Act to allow them to accept orders in option contracts on the same underlying security where the customer specifies the number of contracts for each series and the net debit or credit at which the order will be executed ("Complex Orders"), including spread, straddle, and combination orders.<sup>21</sup> Such an exemption would allow market participants to continue to have the ability to purchase and sell Complex Orders on an exchange market, under conditions that would reduce the discretion the specialist has in executing these orders.

The Commission believes it is necessary for the protection of investors and appropriate in the public interest to condition a specialist's handling of Complex Orders, as indicated below. These conditions will limit a specialist's discretion in the handling of such orders. The conditions also require the

<sup>19</sup> See letter from Jeffrey P. Burns, Assistant General Counsel, Amex, to Sharon M. Lawson, Senior Special Counsel, Division of Market Regulation, Commission, dated October 18, 2001.

<sup>20</sup> For example, the Philadelphia Stock Exchange, Inc. ("PHLX") has stated that the number of foreign currency options ("FCO") participants and firms clearing FCOs has declined steadily since the 1980s as the market has increasingly shifted to OTC trading. See Exchange Act Release No. 44372 (May 31, 2001), 66 FR 30780 (June 7, 2001) (approving on a one-year pilot basis a PHLX proposal to permit FCO participants to, among other things, contact the specialist to negotiate the total debit or credit for transacting a spread, straddle, or combination FCO order). The PHLX allowed the pilot program to expire because there is at least one PHLX floor broker available to handle customer FCO orders and, accordingly, the relief provided by the pilot program currently is not necessary.

<sup>21</sup> For purposes of this order, the term Complex Order does not include orders that have a non-option component.

exchange on which a specialist trades to have surveillance procedures in place to monitor specialists' handling of these orders for compliance with the exchange's rules and the conditions in this exception.

More specifically, the conditions set forth below should help to ensure that a specialist is not able to unduly influence market trends through his or her handling of Complex Orders. In this regard, the conditions limit a specialist's discretion by providing that an exchange's rules must require a specialist to execute a Complex Order as soon as it becomes possible to execute the order at the net debit or credit specified by the customer, consistent with its priority rules. The conditions also provide that an exchange's rules must require a specialist who accepts a Complex Order to announce the terms of the order to the trading crowd immediately after receiving the order. In addition, to address concerns regarding a potential conflict of interest that may arise if a specialist handles the orders of customers of his or her own firm, as well as the orders of other brokers' customers that are given to the specialist for execution, an exchange must have rules that prohibit a specialist from accepting orders from customers of the firm with which the specialist is associated.<sup>22</sup>

As noted above, the conditions set forth below are designed to reduce the specialist's discretion in handling Complex Orders. As a result, the conditions should help to provide the type of protection that the prohibition in Exchange Act Section 11(b) was enacted to provide, and at the same time permit exchange specialists, not solely floor brokers, of which there are relatively few, to accept Complex Orders.

For these reasons, the Commission finds that it is appropriate in the public interest and consistent with the protection of investors to exempt a specialist from the provision in Section 11(b) of the Exchange Act that prohibits a specialist from effecting on the exchange as broker any transaction except upon a market or limit order, provided that:

(1) The order effected by such specialist: (i) Is comprised solely of options on the same underlying security and the customer specifies the number

<sup>22</sup> The Commission has stated previously that specialists should not be permitted to have their own customers, as opposed to customers of other brokers whose orders are given to the specialist for execution. In this regard, the Commission stated that transactions for a specialist's own customers do not affirmatively assist his market making activities and are fraught with possibilities of abuse. See SEC, Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Part 2, 166 (1963).