

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-56269; File No. SR-Amex-2007-75)

August 15, 2007

Self-Regulatory Organizations; American Stock Exchange LLC; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to Establish a Directed Order Program

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 24, 2007, the American Stock Exchange LLC (“Amex” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been substantially prepared by the Exchange. On July 30, 2007, the Exchange filed Amendment No. 1 to the proposed rule change. On August 15, 2007, the Exchange filed Amendment No. 2 to the proposed rule change. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is approving the proposed rule change, as amended, on an accelerated basis.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to adopt Amex Rule 996-ANTE and amend Amex rule 935-ANTE establishing the Exchange’s Directed Order Program (the “Program”). The text of the proposed rule change is available on Exchange’s Web site ([www.amex.com](http://www.amex.com)), at Amex’s principal office, and at the Commission’s Public Reference Room.

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

<sup>2</sup> 17 CFR 240.19b-4.

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

In its filing with the Commission, 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 III below. 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 Exchange proposes to adopt rules establishing the Exchange's Directed Order Program (the "Program"). Proposed Rule 996—ANTE provides that specialists, Registered Options Traders ("ROTs"), Supplemental Registered Options Traders ("SROTs"), and Remote Registered Options Traders ("RROTs") (collectively, the "Directed Order Participants")<sup>3</sup> may choose to enter into arrangements with an Order Flow Provider,<sup>4</sup> whereby a Directed Order Participant would be directed orders upon meeting certain eligibility requirements.

Eligibility

The Exchange will allow for the receipt of marketable orders, through the Exchange's order routing system when the Exchange's disseminated quote is the NBBO, where the order

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<sup>3</sup> The Exchange's SROT and RROT programs were recently approved by the Commission on April 12, 2006 and April 13, 2006, respectively. See Securities Exchange Act Release Nos. 53635 (April 12, 2006), 71 FR 20144 (April 12, 2006) (order approving the SROT program) and 53652 (April 13, 2006), 71 FR 20422 (April 20, 2006) (order approving the RROT program).

<sup>4</sup> Order Flow Providers are defined in proposed Rule 996—ANTE as any member or member organization that submits, as agent, customer orders to the Exchange.

flow providing firm (“Order Flow Provider”)<sup>5</sup> transmitting that order has specified a specialist, ROT, SROT or RROT in that class as the Directed Order Participant for its orders that class.

To be eligible for the Program the Directed Order Participant: (i) must submit quotes electronically through the Exchange’s ANTE system, in options classes in which it is assigned; (ii) must comply with its quoting obligations under Exchange rules and provide continuous two-sided quotations in not less than 100% of the series of each class for which it receives directed orders; and (iii) must also be quoting at the best bid or offer on the Exchange (the “ABBO”)<sup>6</sup>.

#### Enhanced Participation and Allocation

An eligible Directed Order Participant who is directed orders will receive an enhanced participation equal to the greater of 40% of the remaining directed orders, when more than one market participant is quoting at the ABBO, or the amount the Directed Order Participant would be entitled to receive pursuant to the allocation algorithm set forth in Rule 935—ANTE(a)(4).

The enhanced participation rate is based on the number of contracts remaining after all non-broker-dealer customer orders in the book at the best price have been satisfied. If an eligible Directed Order Participant receives enhanced participation under the rule, then no other participation entitlement set forth in Amex Rules shall apply to such order. The eligible Directed Order Participant must also be quoting at the ABBO to receive the guaranteed percentage, and

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<sup>5</sup> An “Order Flow Provider” is any member or member organization that submits, as agent, customer orders to the Exchange. See proposed Rule 996—ANTE(d)

<sup>6</sup> Pursuant to Exchange Rule 958—ANTE(h)(iii)(A), ROTs are responsible for quoting continuous two-sided markets in a certain percentage of series based on the volume of contracts executed electronically on the Exchange during the previous quarter. Pursuant to Exchange Rules 993—ANTE (c)(ii) and 994—ANTE (c)(iv), SROT and RROT are responsible for quoting continuous two-sided markets in 60% of the series of their assigned classes.

can never be allocated more contracts than his quote size.<sup>7</sup> Any contracts remaining after the eligible Directed Order Participant has received his allocation shall be allocated among the remaining participants according to the allocation algorithm set forth in Rule 935—ANTE(a)(4). No participant will be allocated contracts in excess of the size of his disseminated quote.

Finally, the Exchange notes that an eligible Directed Order Participant may not step up and match the ABBO after it receives an order, but must be publicly quoting at the ABBO when the order is received.<sup>8</sup> An Order Flow Provider is prohibited from notifying a Directed Order Participant of its intention to submit a directed order, so that the Directed Order Participant may not change its quotation to match the ABBO immediately prior to the submission of the directed order, and then fade his quote. Specifically, the Exchange currently has rules in place to prevent such conduct as being inconsistent with just and equitable principals of trade and to prevent the misuse of material non-public information.<sup>9</sup>

The Exchange proposes that the effective date of the Program shall be August 20, 2007.<sup>10</sup>

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<sup>7</sup> The allocation algorithm in Rule 935—ANTE (a)(4) is comprised of a Component A and a Component B. Component A is the parity component of the algorithm. In this component all market participants (except for non-broker-dealer customers) who were either quoting or had orders at the ABBO will be treated equally. Accordingly, the percentage used for Component A is an equal percentage derived by dividing 100 by the number of market participants at the ABBO. Component B is the size pro rata component and is designed to reward market participants who quote in size. The percentage used for Component B is the percentage that the size of each market participant's quote or order at the ABBO represents relative to the total number of contracts in the disseminated bid (for sell orders) and offer (for buy orders). The weight each component will have in the final percentage used to allocate executed contracts will initially be equal.

<sup>8</sup> The Exchange's disseminated quote must be at the NBBO at the time of receipt of the Directed Order. See proposed Rule 996—ANTE(a).

<sup>9</sup> See Amex Rules 3(j) and 16.

<sup>10</sup> See Amendment No. 2.

## 2. Statutory Basis

The proposed rule change is consistent with Section 6(b) of the Act<sup>11</sup> in general and furthers the objectives of Section 6(b)(5) of the Act<sup>3</sup> in particular in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of change, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

### B. Self-Regulatory Organization's Statement on Burden on Competition

The proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

No written comments were solicited or received with respect to the proposed rule change.

## III. 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. Comments may be submitted by any of the following methods:

### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-Amex-2007-75 on the subject line.

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<sup>11</sup> 15 U.S.C. 78f.

<sup>12</sup> 15 U.S.C. 78f(b)(5).

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-Amex-2007-75. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of Amex. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Amex-2007-75 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of the Proposed Rule Change

After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of Section 6 of the Act<sup>13</sup> and the rules and regulations thereunder applicable to a national securities exchange<sup>14</sup>, and, in particular, the requirements of Section 6(b)(5) of the Act.<sup>15</sup> Section 6(b)(5) requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to 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.

Pursuant to Section 19(b)(2) of the Act,<sup>16</sup> the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission notes that the proposed rule change is substantially similar to rule changes by CBOE and ISE that were recently approved by the Commission on a permanent basis.<sup>17</sup> The Commission believes that the proposed rule changes to establish a Directed Order

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<sup>13</sup> 15 U.S.C. 78f.

<sup>14</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>15</sup> 15.U.S.C. 78f(b)(5).

<sup>16</sup> 15 U.S.C. 78s(b)(2).

<sup>17</sup> See, e.g., Securities Exchange Act Release Nos. 51799 (June 2, 2005), 70 FR 33564 (June 8, 2005) (order approving SR-CBOE-2004-71), 55826 (May 29, 2007), 72 FR 31357 (SR-CBOE-2007-47) (permanent approval of CBOE's Preferred Market-Maker Program), 51759 (May 27, 2005), 70 FR 32860 (June, 6, 2005) (order approving SR-Phlx-2004-91), 51818 (June 10, 2005), 70 FR 35146 (June 16, 2005) (order approving SR-ISE-2005-18), and 55864 (June 5, 2007), 72 FR 32378 (SR ISE 2007-35) (permanent approval of the ISE's pilot program for preferenced orders).

Program on the Amex do not raise additional significant regulatory issues that have not been previously considered by the Commission. Accordingly, the Commission hereby finds good cause for approving the proposed rule change, as amended, prior to the 30th day after publishing notice thereof in the Federal Register.

The Commission has previously approved a rule that guarantees a specialist a portion of each order when the specialist's quote is equal to the ABBO.<sup>18</sup> The Commission has closely scrutinized exchange rule proposals to adopt or amend a participation guarantee where the percentage of participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange.<sup>19</sup> Because the proposal would not increase the overall percentage of an order that is guaranteed beyond the currently acceptable threshold, but instead would allow any specialist, ROT, SROT or RROT appointed to an options class to be designated as a Directed Order Participant and be eligible to receive an enhanced participation guarantee instead of the specialist, the Commission does not believe that the proposal will negatively impact quote competition on the Exchange. Under the proposal, the remaining portion of each order will still be allocated based on the competitive bidding of market participants.

Under the proposal, in order to be eligible to receive a participation guarantee in any options series, the Exchange proposes to require that a specialist, ROT, SROT, or RROT maintain continuous quotes in not less than 100% of the series of any options class it for which it

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<sup>18</sup> See, e.g., Securities Exchange Act Release No. 49747 (May 20, 2004), 69 FR 30344 (May 27, 2004) (SR-Amex-2003-89).

<sup>19</sup> See, e.g., Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48788 (August 9, 2000).



receives Directed Orders.<sup>20</sup> In addition, a Directed Order Participant will have to be quoting at the NBBO at the time the Directed Order is received to capitalize on the enhanced participation guarantee.<sup>21</sup> The Commission believes it is critical that the Directed Order Participant cannot step up and match the NBBO after it receives an order, but must be publicly quoting at that price when the order is received. In this regard, the Exchange's proposal prohibits an Order Flow Provider from notifying a Directed Order Participant of its intention to submit a Directed Order, so that the Directed Order Participant may not change its quotation to match the ABBO prior to the submission of the Directed Order, and then fade his quote. The Exchange represented that it has rules in place to prevent such conduct as being inconsistent with just and equitable principles of trade and to prevent the misuse of material non-public information.<sup>22</sup> Furthermore, the Exchange represented that it will proactively conduct surveillance for compliance with the applicable rules in conjunction with the Exchange's Directed Order Flow Program and enforce these rules.

The Commission emphasizes that approval of this proposal does not affect a broker-dealer's duty of best execution. A broker-dealer has a legal duty to seek to obtain best execution of customer orders, and any decision to preference a particular specialist, ROT, SROT, or RROT must be consistent with this duty.<sup>23</sup> A broker-dealer's duty of best execution derives from

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<sup>20</sup> See Amex Rule 996—ANTE. The specialist, ROT, SROT, or RROT also must have an appointment/allocation in such options class. *Id.*

<sup>21</sup> Specifically, Rule 996-ANTE requires a Directed Order Participant to be quoting at the ABBO while the Exchange's disseminated quote is the NBBO in order to be eligible to receive an enhanced participation for the order.

<sup>22</sup> See Amex Rules 3(j) and 16.

<sup>23</sup> See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (January 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 SEC 629, 636

common law agency principles and fiduciary obligations, and is incorporated in rules of self-regulatory organization and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws.<sup>24</sup>

The duty of best execution requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, *i.e.*, at the best reasonably available price.<sup>25</sup> The duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders.<sup>26</sup> Broker-dealers must examine their procedures

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(1948), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Handling Rules Release").

<sup>24</sup> Order Handling Rules Release, 61 FR at 48322. See also *Newton*, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See *Newton*, 135 F.3d at 273 ("[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal."); *Marc N. Geman*, Securities Exchange Act Release No. 43963 (February 14, 2001) (citing *Newton*, but concluding that respondent fulfilled his duty of best execution). See also Payment for Order Flow, Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55009 (November 2, 1994) ("Payment for Order Flow Final Rules"). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See *Newton*, 135 F.3d at 273-274.

<sup>25</sup> *Newton*, 135 F.3d at 270. *Newton* also noted certain factors relevant to best execution - order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *Id.* at 270 n. 2 (citing Payment for Order Flow, Securities Exchange Act Release No. 33026 (October 6, 1993), 58 FR 52934, 52937-38 (October 13, 1993) (Proposed Rules)). See *In re E.F. Hutton & Co.* ("Manning"), Securities Exchange Act Release No. 25887 (July 6, 1988). See also Payment for Order Flow Final Rules, 59 FR at 55008-55009.

<sup>26</sup> Order Handling Rules Release, 61 FR at 48322-48333 ("In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and

for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices.<sup>27</sup>

In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.<sup>28</sup>

For these reasons, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5) of the Act,<sup>29</sup> and will not jeopardize market integrity or the incentive for market participants to post competitive quotes.<sup>30</sup>

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rigorously examine execution quality likely to be obtained from different markets or market makers trading a security.”). See also Newton, 135 F.3d at 271; Market 2000: An Examination of Current Equity Market Developments V-4 (SEC Division of Market Regulation January 1994) (“Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer’s order.”); Payment for Order Flow Final Rules, 59 FR at 55009.

<sup>27</sup> Order Handling Rules, 61 FR at 48323.

<sup>28</sup> Order Handling Rules, 61 FR at 48323. For example, in connection with orders that are to be executed at a market opening price, “[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders.” Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000) (adopting new Rules 11Ac1-5 and 11Ac1-6 under the Act and noting that alternative methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

<sup>29</sup> 15 U.S.C. 78f(b)(5).

<sup>30</sup> Approval of this proposal is in no way an endorsement of payment for order flow by the Commission.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>31</sup> that the proposed rule change (SR-Amex-2007-75), as modified by Amendments No. 1 and 2, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>32</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>31</sup> 15 U.S.C. 78s(b)(2).

<sup>32</sup> 17 CFR 200.30-3(a)(12).