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## COMMISSION ANNOUNCEMENTS

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### **SEC STAFF REPORT DESCRIBES DEVELOPMENT OF PAYMENT FOR ORDER FLOW AND INTERNALIZATION IN THE OPTIONS MARKETS**

The staffs of the Commission's Office of Compliance Inspections and Examinations and Office of Economic Analysis today issued a report entitled "Payment for Order Flow and Internalization in the Options Markets." Text of the report, requested by Chairman Levitt in July of this year, is available on the Commission's website at <http://www.sec.gov/news/studies/ordpay.htm>.

In August 1999, the options exchanges began to multiply list many options that had previously traded on only one exchange, giving brokers a choice of where to send their customers' orders. Accordingly, exchanges and their members are competing intensely for those orders. With increased competition for options order flow, options market participants have begun to offer cash payments to brokers in return for brokers agreeing to route their customers' order flow to them. Other indirect inducements also have arisen in the options markets, such as "internalization" of retail options orders, i.e., firms trading as counter-parties with their customer orders. In July 2000, the options exchanges began facilitating their members' payment for order flow strategies.

Firms are obligated to seek the best possible executions for their customers' orders, irrespective of payment for order flow or other order routing inducements. However, payment for order flow and internalization create conflicts of interest for brokers because of the tension between the firms' interests in maximizing payment for order flow or trading profits generated from internalizing their customers' orders, and this fiduciary obligation to route their customers' orders to the best markets.

Today's staff report describes current payment for order flow and internalization practices, and outlines how the practices of payment for order flow and internalization have affected order routing decisions and the execution quality of customer options orders. Among other things, the staff found the following:

- The number of retail customer options orders paid for pursuant to payment for order flow arrangements has steadily increased. In March 2000, in those options classes reviewed by the Staff, specialists paid brokers for 14% of the retail options orders sent to them. By August 2000, specialists paid brokers for over 75% of the retail options orders sent to them.
- During the period of November 1999 to September 2000, options specialists paid over \$33 million to brokers to induce them to route their customer orders to the specialists.
- As of September 2000, 19 of the 24 brokers examined by the Staff accepted payments for their customers' order flow. Four of the 24 firms reviewed maintained policies not to accept payment for order flow.
- One broker has received in excess of \$6 million, and six brokers have received in excess of \$2 million in payments for their order flow. As of November 30, 2000, these firms have not passed along to retail customers the benefits of payments received for order flow in the form of reduced retail commissions or direct rebates. In fact, only one firm has significantly reduced retail customer commissions for executing listed options orders, and another firm maintains a policy to rebate payments received for order flow to customers.
- Payment for order flow has had an impact on order routing decisions. Firms that maintained policies not to accept payment for order flow re-routed significantly fewer options classes to specialists that pay for order flow than did firms that maintain policies to accept payment for order flow. In fact, four of the 19 firms reviewed that accept payment for order flow re-routed 75% or more of their customers' options orders in at least 8 of the 12 classes reviewed by the Staff to specialists that paid them for order flow. Four other firms similarly re-routed 25% or more of their customers' options orders in at least 8 of the 12 classes to specialists that paid them for order flow.
- Brokers do not have adequate market execution quality information to reliably compare the quality of executions between specialist firms.
- Internalization of retail customer options orders is not yet a prevalent practice in the options industry. Only two brokers reviewed have developed systems to trade against retail customers' options orders.
- The trend in quoted spreads (along with other measurements of quoting behavior discussed in this report) suggest a decline in aggressive quoting that may be related to a concurrent growth of payment for order flow and other forms of internalization.
- Effective spreads have remained generally constant after an initial decline following the advent of multiple-listing.











