

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51036; File No. SR-Phlx-2004-92)

January 13, 2005

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendments No. 1 and 2 Thereto by the Philadelphia Stock Exchange, Inc. Relating to Adopting Phlx Rule 1017, Openings in Options, on a Permanent Basis

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹, and Rule 19b-4 thereunder,² notice is hereby given that on December 15, 2004, the Philadelphia Stock Exchange, Inc. (“Phlx” 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 prepared by Phlx. On December 28, 2004, Phlx filed Amendment No. 1 to the proposed rule change.³ On January 12, 2005, Phlx filed Amendment No. 2 to the proposed rule change.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons and is approving the proposed rule change, as amended, on an accelerated basis.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced the original proposed rule change in its entirety.

⁴ In Amendment No. 2, Phlx proposes to clarify the specialist’s requirement to give precedence to orders entrusted to him as an agent in any option in which he is registered. Specifically, Phlx represents that the 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: (i) the same price; (ii) a lower bid; or (iii) a higher offer, any purchase or sale in the same option for an account in which he has an interest. The Exchange’s Market Surveillance Department conducts surveillance for violations of this requirement. Therefore, if a specialist intends to trade for his own account on the opening, the specialist must first be sure that he does not trade ahead of any orders (as agent). Otherwise, he would be subject to possible disciplinary action, regardless of when such an order is received (i.e., in this circumstance, after the underlying security opens but prior to the opening in the underlying security). See, e.g., Phlx Rule 1019.

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

Phlx proposes to adopt, on a permanent basis, Phlx Rule 1017, Openings in Options, which is currently subject to a 180-day pilot scheduled to expire January 28, 2005. The text of the proposed rule change is available at the principal office of the Exchange and at the Commission's Public Reference Room.

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

In its filing with the Commission, Phlx included statements concerning the purpose of, and basis for, the proposed rule change, as amended, and discussed any comments it received. The text of these statements may be examined at the places specified in Item III below. Phlx 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 Statutory Basis for, the Proposed Rule Change

1. Purpose

In July 2004, the Commission approved the Exchange's proposal to adopt rules applicable to the Exchange's electronic trading platform for options, Phlx XL.⁵ Among the rules approved was Phlx Rule 1017, which describes in detail the process for openings in options on the Exchange. Phlx Rule 1017, which was approved on pilot basis, addresses the opening process in three main parts: the pre-opening, the opening rotation, and the specialist's calculation of the price of the opening trade of the session in a given series. The purpose of this

⁵ See Securities Exchange Act Release No. 50100 (July 27, 2004), 69 FR 46612 (August 3, 2004) (SR-Phlx-2003-59).

proposed rule change, as amended, is to assure the continuity of the Exchange's rules relating to openings by adopting Phlx Rule 1017 on a permanent basis.

Phlx Rule 1017 is intended to provide for an orderly and efficient process for the opening of an option and for re-opening following a trading halt. First, the sections of Phlx Rule 1017 concerning pre-openings are intended to describe which orders and quotes the specialist in a particular option is required to accept and consider prior to the opening in a given series and when the specialist must accept and include market orders in the opening. Specifically, prior to the opening, the specialist determines from Floor Brokers, and from orders resting on the limit order book, the size and prices of orders which are near the previous closing prices of those options in which the specialist is assigned. Also, in addition to establishing the specialist's own quote in the series, the specialist considers markets from Registered Options Traders ("ROTs") in the crowd and, respecting Streaming Quote Options traded on Phlx XL, considers electronic quotations submitted by Streaming Quote Traders ("SQTs"). This enables the specialist to ascertain orders and quotes on both sides of the market for a series to determine the opening price for that series.

Because openings on the Exchange are not currently automated, there is no "broadcast" of opening limit orders and quotes on the Phlx XL. The participants, however, have access to market information necessary to ascertain bids and offers in the pre-opening phase. Specialists are able to view the entire limit order book, including orders resting on the book from the previous trading session and any orders submitted before the opening, on their on-floor screens (known as the X-Station). Specialists are also able to view all electronically submitted quotes in Phlx XL options. SQTs have the same view of the limit order book and their own quotes but not those of other SQTs. Non-SQT ROTs are able to view the current on-floor displayed market,

whether generated by a pre-opening quote or by limit orders at the then-best bid or offer. All in-crowd SQTs and the specialist, together with non-SQT ROTs in the crowd, are able to ascertain all in-crowd verbal bids and offers. Following the pre-opening phase, the specialist conducts an opening rotation.⁶

Phlx Rule 1017 provides that the opening price is the price at which the specialist determines that the greatest number of contracts will trade, as long as such opening price falls within an acceptable range to be determined by the Exchange's Options Committee.⁷ An acceptable range is determined as a percentage of the lowest bid as the lower boundary of the acceptable range and as a percentage of the highest offer as the upper boundary of the acceptable range. For example, such an acceptable range may be established as 75% of the lowest bid and 125% of the highest offer. Once determined by the Exchange's Options Committee, such an acceptable range would be announced to the Exchange's membership via regulatory circular.⁸ The Exchange believes that the establishment of such bright-line parameters defining an acceptable opening price range provides specialists with clear guidance on the amount by which the opening price may differ from the lowest bid and highest offer. In the interest of a fair and orderly market, a Floor Official may provide a specific exemption from the established acceptable range in a particular series.

⁶ A trading rotation is a series of very brief time periods during each of which bids, offers, and transactions in only a single, specified option contract can be made. See Phlx Rule 1047, Commentary .01.

⁷ The Options Committee has general supervision of the dealings of members on the equity and index options trading floor, and of the premises of the Exchange immediately adjacent thereto, and has supervision of the activities on the equity and index options trading floor of specialists, assistant specialists, registered option traders, floor brokers, or other types of market-makers. See Phlx By-Law Article X, Section 10-20.

⁸ This provision in the proposed rule is based on Chicago Board Options Exchange, Inc. ("CBOE") Rule 6.2B(e)(ii).

Commentary .03(b) to Phlx Rule 1017 includes further limitations on the opening price to be determined by the specialist. First, if two or more prices would satisfy the criteria for determining the opening price, the price which would leave the fewest number of contracts resting on the limit order book is selected as the opening price. If there are still two or more prices that would satisfy such criteria, the price which is closest to the previous session's closing price is selected as the opening price. Complex orders and contingency orders do not participate in opening rotations or in the determination of an opening price.

Once the specialist determines the opening price, the Exchange disseminates the opening trade price to the Option Price Reporting Authority ("OPRA"). At this point, the series is open for trading. Once the opening trade price in a series has been disseminated to OPRA, the specialist, ROTs, and SQTs trading such series are required to fulfill their respective quoting obligations under Phlx Rule 1014.

The rule also includes circumstances in which a specialist would not open a series. Specifically, the specialist would not open a series if it is not within an acceptable range, as described above, unless a specific exemption is given by a Floor Official in the interest of a fair and orderly market, or the opening trade would leave a market order imbalance (i.e., there are more market orders to buy or to sell for the particular series than can be satisfied by the market orders, limit orders, and specialist or SQT quotations on the opposite side). For purposes of this provision, "market orders" include those limit orders that are treated as market orders in accordance with Phlx Rule 1017(b) (i.e., orders at a limited price order to buy which is at a higher price than the price at which the option is to be opened and a limited price order to sell which is at a lower price than the price at which the option is to be opened) and market-on-opening orders. In such a circumstance, the specialist requests bids and offers from ROTs in the

crowd and, in the case of Streaming Quote Options, from SQTs that are assigned in the option. Such ROTs and/or SQTs are required to respond to such a request immediately. The series could not open until responses to the specialist's request have been received and the consequent opening price is deemed by a Floor Official to be compatible with a fair and orderly market.

Finally, Phlx Rule 1017 addresses the situation in which there are no orders in a particular series when the underlying security opens. In such a situation the Exchange would disseminate quotations in such series via the Exchange's Auto-Quote or Specialized Quote Feed upon the opening in the underlying security.

Phlx Rule 1017 was adopted as a 180-day pilot, which is scheduled to expire on January 28, 2005.⁹ The proposal would adopt Phlx Rule 1017 on a permanent basis by deleting Phlx Rule 1017(f), which describes the pilot. The Exchange represents that it has received no negative comments or complaints since the Commission's approval of the pilot.

2. Statutory Basis

The Exchange believes that its proposal, as amended, is consistent with Section 6(b) of the Act¹⁰ in general and furthers the objectives of Section 6(b)(5) of the Act¹¹ in particular in that it is designed to perfect the mechanisms of a free and open market and the national market system, protect investors and the public interest and promote just and equitable principles of trade by establishing permanent rules relating to openings on the Exchange that provide for an orderly and efficient process for the opening of an option, and for re-opening following a trading halt.

⁹ See *supra*, note 5.

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

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

The Exchange does not believe that the proposed rule change, as amended, will impose any inappropriate burden on competition.

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

No written comments were either solicited or received.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the amended 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. Please include File Number SR-Phlx-2004-92 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-Phlx-2004-92. 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. Copies of the filing also will be available for inspection and copying at the principal office of the Phlx. 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-Phlx-2004-92 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 Proposed Rule Change

After careful consideration, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder, applicable to a national securities exchange,¹² and, in particular, with the requirements of Section 6(b) of the Act¹³ and the rules and regulations thereunder. The Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act¹⁴ in that it is designed to perfect the mechanisms of a free and open market and the national market system, protect investors and the public interest and promote just and equitable principles of trade.

Specifically, the Commission believes that the proposed rule change establishes permanent rules governing the opening procedures on options that should provide a reasonable process by which Phlx participants would access and participate in the opening rotations and re-opening following a trading halt. The Commission also believes that the proposed rules

¹² In approving this rule, the Commission notes that it has considered its impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹³ 15 U.S.C. 78f(b).

¹⁴ 15 U.S.C. 78f(b)(5).

governing the opening procedures on options should provide transparency to all market participants with respect to the manner in which an opening price is determined on the Exchange.

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹⁵ for approving the proposed rule change prior to the thirtieth day after the date of publication of the notice of the filing thereof in the Federal Register. The Commission notes that the Exchange represents that it has received no negative comments or complaints since the Commission approved the Phlx XL opening procedures on a pilot basis. Further, accelerating approval of the instant proposed rule change will ensure that the Phlx XL opening procedures will continue to operate without any undue interruption when the pilot period ends on January 28, 2005.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁶ that the proposed rule change and Amendments No. 1 and 2 thereto (SR-Phlx-2004-92) are hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

J. Lynn Taylor
Assistant Secretary

¹⁵ 15 U.S.C. 78s(b)(2).

¹⁶ 15 U.S.C. 78s(b)(2).

¹⁷ 17 CFR 200.30-3(a)(12).