

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53004; File No. SR-Phlx-2005-78)

December 22, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change Relating to the Extension of a Pilot Concerning Priority in Trades Involving Synthetic Option Orders

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 13, 2005, 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. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is approving the proposed rule change on an accelerated basis, for a pilot period expiring on June 30, 2006.

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

Phlx proposes to extend, for an additional six months, the pilot concerning Exchange Rule 1033(e), which affords priority to synthetic option orders (as defined below) traded in open outcry over bids and offers in the trading crowd but not over bids (offers) of public customers on the limit order book and not over crowd participants who are willing to participate in the synthetic option order at the net debit or credit price. The proposed rule change would apply to orders for 100 contracts or more and would be subject to a pilot program scheduled to expire on June 30, 2006. The text of the proposed rule change is set forth below. Brackets indicate deletions; underline indicates new text.

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¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Bids And Offers --Premium

Rule 1033. (a) - (d) No change.

(e) Synthetic Option Orders. When a member holding a synthetic option order, as defined in Rule 1066, and bidding or offering on the basis of a total credit or debit for the order has determined that the order may not be executed by a combination of transactions at or within the bids and offers established in the marketplace, then the order may be executed as a synthetic option order at the total credit or debit with one other member, provided that, the member executes the option leg at a better price than the established bid or offer for that option contract, in accordance with Rule 1014. Subject to a pilot expiring [December 31] June 30, 200[5] 6, synthetic option orders in open outcry, in which the option component is for a size of 100 contracts or more, have priority over bids (offers) of crowd participants who are bidding (offering) only for the option component of the synthetic option order, but not over bids (offers) of public customers on the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price.

(f) - (i) No change.

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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 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. 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

The purpose of the proposed rule change is to extend for a six-month period the pilot that facilitates the execution of an option order that is represented in the crowd together with a stock component, known under the Exchange rules as a synthetic option order,³ which by virtue of the stock component may be difficult to execute without a limited exception to the Exchange priority rules. The current pilot is scheduled to expire on December 31, 2005.⁴ Phlx proposes to extend the pilot to June 30, 2006.

The pilot provides that, if an Exchange member who is holding a synthetic option order and bidding or offering on a net debit or credit basis determines that such synthetic option order cannot be executed at the net debit or credit against the established bids and offers in the crowd, the member bidding for or offering the synthetic option on a net debit or credit basis may execute the synthetic option order with one other crowd participant, provided that the option portion of the synthetic option order is executed at a price that is better than the established bid or offer for the option. Thus, if the desired net debit or credit amount cannot be achieved by way of

³ Exchange Rule 1066(g) defines a synthetic option order as an order to buy or sell a stated number of option contracts and buy or sell the underlying stock or Exchange-Traded Fund Share in an amount that would offset (on a one-for-one basis) the option position. For example:

(1) Buy-write: an example of a buy-write is an order to sell one call and buy 100 shares of the underlying stock or Exchange-Traded Fund Share.

(2) Synthetic put: an example of a synthetic put is an order to buy one call and sell 100 shares of the underlying stock or Exchange-Traded Fund Share.

(3) Synthetic call: an example of a synthetic call is an order to buy (or sell) one put and buy (or sell) 100 shares of the underlying stock or Exchange-Traded Fund Share.

⁴ See Securities Exchange Act Release No. 52140 (July 27, 2005), 70 FR 45481 (August 5, 2005) (SR-Phlx-2005-31).

executing against the established bids and offers in the crowd, the member may elect to trade at the desired net debit or credit amount with one other member, provided that there is price improvement for the option component of the synthetic option order.

Exchange Rule 1033(e) affords synthetic option orders priority over bids (offers) of the trading crowd but not over bids (offers) of public customers on the limit order book and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price. The effect of Exchange Rule 1033(e) is that a crowd participant bidding or offering for the synthetic option order has priority over other crowd participants that are bidding or offering only for the option component of the order. Exchange Rule 1033(e) applies only to synthetic option orders of 100 contracts or more.

In addition, Exchange Rule 1033(e) provides that members bidding and offering for synthetic option orders of 100 contracts or more do not have priority over bids (offers) of public customers on the limit order book.⁵ Therefore, if members of the trading crowd wish to trade a synthetic option order that is marketable against public customer orders on the limit order book, public customers would have priority. Multiple public customer orders at the same price are accorded priority based on time.

The Exchange believes that the pilot, which provides a limited exception to the Exchange's priority rules only respecting controlled accounts⁶ competing at the same price, should enable Floor Brokers representing synthetic option orders to provide best executions to

⁵ See Exchange Rule 1080, Commentary .02.

⁶ A controlled account includes any account controlled by or under common control with a broker-dealer. Customer accounts are all other accounts. Orders of controlled accounts are required to yield priority to customer orders when competing at the same price. Orders of controlled accounts generally are not required to yield priority to other controlled account orders. See Exchange Rule 1014(g)(i)(A).

customers placing such orders and should enable the Exchange to provide liquid markets and compete for order flow in such orders.

As stated above, the pilot applies only to synthetic option orders in which the option component is for a size of 100 contracts or more that are represented in the trading crowd in open outcry and would be subject to a pilot program through June 30, 2006.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act⁷ in general, and furthers the objectives of Section 6(b)(5) of the Act⁸ 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 adopting a limited exception to the Exchange's priority rules concerning synthetic option orders.

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

The Exchange does not believe that the proposed rule change would impose any burden on competition 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 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 proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

⁷ 15 U.S.C. 78f(b).

⁸ 15 U.S.C. 78f(b)(5).

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-2005-78 in the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-Phlx-2005-78. 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 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-2005-78 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 is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange,⁹ and, in particular, with the requirements of Section 6(b) of the Act¹⁰ and the rules and regulations thereunder. The Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹¹ which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest. The Commission notes that the priority rules with respect to the execution of synthetic option orders on other options exchanges are similar to Exchange Rule 1033(e).¹² In general, such rules serve to reduce the risk of incomplete or inadequate executions of synthetic option orders by allowing the synthetic option orders to have priority over bids and offers of crowd participants who are bidding or offering only for the option component of the synthetic option order but only subject to restrictions such as those proposed by Phlx. For example, the pilot would continue to protect the priority of public customer orders on the limit order book. In addition, the pilot protects the priority of crowd participants who are willing to participate in the synthetic option order at the net debit or credit price.

⁹ 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).

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

¹² See, e.g., Securities Exchange Act Release Nos. 20294 (October 17, 1983), 48 FR 49114 (October 24, 1983) (approving SR-CBOE-83-4); 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003) (approving SR-CBOE-2002-05); 44955 (October 18, 2001), 66 FR 53819 (October 24, 2001) (approving SR-ISE-2001-18); and 46646 (October 11, 2002), 67 FR 64428 (October 18, 2002) (approving SR-ISE-2002-20).

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹³ 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 believes that granting accelerated approval would preserve the pilot for synthetic option orders without interruption.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act¹⁴ that the proposed rule change (SR-Phlx-2005-78) is hereby approved on an accelerated basis for a pilot period to expire on June 30, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁵

Jonathan G. Katz
Secretary

¹³ 15 U.S.C. 78s(b)(2).

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ 17 CFR 200.30-3(a)(12).