

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49785; File No. SR-Phlx-2003-68)

May 28, 2004

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Amendment Nos. 1 and 2, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto Relating to Options Transactions Resulting from Obvious Errors

On September 29, 2003, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt new Phlx Rule 1092, which would permit the Exchange to nullify or adjust a transaction resulting from an obvious error. On November 25, 2003, Phlx filed Amendment No. 1 to the proposed rule change.³ On January 15, 2004, Phlx filed Amendment No. 2 to the proposed rule change.⁴ The proposed rule change, as amended, was published for comment in the Federal Register on March 29, 2004.⁵ The Commission received no comments on the proposal. On May 26, 2004, Phlx filed Amendment No. 3 to the proposed rule change.⁶

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from Richard S. Rudolph, Director and Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated November 24, 2003.

⁴ See Letter from Richard S. Rudolph, Director and Counsel, Phlx, to Susie Cho, Special Counsel, Division, Commission, dated January 14, 2004.

⁵ See Securities Exchange Act Release No. 49435 (March 17, 2004), 69 FR 16327.

⁶ See Letter from Richard S. Rudolph, Director and Counsel, Phlx, to Susie Cho, Special Counsel, Division, Commission, dated May 25, 2004 ("Amendment No. 3"). In Amendment No. 3, the Exchange revised the rule text to clarify that an obvious error as defined in paragraph (a) of Phlx Rule 1092 is also covered under paragraph (c) of Phlx Rule 1092.

This order approves Phlx's proposed rule change, as amended, publishes notice of Amendment No. 3 to the proposed rule change, and grants accelerated approval to Amendment No. 3.

I. Description of the Proposal

The Exchange proposes to adopt Phlx Rule 1092, which would allow the Exchange to either nullify or adjust an options transaction resulting from an obvious error. Phlx Rule 1092(a) would define an "obvious error" transaction price, which would be based on the "Theoretical Price" of the option. The definition of "Theoretical Price" would be set forth in Phlx Rule 1092(b).

Absent the mutual agreement of the parties to a trade, Phlx Rule 1092(c) would permit a Floor Official(s) to adjust or nullify a transaction in the following circumstances: (1) the trade resulted from a verifiable Exchange system disruption or malfunction that caused a quote/order to trade in excess of its disseminated size (in which case trades in excess of the disseminated size would be nullified); (2) the trade resulted from a verifiable Exchange system disruption or malfunction that prevented a member from updating or canceling a quote/order; (3) the trade resulted from an erroneous print in the underlying market which is later cancelled or corrected; (4) the trade resulted from an erroneous quote in the underlying market; (5) the trade resulted in an execution price in a series quoted no bid (in which case the trade would be nullified); (6) the trade is automatically executed at a price where the specialist or ROT sells \$0.10 or more below parity; or (7) the trade occurred at a price that is deemed to be an obvious error as defined in Phlx Rule 1092(a). In addition to the circumstances described above, the

determination as to whether a trade was automatically executed at an erroneous price may be made by mutual agreement of the affected parties to a particular transaction.

The proposed rule change also sets forth the procedures the Exchange's Market Surveillance Department ("Market Surveillance") must follow when it is determined that a transaction is the result of an obvious error, including standards for adjusting or nullifying trades, and how an affected party may request a review of obvious error determinations. Phlx Rule 1092(d) would provide criteria for determining the adjusted price of an obvious error trade. Under Phlx Rule 1092(e), when a member or member organization believes it has participated in a transaction that was the result of an obvious error, it must notify Market Surveillance within a specified time of the execution in order to allow the transaction to be nullified or adjusted. Once Market Surveillance has been timely notified of a participant's belief that he or she has participated in a transaction that was the result of an obvious error, Market Surveillance would be required to determine the "Theoretical Price" of the option series in question, against which the price at which the trade was executed would be compared to determine if there was indeed an obvious error. Phlx Rule 1092(f) would set forth the procedures for seeking review of an obvious error determination made by a Floor Official.

Finally, the Exchange proposes to amend Phlx Rule 124(a) to state that Phlx Rule 124(a) would not apply to options transactions that are the result of an obvious error (as defined in Phlx Rule 1092). Options transactions that are the result of an obvious error would be subject to the provisions and procedures set forth in Phlx Rule 1092.

II. Discussion

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 exchange⁷ and, in particular, the requirements of Section 6(b) of the Act⁸ and the rules and regulations thereunder. The Commission finds that the proposed rule change is consistent with Section 6(b)(5)⁹ of the Act, which requires that the rules of an 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.

The Commission considers that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an "obvious error" may exist, suggesting that it is unrealistic to expect that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether an "obvious error" has occurred, and the adjustment or nullification of a transaction because an obvious error is considered to exist, should be based on specific and objective criteria and subject to specific and objective procedures. The Commission believes that Phlx's proposed obvious error rule establishes specific and objective criteria for determining when a trade is an "obvious error." Moreover, the Commission believes that the Exchange's proposal

⁷ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

establishes specific and objective procedures governing the adjustment or nullification of a trade that resulted from an “obvious error.” Finally, the Commission notes that the Exchange's proposed obvious error rule for options is similar to the rules of other exchanges that Commission has previously approved with respect to the adjustment or nullification of transactions resulting from obvious error.¹⁰

Pursuant to Section 19(b)(2) of the Act,¹¹ 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 hereby finds good cause for approving Amendment No. 3 to the proposal, prior to the 30th day after publishing notice of Amendment No. 3 in the Federal Register. The revisions made to the proposal in Phlx’s Amendment No. 3 merely clarify the operation of the proposed obvious error rule. The Commission further believes that accelerating approval of Amendment No. 3 would expedite the implementation of the obvious error rule. Accordingly, pursuant to Section 19(b)(2) of the Act,¹² the Commission finds good cause to approve Amendment No. 4 prior to the thirtieth day after notice of the Amendment is published in the Federal Register.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether the proposed amendment is consistent with the Act. Comments may be submitted by any of the following methods:

¹⁰ See, e.g., Securities Exchange Act Release No. 48827 (November 24, 2003), 68 FR 67498 (December 2, 2003) (File No. SR-CBOE-2001-04).

¹¹ 15 U.S.C. 78s(b)(2).

¹² 15 U.S.C. 78s(b)(2).

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-2003-68 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-2003-68. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such 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-2003-68 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act¹³, that the proposed rule change (File No. SR-Phlx-2003-68), as amended, be, and hereby is, approved, and that Amendment No. 3 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Margaret H. McFarland
Deputy Secretary

¹³ 15 U.S.C. 78s(b)(2).

¹⁴ 17 CFR 200.30-3(a)(12).