SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51394; File No. SR-Phlx-2004-83)

March 18, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to the Matching of Certain Incoming Orders with Certain Phlx Existing Orders

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1], and Rule

19b-4[2] thereunder, notice is hereby given that on November 26, 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, II, and III, below, which Items

have been prepared by the Phlx. On March 10, 2005, the Phlx filed Amendment No. 1 to the

proposed rule change.[3] The Commission is publishing this notice to solicit comments on the

proposed rule change, as amended, from interested persons.

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

The Phlx proposes to modify Phlx Rule 229 to permit the PACE[4] System to match certain

incoming orders with certain Phlx existing orders (the "Matching Rule").

The text of amended Phlx Rule 229 is set forth below. New text is _italicized_ and

[brackets] indicate deletions.

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[1]   15 U.S.C. 78s(b)(1).

[2]   17 CFR 240.19b-4.

[3]   In Amendment No. 1, which replaced the original proposal in its entirety, Phlx modified two concepts contained in the original proposed rule change (those of the Midpoint Price and the Modified PACE Quote), clarified the operation of the proposed rule change, reorganized the rule text of proposed new Supplementary Material .04A to Phlx Rule 229 into subsections, and made corresponding changes to other portions of the Supplementary Material to Phlx Rule 229 to reflect the applicability of the proposed rule change.

[4]   PACE is the Exchange's automated order routing, delivery, execution and reporting system for equities. See Phlx Rule 229.

Rule 229. Philadelphia Stock Exchange Automated Communication and Execution System (PACE)

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Supplementary Material: ...

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.01 No Change

.02 Specialists are required to provide, at a minimum, PACE execution parameters, as defined by the Rule, to agency orders received through the system, except as provided below.

Although specialists are not required to provide PACE execution parameters, except enhanced matching in Supplementary Material .04A, to non-agency orders received through PACE, if the specialists choose to execute non-agency orders automatically through PACE, they must provide the same PACE executions to non-agency orders as they provide to agency orders. If however, the specialists choose to execute non-agency orders manually, they must adhere to existing Exchange rules governing orders not on the system with respect to such orders.

For purposes of the PACE System, an agency order is any order entered on behalf of a public customer, and does not include any order entered for the account of a broker-dealer, or any account in which a broker-dealer or an associated person of a broker-dealer has any direct or indirect interest. Non-agency orders are not permitted on PACE except where the Exchange has been provided with a Specialist Agreement, signed by the respective specialist, acknowledging the acceptance of such non-agency orders from the specific firm(s), and any minimum execution parameters (order size guarantees) agreed to

be provided to such orders by the respective specialist. Any such Specialist Agreement must provide the same minimum execution parameters to all non-agency orders by that specialist and will not provide for greater order size guarantees to non-agency orders than those provided to agency orders. Specialists' agreements to execute non-agency orders on PACE, and the termination of such agreements, shall be in accordance with the procedures set by the Exchange.

The specialist may choose to accept orders through PACE, without participating in the PACE execution guarantees for agency orders, where the entering member organization has generally elected not to receive automatic execution or primary market print protection for electronically delivered limit orders, in accordance with the procedures established by the Floor Procedure Committee.

.03-.04 No Change.

.04A (a) Definitions. For purposes of this Supplementary Material:

> (i) Midpoint Price means the midpoint of the Modified PACE Quote as rounded, if applicable. Rounding will be applicable if the midpoint of the Modified PACE Quote is not a penny increment, in which case the Midpoint Price shall be rounded down (up) to the nearest penny if the existing Phlx order is an order to buy (sell). When the Modified PACE Quote is locked, the Midpoint Price is the locked price.

> (ii) Modified PACE Quote means the PACE Quote, unless the PACE Quote is comprised of another market's quote of 100 shares or less ("100

Share Away Quote"), in which case the Modified PACE Quote will be 1 cent away from such 100 Share Away Quote.

(b) Enhanced Matching

(i) Round-lot market and limit orders (except as provided in (ii) below) and the round-lot portion of non-all-or-none PRL market and limit orders entered after the opening when the PACE Quote is not crossed will execute against existing round-lot market and limit orders and the round-lot portion of non-all-or-none PRL market and limit orders that have not been marked for lay-off and are executable at or within the Modified PACE Quote, if any, before being processed according to Supplementary Material .05, .07(b), (c)(i)-(ii) or .10(a)(i) of this rule or Rule 229A.

(ii) If the round-lot order entered after the opening is an all-or-none order, then such order will only receive the treatment described in the previous sentence if the size of the first potential existing order it would execute against is equal to or greater than such order.

(iii) No order for which the entering member organization has elected primary market high-low protection (as provided in .07(a)(ii)) will be matched in (i) above, if the execution price of such execution would be outside the primary market high-low range for the day.

(iv) Enhanced Matching Priority. Notwithstanding Supplementary Material .01 regarding priority, existing Phlx orders will be executed in price/time priority with the highest bid/lowest offer executed first, with existing market orders, for purposes of enhanced matching priority, being treated as limit orders priced at the Midpoint Price.

(c) Execution Price

(i) If the orders to be matched in (b) above are both market orders, then the execution price of these orders is the Midpoint Price.

(ii) If the orders to be matched in (b) above are both limit orders, then the execution price of these orders is the price closest to the Midpoint Price that will allow both orders to execute.

(iii) If the orders to be matched in (b) above are a market order and a limit order, the execution price of these orders is the price closest to the Midpoint Price that will allow the limit order to execute.

.05 Subject to Supplementary Material Section .07, all round-lot market orders up to 500 shares and PRL market orders up to 599 shares entered after the opening will be automatically executed at the PACE Quote.

Subject to these procedures, the specialist may voluntarily agree to execute round-lot market orders of a size greater than 500 shares and PRL market orders of a size greater than

599 shares upon entry into the system. Where the specialist has voluntarily agreed to automatically execute market orders greater than 599 shares and the market order size is greater than 599 shares, but less than or equal to the size of the PACE Quote, the order is automatically executable at the PACE Quote; if such order is greater than the size of the PACE Quote, the order shall receive an execution at the PACE Quote up to the size of the PACE Quote, either manually or automatically (once this feature is implemented) with the balance of the order available to be executed as an existing order pursuant to Supplementary Material .04A(b)(i) above, or receiving a professional execution, in accordance with Supplementary Material, .10(b) below; provided that the specialist may guarantee an automatic execution at the PACE Quote up to the entire size of such specialist's automatic execution guarantee (regardless of the size of the PACE Quote).

When the PACE Quote is locked, automatically executable market orders entered after the opening will be automatically executed at the locked price, if all the specialists assigned to a security determine to elect this feature for a particular security.

.06-.07(a) No Change

.07(b) Market orders (round-lots of 600 to 2000 shares or such greater size which the specialist agrees to accept and PRL's of 601 to 2099 shares or such greater size which the specialist agrees to accept) which are entered after the opening and which the specialist has not agreed to accept for automatic execution shall not be subject to the execution parameters set forth in Supplementary Material .05 and shall be available to be executed as an existing order pursuant to Supplementary Material .04A(b)(i) above, or executed in accordance with

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Supplementary Material .10(b) and other applicable rules of the Philadelphia Stock

Exchange; provided, however, that the odd-lot portion of PRL's of 601 or more shares shall

be executed at the same price as the round-lot portion. In the case of a PRL order, the

round-lot portion(s) of which is executed at more than one price, the odd-lot portion shall be

executed at the same price as the first round-lot portion is executed.

.07(c)-.09 No Change

.10(a) [In the case of stocks for which the PACE quote bid is less than $ 1.00, the

provisions of paragraph .10(b) shall apply.

In the case of stocks for which the PACE quote bid is $1.00 or more:]

(i) Marketable Limit Orders--round-lot orders up to 500 shares and the round-lot portion of

PRL limit orders up to 599 shares which are entered at the PACE Quote shall be executed at

the PACE Quote. Such orders shall be executed automatically unless the member

organization entering orders otherwise elects. Specialists may voluntarily agree to execute

marketable limit orders greater than 599 shares. Where the specialist has voluntarily agreed

to automatically execute marketable limit orders greater than 599 shares and the order size

is greater than 599 shares, but less than or equal to the size of the PACE Quote, the

marketable limit order is automatically executable at the PACE Quote; if the order size is

greater than 599 shares and greater than the size of the PACE Quote, the marketable limit

order shall manually receive an execution at the PACE Quote up to the size of the PACE

Quote, with the balance of the order available to be executed as an existing order pursuant

to Supplementary Material .04A(b)(i) above, or receiving a professional execution, in

accordance with Supplementary Material, .10(b) below; provided that the specialist may guarantee an automatic execution at the PACE Quote up to the entire size of such specialist's automatic execution guarantee.

When the PACE Quote is locked, automatically executable marketable limit orders entered after the opening will be automatically executed at the locked price, if all the specialists assigned to a security determine to elect this feature for a particular security.

Marketable limit orders may be eligible for automatic price improvement or manual double-up/double-down price protection pursuant to Supplementary Material .07(c) above.

.10(a)(ii)-.15 No Change

.16 For securities in which the Exchange is the primary market or for over-the-counter securities which the Exchange trades on an unlisted trading privileges basis, the specialist in that security may receive orders over the PACE System, in which case such orders will be subject to enhanced matching in Supplementary Material .04A but such orders will not be subject to the other automatic execution parameters set forth in this rule.

.17-.22 No Change

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

In its filing with the Commission, the 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 IV below. The 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 increase automated handling of equity

orders. Under the Matching Rule, PACE will check incoming orders against existing orders, and

if possible, execute those incoming orders against the existing orders, therefore helping to

preserve the priority of those existing orders and reducing the incidents of inadvertent trading

ahead of customer orders.

The rule change proposes that round-lot market and limit orders (except as noted below)

and the round-lot portion of non-all-or-none PRL[5] market and limit orders entered after the

opening will execute against existing round-lot market and limit orders and the round-lot portion

of non-all-or-none PRL market and limit orders that have not been marked for layoff, if

executable within the Modified PACE Quote[6] (thereby preventing a violation of applicable trade-

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[5]   PRL means a combined round-lot and odd-lot order. See Phlx Rule 229.

[6]   The "PACE Quote" means the best bid/ask quote among the American, Boston, National, Chicago, New York, or Philadelphia Stock Exchanges, the Pacific Exchange, or the Intermarket Trading System/Computer Assisted Execution System ("ITS/CAES") quote, as appropriate. See Phlx Rule 229. As further discussed by the Phlx below, the "Modified PACE Quote" is defined

through rules).[7] The Phlx notes that for incoming round lot all-or-none orders, the Phlx will only automatically match such orders if the size of the incoming all-or-none order is equal to or smaller than the first existing order it would match against. Conversely, if the incoming all-or-none order is larger than the first existing order it could match against, the incoming order will not automatically match, but will be handled manually by the specialist. (See Example 1 below.)

The Phlx also notes that orders that have been marked for lay-off[8] (i.e., orders that are being sent to other marketplaces for execution and appropriately marked by the specialist within PACE) will not be eligible to be matched against an incoming order. (See Example 2 below.) Additionally, no order for which the entering member organization has elected primary market high-low protection (as provided in Phlx Rule 229, Supplementary Material .07(a)(ii)) will be matched if the execution price of such execution would be outside the primary market high-low range for the day. Finally, notwithstanding Phlx Rule 229, Supplementary Material .01 regarding priority, existing Phlx orders will be executed in price/time priority with the highest bid/lowest offer executed first, with existing market orders, for purposes of enhanced matching priority, being treated as limit orders priced at the Midpoint Price.[9]

Example 1

The Phlx receives an order to buy 500 shares all-or-none at the market ("Incoming Order") when the Phlx has an existing order to sell 1000 shares at the market ("Existing Order"). At the time of the receipt of the Incoming Order, the PACE Quote shows the

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in the proposed rule change to mean the PACE Quote, unless the PACE Quote is comprised of another market's quote of 100 shares or less, in which case the Modified PACE Quote will be 1 cent away from such 100 share away quote.

[7]   The price at which the orders will be executed will be dependent, generally, on the "Midpoint Price" of the Modified PACE Quote and the type of orders that are being matched, as further discussed by the Phlx below, following Example 2.

[8]   See 17 CFR 240.11Ac1-4(c)(5).

[9]   See, e.g., Example 5 below.

National Stock Exchange ("NSX") bidding for 1,000 shares at $10.50 and the Pacific

Exchange ("PCX") offering 600 shares at $10.52. In this case, the PACE System would

execute the Incoming Order with 500 shares of the Existing Order at $10.51 (which is the

Midpoint Price). If the Incoming Order were instead a 1,500 share all-or-none order,

then the Incoming Order and the Existing Order would not match automatically and

would remain for the specialist to execute manually or be available to be matching by a

later incoming order.

Example 2

The Phlx receives an order to buy 1,200 shares at the market ("Incoming Order") when

the Phlx has two existing orders to sell, one for 1,000 shares at the market ("Existing

Order #1"), followed in time by one for 1,000 shares at $10.51, which has been marked

by the specialist for lay-off because the specialist is seeking execution of that order on

another exchange ("Existing Order #2"). At the time of the receipt of the Incoming

Order, the PACE Quote shows the NSX bidding for 1,000 shares at $10.51 and the PCX

offering 2,000 shares at $10.51. In this case, the PACE System would execute the 1,000

shares of the Incoming Order with Existing Order #1 at $10.51 (which is the Midpoint

Price). This would leave 200 shares of the Incoming Order unexecuted to be handled

manually by the specialist or available to be matched by a later incoming order.

Under the Matching Rule, the price of the execution will be dependent on the Midpoint

Price and the type of orders that are being matched. The Midpoint Price means the midpoint of

the Modified PACE Quote as rounded, if applicable. Rounding will be applicable if the

midpoint of the Modified PACE Quote is not a penny increment, in which case the Midpoint

Price shall be rounded down (up) to the nearest penny if the existing Phlx order is an order to buy (sell). (See Example 3 below.) The Modified PACE Quote means the PACE Quote, unless the PACE Quote is comprised of another market's quote of 100 shares or less ("100 Share Away Quote"), in which case the Modified PACE Quote will be 1 cent away from such 100 Share Away Quote. (See Example 4 below.) When the Modified PACE Quote is locked, the Midpoint Price is the locked price. Regarding different types of orders, if the orders to be matched are both market orders, then the execution price of these orders is the Midpoint Price. If the orders to be matched are both limit orders, then the execution price of these orders is the price closest to the Midpoint Price that will allow both orders to execute. If the orders to be matched are a market order and a limit order, the execution price of these orders is the price closest to the Midpoint Price that will allow the limit order to execute. (See Examples 5 and 6 below for illustrations of these three situations.)

Example 3

The Phlx receives an order to sell 1,200 shares at the market ("Incoming Order") when the Phlx has two existing orders to buy, one for 1,000 shares at $10.51 ("Existing Order #1"), followed in time by one for 1,000 shares at the market ("Existing Order #2"). At the time of the receipt of the Incoming Order, the PACE Quote shows the Phlx bidding for 1,000 shares at $10.51 and the Chicago Stock Exchange ("CHX") offering 1,600 shares at $10.52. In this case, the PACE System would execute the 1,000 shares of the Incoming Order with Existing Order #1 at $10.51. Then PACE would execute the remaining 200 shares of the Incoming Order with 200 shares of Existing Order #2 at $10.51 (which is the midpoint of the Modified PACE Quote rounded down because the Existing Order #2 is an order to buy). This would leave 800 shares of Existing Order #2

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to be handled manually by the specialist or available to be matched by a later incoming order.

Example 4

The Phlx receives an order to sell 3,500 shares at the market ("Incoming Order") when the Phlx has two existing orders to buy, one for 1,000 shares at the market ("Existing Order #1"), followed in time by one for 1,000 shares at $10.05 ("Existing Order #2"). At the time of the receipt of the Incoming Order, the PACE Quote shows the NSX bidding for 100 shares at $10.10 and the PCX offering 100 shares at $10.12. The next best quotes are Phlx bidding for 1,000 shares at $10.05 and the CHX offering 200 shares at $10.13. In this case, the PACE System would execute the 1,000 shares of the Incoming Order with Existing Order #1 at $10.11 (which is the Midpoint Price, being the midpoint of the Modified PACE Quote of $10.09 and $10.13). Order #2 will not be executed at this time pursuant to the Matching Rule because it is outside of the Modified PACE Quote. This would leave 2,500 shares of the Incoming Order to be handled manually by the specialist or available to be matched by a later incoming order.

Example 5

The Phlx receives an order to sell 1,200 shares at the market ("Incoming Order") when the Phlx has two existing orders to buy, one for 1,000 shares at $10.50 ("Existing Order #1"), followed in time by one for 1,000 shares at the market ("Existing Order #2"). At the time of the receipt of the Incoming Order, the PACE Quote shows the Phlx bidding for 1,000 shares at $10.50 and the PCX offering 600 shares at $10.52. In this case, the PACE System would execute the 1,000 shares of the Incoming Order with Existing Order #2 at $10.51 (which is the Midpoint Price). Then PACE would execute the remaining

200 shares of the Incoming Order with 200 shares of Existing Order #1 at $10.50 (which is the price closest to Midpoint Price that will allow the limit order to execute). This would leave 800 shares of Existing Order #1 displayed at $10.50 to be handled manually by the specialist or available to be matched by a later incoming order. The Phlx then receives another order to sell 500 shares at $10.50 (Incoming Order #2). In this case, the PACE System would execute Incoming Order #2 with 500 shares of Existing Order #1 at $10.50 (which is the price closest to the Midpoint Price that will allow both orders to execute). This would leave 300 shares of Existing Order #1 displayed at $10.50 to be handled manually by the specialist or available to be matched by a later incoming order.

Example 6

The Phlx receives an order to sell 1,200 shares at $10.11 ("Incoming Order") when the Phlx has an existing order to buy for 1,200 shares all-or-none at $10.13 ("Existing Order"). At the time of the receipt of the Incoming Order, the PACE Quote shows the PCX bidding for 1,000 shares at $10.10 and the CHX offering 1,600 shares at $10.14 (the Phlx is not displaying the all-or-none order[10]). In this case, the PACE System would execute the Incoming Order with Existing Order at $10.12 ($10.12 is the price closest to the Midpoint Price (in this case it is the Midpoint Price) that will allow both orders to execute). Note that the outcome will be the same if the Incoming Order is instead an order to sell 1,200 shares at the market because $10.12 is the price closest to the Midpoint Price that will allow the limit order to execute.

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[10]   All-or-none orders are an exception to the Limit Order Display Rule. See 17 CFR 240.11Ac1-4(c)(7).

The Phlx is also modifying language in other sections of Phlx Rule 229. Specifically, language is being added to Phlx Rule 229, Supplementary Materials .05, .07(b) and .10(a)(i) to clarify that market and limit orders available for profession execution, as described in those sections, will also be available to be executed as an existing order pursuant to proposed Phlx Rule 229, Supplementary Material .04A(b)(i). Phlx Rule 229, Supplementary Material .02 is being modified to clarify that if specialists offer access to PACE for non-agency orders, those orders will be eligible for enhanced matching in Phlx Rule 229, Supplementary .04A, whether or not those specialists choose to provide other PACE execution parameters to such orders. Phlx Rule 229, Supplementary Material .16 is being modified to clarify that orders described in that section will be subject to enhanced matching in Phlx Rule 229, Supplementary Material .04A, even though they are not subject to other automatic execution parameters. Finally, Phlx Rule 229, Supplementary Material .10(a) is being modified to remove language which directs a different treatment for orders when the PACE Quote bid is less than $1.00, so that such orders will receive the same treatment regardless of the PACE Quote bid.[11]

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[11] According to the Phlx, the proposed change to Supplementary Material .10(a) codifies the current system of processing orders in PACE. Previously, under the Intermarket Trading System ("ITS") Plan, orders quoting less than $1.00 were not ITS eligible and thus were not eligible for the automatic execution guarantees in the PACE system. Since the $1.00 threshold has been eliminated from the ITS Plan, orders quoting less than $1.00 are subject to the same processing and automatic execution guarantees in the PACE system as orders quoting more than $1.00. Telephone conversation between John Dayton, Assistant Secretary and Counsel, Phlx, and Leah Mesfin, Special Counsel, Division of Market Regulation, Commission, on March 17, 2005.

2.   Statutory Basis

The Exchange believes that its proposal is consistent with Sections 6(b) and 11A(a)(1)(C) of the Act[12] in general, and furthers the objectives of Sections 6(b)(5) and 11A(a)(1)(C)(v) of the Act[13] in particular, in that it should to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and protect investors and the public interest by increasing the number of orders that are matched without the participation of a dealer.

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

The Exchange does not believe that the proposed rule change 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.   Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Phlx consents, the Commission will:

(a)   by order approve such proposed rule change; or

(b)   institute proceedings to determine whether the proposed rule change should be disapproved.

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[12]   15 U.S.C. 78f(b) and 15 U.S.C. 78k-1(a)(1)(C).

[13]   15 U.S.C. 78f(b)(5) and 15 U.S.C. 78k-1(a)(1)(C)(v).

IV.   Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning

the foregoing, including whether the proposed rule change, as amended, 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-
  83 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-2004-83. 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

such 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

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make available publicly. All submissions should refer to File Number SR-Phlx-2004-83 and

should be submitted on or before [insert date 21 days from publication in the <u>Federal Register</u>].

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

authority.[14]

        Margaret H. McFarland
        Deputy Secretary

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[14]   17 CFR 200.30-3(a)(12).