

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51909; File No. SR-Phlx-2005-37)

June 22, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to Payment for Order Flow and Directed Orders

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 2, 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, II, and III below, which Items have been prepared by the Exchange. The Phlx has designated this proposal as one changing a fee imposed by the Phlx under Section 19(b)(3)(A)(ii) of the Act<sup>3</sup> and Rule 19b-4(f)(2) thereunder,<sup>4</sup> which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Phlx proposes to modify its equity options payment for order flow program in order to establish a payment for order flow program that takes into account Directed Orders<sup>5</sup> pursuant to new Exchange Rule 1080(l). Pursuant to Exchange Rule 1080(l),

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>4</sup> 17 CFR 240.19b-4(f)(2).

<sup>5</sup> The Exchange states that the term "Directed Order" means any customer order to buy or sell which has been directed to a particular specialist, Remote Streaming Quote Trader (defined below), or Streaming Quote Trader (defined below) by an Order Flow Provider (defined below). The provisions of Rule 1080(l) are in

Exchange specialists,<sup>6</sup> Streaming Quote Traders ("SQTs"),<sup>7</sup> and Remote Streaming Quote Traders ("RSQTs")<sup>8</sup> trading on the Exchange's electronic options trading platform, Phlx XL,<sup>9</sup> may receive Directed Orders from Order Flow Providers.<sup>10</sup>

In addition, the Exchange proposes to modify the time periods during which the specialists, SQTs, and RSQTs must notify the Exchange in connection with electing to participate or not to participate in the Exchange's payment for order flow program.

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effect for a one-year pilot period to expire on May 27, 2006. See Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91).

<sup>6</sup> The Exchange uses the terms "specialist" and "specialist unit" interchangeably herein.

<sup>7</sup> An SQT is an Exchange Registered Options Trader ("ROT") who has received permission from the Exchange to generate and submit option quotations electronically through an electronic interface with AUTOM via an Exchange-approved proprietary electronic quoting device in eligible options to which such SQT is assigned. AUTOM is the Exchange's electronic order delivery, routing, execution, and reporting system, which provides for the automatic entry and routing of equity option and index option orders to the Exchange trading floor. See Exchange Rules 1014(b)(ii) and 1080.

<sup>8</sup> An RSQT is an Exchange ROT that is a member or member organization of the Exchange with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically through AUTOM in eligible options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. An RSQT may only trade in a market making capacity in classes of options in which he is assigned. See Exchange Rule 1014(b)(ii)(B). See Securities Exchange Act Release Nos. 51126 (February 2, 2005), 70 FR 6915 (February 9, 2005) (SR-Phlx-2004-90); and 51428 (March 24, 2005), 70 FR 16325 (March 30, 2005) (SR-Phlx-2005-12).

<sup>9</sup> In July, the Exchange began trading equity options on Phlx XL, followed by index options in December 2004. See Securities Exchange Act Release No. 50100 (July 27, 2004), 69 FR 46612 (August 3, 2004) (SR-Phlx-2003-59).

<sup>10</sup> The term "Order Flow Provider" means any member or member organization that submits, as agent, customer orders to the Exchange. See Exchange Rule 1080(l).

## Equity Options Payment for Order Flow Program in Effect Prior to June 2, 2005

The Exchange currently charges a payment for order flow fee to ROTs of \$0.40 on all equity options traded on the Phlx when the specialist unit has opted into the Exchange's payment for order flow program, other than options on the Nasdaq-100 Index Tracking Stock<sup>SM</sup> traded under the symbol QQQQ ("QQQ"),<sup>11</sup> which are assessed \$1.00 and options on the iShares FTSE/Xinhua China Index Fund ("FXI Options"), an exchange-traded fund, which are not assessed a payment for order flow fee.<sup>12</sup>

The payment for order flow fee applies, in effect, to equity option transactions between a ROT and a customer.<sup>13</sup> In addition, a 500-contract cap per individual cleared side of a transaction is imposed.<sup>14</sup>

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<sup>11</sup> The Nasdaq-100®, Nasdaq-100 Index®, Nasdaq®, The Nasdaq Stock Market®, Nasdaq-100 Shares<sup>SM</sup>, Nasdaq-100 Trust<sup>SM</sup>, Nasdaq-100 Index Tracking Stock<sup>SM</sup>, and QQQ<sup>SM</sup> are trademarks or service marks of The Nasdaq Stock Market, Inc. ("Nasdaq") and have been licensed for use for certain purposes by the Exchange pursuant to a License Agreement with Nasdaq. The Nasdaq-100 Index® (the "Index") is determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 Trust<sup>SM</sup>, or the beneficial owners of Nasdaq-100 Shares<sup>SM</sup>. The Exchange states that Nasdaq has complete control and sole discretion in determining, comprising, or calculating the Index or in modifying in any way its method for determining, comprising, or calculating the Index in the future.

<sup>12</sup> See Securities Exchange Act Release No. 50723 (November 23, 2004), 69 FR 69978 (December 1, 2004) (SR-Phlx-2004-68).

<sup>13</sup> Thus, currently, the ROT payment for order flow fee is not assessed on transactions between: (1) a specialist and a ROT; (2) a ROT and a ROT; (3) a ROT and a firm; and (4) a ROT and a broker-dealer. The ROT payment for order flow fee does not apply to index options or foreign currency options.

<sup>14</sup> Thus, the applicable payment for order flow fee is imposed only on the first 500 contracts, per individual cleared side of a transaction. For example, if a transaction consists of 750 contracts by one ROT, the applicable payment for order flow fee would be applied to, and capped at, 500 contracts for that transaction. Also, if a transaction consists of 600 contracts, but is equally divided among three ROTs, the 500 contract cap would not apply to any such ROT and each ROT would be assessed the applicable payment for order flow fee on

Specialists request payment for order flow reimbursements on an option-by-option basis. The collected funds are to be used by each specialist unit to reimburse it for monies expended to attract options orders to the Exchange by making payments to Order Flow Providers who provide order flow to the Exchange. The specialists receive their respective funds only after submitting an Exchange certification form identifying the amount of the requested funds.<sup>15</sup>

Specialist units elect to participate or not to participate in the program in all options in which they are acting as a specialist by notifying the Exchange in writing no later than five business days prior to the start of the month.<sup>16</sup> If electing not to participate

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200 contracts, as the payment for order flow fee is assessed on a per ROT, per transaction basis. See Securities Exchange Act Release Nos. 47958 (May 30, 2003), 68 FR 34026 (June 6, 2003) (proposing SR-Phlx-2002-87); 48166 (July 11, 2003), 68 FR 42450 (July 17, 2003) (approving SR-Phlx-2002-87); and 50471 (September 29, 2004), 69 FR 59636 (October 5, 2004) (SR-Phlx-2004-60).

<sup>15</sup> Specialist units are given instructions as to when the certification forms are required to be submitted. The Exchange states that, while all determinations concerning the amount that will be paid for orders and which Order Flow Providers shall receive these payments are made by the specialists, the specialists provide to the Exchange on an Exchange form certain information, including what firms they paid for order flow, the amount of the payment and the price paid per contract. The Exchange states that the purpose of the form, in part, is to assist the Exchange in determining the effectiveness of the proposed fee and to account for and track the funds transferred to specialists, consistent with normal bookkeeping and auditing practices. In addition, certain administrative duties are provided by the Exchange to assist the specialists.

<sup>16</sup> A specialist unit must notify the Exchange in writing to either elect to participate or not to participate in the program. Once a specialist unit has either elected to participate or not to participate in the Exchange's payment for order flow program in a particular month, it is not required to notify the Exchange in a subsequent month if it does not intend to change its participation status. For example, if a specialist unit elected to participate in the program and provided the Exchange with the appropriate notice, that specialist unit would not be required to notify the Exchange in the subsequent month(s) if it intends to continue to participate in the program. However, if it elects not to participate (a change from its current status), it would need to notify the Exchange in accordance with the requirements stated above.

in the program, the specialist unit waives its right to any reimbursement of payment for order flow funds for the month(s) during which it elected to opt out of the program. Payment for order flow charges apply to ROTs as long as the specialist unit for that option has elected to participate in the Exchange's payment for order flow program.<sup>17</sup> Specialist units may opt out entirely from the program as long as they notify the Exchange in writing by the 15<sup>th</sup> of the month, or the next business day if the 15<sup>th</sup> of the month is not a business day. If a specialist unit opts out of the program by the 15<sup>th</sup> of the month, no payment for order flow charges will be incurred by the ROTs for transactions in the affected options for that month.

In addition to opting out entirely from the program, specialists may opt out of the program on an option-by-option basis if they notify the Exchange in writing no later than three business days after the end of the month (which is before the payment for order flow fee is billed). If a specialist unit opts out of an option at the end of the month then no payment for order flow fees are assessed on the applicable ROT(s) for that option. If a specialist unit opts out of the program in a particular option more than two times in a six-month period, it will be precluded from entering into the payment for order flow program for that option for the next three months.

The payment for order flow fee is billed and collected on a monthly basis. Because the specialists are not being charged the payment for order flow fee for their

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<sup>17</sup> For example, a payment for order flow fee will be assessed, even beginning mid-month, if an option is allocated, or reallocated from a non-participating specialist unit, to a specialist unit that participates in the Exchange's payment for order flow program.

own transactions, they may not request reimbursement for order flow funds in connection with any transactions to which they were a party.<sup>18</sup>

The Exchange states that excess funds are returned to the ROTs (reflected as a credit on the monthly invoices) and distributed on a pro rata basis to the applicable ROTs.<sup>19</sup>

#### Proposed Equity Options Payment for Order Flow Program Commencing June 2, 2005

The Exchange proposes to modify its payment for order flow program to establish a payment for order flow program that takes into account Directed Orders that are sent to the Exchange.

The amount of the payment for order flow fee would not change. The Exchange would continue to charge a payment for order flow fee of \$0.40 on equity options traded

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<sup>18</sup> The amount a specialist may receive in reimbursement is limited to the percentage of ROT monthly volume to total specialist and ROT monthly volume in the equity option payment for order flow program. For example, if a specialist unit has a payment for order flow arrangement with an Order Flow Provider to pay that Order Flow Provider \$0.70 per contract for order flow routed to the Exchange and that Order Flow Provider sends 90,000 customer contracts to the Exchange in one month for one option, then the specialist would be required, pursuant to its agreement with the Order Flow Provider, to pay the Order Flow Provider \$63,000 for that month. Assuming that the 90,000 represents 30,000 specialist transactions, 20,000 ROT transactions and 40,000 transactions from firms, broker-dealers and other customers, the specialist may request reimbursement of up to 40% ( $20,000 / 50,000$ ) of the amount paid ( $\$63,000 \times 40\% = \$25,200$ ). However, because the ROTs will have paid \$8,000 into the payment for order flow fund for that month, the specialist may collect only \$8,000 ( $20,000 \text{ contracts} \times \$0.40 \text{ per contract}$ ) of its \$25,200 reimbursement request.

<sup>19</sup> For example, if a specialist unit requests \$10,000 in reimbursement for one option and the total amount billed and collected from the ROTs was \$30,000, the remaining \$20,000 will be rebated to the ROTs on a pro rata basis. If ROT A was assessed \$15,000 in payment for order flow fees, it would receive a rebate of \$10,000 ( $\$15,000 / \$30,000 = 50\%$ , and 50% of \$20,000 is \$10,000). If ROT B was assessed \$8,000 in payment for order flow fees, it would receive \$5,333.33, which represents 26.67% ( $\$8,000 / \$30,000$ ) of \$20,000. If ROT C was assessed

on the Phlx, other than options on the QQQ, which would continue to be assessed a payment for order flow fee of \$1.00 and FXI Options, which would continue to not be assessed a payment for order flow fee. However, the way in which the payment for order flow fees would be charged and reimbursed would be changed to take into account Directed Orders.

Pursuant to Exchange Rule 1080, specialists, SQTs and RSQTs may receive Directed Orders in accordance with the provisions of Exchange Rule 1080(l). When a Directed Order is received, the specialist, SQT, or RSQT to whom the order is directed (the "Directed Participant") would not be assessed a payment for order flow fee.<sup>20</sup> For trades involving Directed Orders, the payment for order flow fee would be assessed, however, on a specialist and ROT when they are not Directed Participants for that transaction,<sup>21</sup> as long as they are allocated any remaining contracts after the Directed Participant receives its trade allocation if the specialist or Directed ROT has made arrangements to pay for order flow (a "Participant") and has elected to participate in the Exchange's payment for order flow program.<sup>22</sup> The Exchange states that, thus, consistent with current practice, the payment for order flow fee would be applied, in effect, to equity

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\$7,000 in payment for order flow fees, it would receive \$4,666.67, which represents 23.33% ( $\$7,000 / \$30,000$ ) of \$20,000.

<sup>20</sup> The Exchange states that this is similar to the previous program where the payment for order flow fee was not assessed on the specialist because the specialist would be asking, in effect, for reimbursement of its own funds.

<sup>21</sup> References to ROTs include all ROTs, *i.e.*, on-floor ROTs, SQTs, and RSQTs, other than an SQT or RSQT to whom an order is directed ("Directed ROT").

<sup>22</sup> For example, if an order is directed to an RSQT and the RSQT receives its trade allocation, after all public customers bidding or offering at the same price have received allocations, any contracts remaining from the Directed Order may be allocated to the specialist, SQTs or RSQTs as well as other ROTs in accordance with Exchange Rule 1014(g)(viii).

option transactions between a ROT and a customer, and now also to trades between a specialist and a customer when an order is directed to a Directed ROT.

For orders that are delivered electronically,<sup>23</sup> but are not directed to a Directed Participant, the specialist would continue not to be assessed a payment for order flow fee.<sup>24</sup> Similarly, ROTs would continue to be assessed the applicable payment for order flow fee if the specialist participates in the Exchange's payment for order flow program.

For orders that are not delivered electronically and thus not directed to a Directed Participant, such as orders represented by a floor broker, ("Non-Directed Orders"), a payment for order flow fee would be assessed if more than one specialist or Directed ROT participates in the Exchange's payment for order flow program for that option. Thus, for Non-Directed Orders, a payment for order flow fee would be assessed on equity option transactions between: (1) a specialist and customer if a Directed ROT participates in the Exchange's payment for order flow program in that option<sup>25</sup> and; (2) a ROT and a customer, if either the specialist or Directed ROT participates in the Exchange's payment for order flow program for that option. Conversely, a Directed ROT would be charged a

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<sup>23</sup> The Exchange states that electronically-delivered orders do not include orders delivered through the Floor Broker Management System pursuant to Exchange Rule 1063.

<sup>24</sup> The Exchange states that this is similar to the previous program where the payment for order flow fee was not assessed on the specialist because the specialist would be asking, in effect, for reimbursement of its own funds.

<sup>25</sup> For example, if there are no Directed ROTs participating in the Exchange's payment for order flow program, the specialist would not be billed a payment for order flow fee for that option. Also, if the specialist does not participate in the payment for order flow program and there is one Directed ROT who participates in the payment for order flow program for that option, the Directed ROT would not be charged a payment for order flow fee.



payment for order flow fee if the specialist has elected to participate in the Exchange's payment for order flow program.

The Exchange also proposes to modify the time periods during which Participants elect to participate in the program. Consistent with current practice, the Exchange must be notified of the election to participate or not to participate in the payment for order flow program in writing no later than five business days prior to the start of the month for which reimbursement for monies expended on payment for order flow would be requested.<sup>26</sup> The result of electing not to participate in the program is a waiver of the right to any reimbursement of payment for order flow funds for such month(s). If a Participant opts in its entirety into the program and does not request any payment for order flow reimbursement more than two times in a six-month period, it would be precluded from entering in its entirety in the payment for order flow program for the next three months.<sup>27</sup>

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<sup>26</sup> Consistent with the current practice, Participants would be required to notify the Exchange in writing to either elect to participate or not to participate in the program. Once an election to participate or not to participate in the Exchange's payment for order flow program in a particular month has been made, no notice to the Exchange is required in a subsequent month, as described above, unless there is a change in participation status. For example, if a Directed ROT elected to participate in the program and provided the Exchange with the appropriate notice, that Directed ROT would not be required to notify the Exchange in the subsequent month(s) if it intends to continue to participate in the program. However, if it elects not to participate (a change from its current status), it would need to notify the Exchange in accordance with the requirements stated above. Participants who have already notified the Exchange in writing as to whether they have elected to participate or not to participate in the program that was in effect prior to June 2, 2005 do not need to notify the Exchange again, unless there is a change from their current status.

<sup>27</sup> Specialist units would no longer be able to opt out of the program entirely by notifying the Exchange in writing by the 15<sup>th</sup> of the month.

Participants may also elect to participate or not to participate in the payment for order flow program on an option-by-option basis if they notify the Exchange in writing no later than three business days prior to entering into or opting out of the payment for order flow program. Participants may only opt into or out of the Exchange's payment for order flow program by option one time in any given month.

Thus, if at any time during a month, a Participant opts into the payment for order flow program for a particular option, a payment for order flow fee would be assessed that month. For example, a payment for order flow fee would be assessed, even beginning mid-month, if an option is allocated, or reallocated from a non-participating specialist unit, to a specialist unit that participates in the Exchange's payment for order flow program. In addition, payment for order flow fees would be assessed, even beginning mid-month, if order flow is directed to a Directed ROT who has elected to participate in the Exchange's payment for order flow program, even if the specialist to whom the option is allocated has opted out of the program.

The payment for order flow fee would continue to be billed and collected on a monthly basis. Because the Participants in the payment for order flow program would not be charged the payment for order flow fee for orders directed to them, they may not request reimbursement for order flow funds in connection with any transactions directed to them to which they were a party.

Payment for order flow reimbursements would be requested on an option-by-option basis, consistent with the payment for order flow program in effect prior to June 2, 2005. The Exchange states that the collected funds are to be used as a reimbursement for monies expended to attract options orders to the Exchange by making payments to Order

Flow Providers who provide order flow to the Exchange. The Exchange states that the funds would be received only after submitting an Exchange certification form identifying the amount of the requested funds.<sup>28</sup>

The Exchange further states that the amount received in reimbursement would be limited. For a specialist who has elected to participate in the Exchange's payment for order flow program ("Participating specialist"), the amount of reimbursement would be limited to the percentage of ROT monthly volume to total Participating specialist and ROT monthly volume in the equity option payment for order flow program. For a Directed ROT, the amount of reimbursement would be limited to the percentage of ROT and specialist monthly volume to total ROT, specialist, and that Directed ROT's monthly volume in the payment for order flow program. Thus, payment for order flow charges may be assessed and reimbursed as described in detail below:

#### Participating Specialist Method

If a Participating specialist unit has a payment for order flow arrangement with an Order Flow Provider to pay that Order Flow Provider \$0.50 per contract for order flow routed to the Exchange and that Order Flow Provider sends 90,000 customer contracts to the Exchange in one month for one option, then the Participating specialist would be required, pursuant to its agreement with the Order Flow Provider, to pay the Order Flow Provider \$45,000 for that month. Assuming that the 90,000 represents 30,000

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<sup>28</sup> The Exchange states that, consistent with the current practice regarding specialist units, all Participants would be given instructions as to when the certification forms are required to be submitted. The Exchange states that, while all determinations concerning the amount that would be paid for orders and which Order Flow Providers shall receive these payments are made by the Participants, the Participants would provide to the Exchange on an Exchange form certain information, including what Order Flow Providers they paid for order flow, the amount of the payment and the price paid per contract. See infra note 15.

Participating specialist contracts, 30,000 ROT contracts (which includes 10,000 from Directed ROTs who, in effect, are ROTs for that order) and 30,000 contracts from firms, broker-dealers and other customers, the Participating specialist may request reimbursement of up to 50% (30,000 ROTs contracts / 60,000, which is comprised of 30,000 ROT contracts + 30,000 specialist contracts) of the amount paid ( $\$45,000 \times 50\% = \$22,500$ ). Although the ROTs would have paid a total of \$30,000 (30,000 contracts x \$.40 per contract, which equals \$12,000, + \$18,000 non-directed orders (calculated below)) into the payment for order flow fund for that month, the Participating specialist may collect up to \$22,500 of its \$22,500 reimbursement request. Consistent with current practice, the excess funds (funds remaining after reimbursement requests are processed, which in this instance totals \$7,500 ( $\$30,000 - \$22,500$ ) for that particular month would be rebated on a pro rata basis by option to all those who were billed payment for order flow charges in that option for that same month.

#### Directed ROT Method

If a Directed ROT unit has a payment for order flow arrangement with an Order Flow Provider to pay that Order Flow Provider \$0.60 per contract for order flow routed to the Exchange and that Order Flow Provider sends 90,000 customer contracts to the Exchange in one month for one option, then the Directed ROT would be required, pursuant to its agreement with the Order Flow Provider, to pay the Order Flow Provider \$54,000 for that month. Assuming that the 90,000 represents 30,000 specialist contracts, 20,000 ROT contracts, 10,000 Directed ROT contracts, and 30,000 contracts from firms, broker-dealers and other customers, the Directed ROT may request reimbursement of up to 83.33% (50,000 which is comprised of  $30,000 + 20,000 / 60,000$ , which is comprised

of 30,000 + 20,000 + 10,000) of the amount paid ( $\$54,000 \times 83.33\% = \$44,998.20$ ).

However, because the specialist and ROTs would have paid \$26,000 (50,000 contracts x \$0.40 per contract, which equals \$20,000, + \$6,000 from the non-directed funds (calculated below)) into the payment for order flow fund for that month, the Directed ROT may collect only \$26,000 of its \$44,998.20 reimbursement request. Any excess funds for that particular month would be rebated on a pro rata basis by option to all those who were billed payment for order flow charges in that option for that same month.

#### Non-Directed Order Method

Non-Directed Orders would also be billed the applicable per contract payment for order flow charge for all specialist and ROT orders matching with a customer order if a Directed ROT participates in the Exchange's payment for order flow program along with a specialist or more than one Directed ROT in that option. The Exchange states that the funds billed and collected for Non-Directed Orders would be apportioned on a pro rata basis among those seeking reimbursement. For example, if Order Flow Providers send 90,000 Non-Directed customer contracts to the Exchange's trading floor via a floor broker in one month for one option in which both the specialist and Directed ROT participate in the payment for order flow program, then the specialists and ROTs (including the Directed ROT) would be billed the applicable per contract payment for order flow fee on orders matching with a customer.

Assuming that the 90,000 represents 30,000 specialist contracts, 30,000 ROT contracts, and 30,000 contracts from firms, broker-dealers and other customers, the Exchange would bill payment for order flow charges of \$24,000 on these transactions.

Funds collected from the payment for order flow program would be available as described below. The payment for order flow funds would be collected and distributed on a pro rata basis. Each Participant in the payment for order flow program has an amount from which it can request payment for order flow funds. The Participating specialist fund would contain payment for order flow funds as calculated by the Participating specialist reimbursement method plus payment for order flow funds allocated to it from the Non-Directed allocation method. The Directed ROT fund would contain payment for order flow funds as calculated by the Directed ROT reimbursement method plus payment for order flow funds allocated to it from the Non-Directed method.

For example, the payment for order flow funds generated from Non-Directed Orders to multiple Participants in the payment for order flow program would be calculated as follows: assuming the activity in the month is 300,000 contracts for which the specialist traded 150,000 contracts and the Directed ROT traded 50,000 contracts and 100,000 contracts from firms, broker-dealers, ROTs, and other customers, the Participating specialist fund, which includes Directed Orders and Non-Directed Orders ("Participating specialist fund") represents 75% ( $150,000 / 150,000 + 50,000$ ) of the total non-directed payment for order flow charges for that option \$24,000, which totals \$18,000 ( $75\% \times \$24,000$ ) and the Directed ROT fund represents 25% ( $50,000 / 150,000 + 50,000$ ) x \$24,000) of the total non-directed payment for order flow charges for that option (\$6,000). Thus, the Participating specialist fund would include \$18,000 ( $75\% (150,000 / 150,000 + 50,000) \times \$24,000$ ) from the non-directed calculation plus \$12,000 from the Directed specialist calculation above and the Directed ROT fund would include \$6,000 ( $25\% (50,000 / 150,000 + 50,000) \times \$24,000$ ) from the non-directed calculation

plus \$20,000 from the Directed ROT calculation above. As stated above, any excess funds for that particular month would be rebated on a pro rata basis by option to all those who were billed payment for order flow charges in that option for that same month.

The Exchange states that excess funds would be reflected as a credit on the monthly invoices and rebated on a pro rata, option-by-option, basis to the specialists and ROTs who were billed payment for order flow charges for that same month.

The Exchange states that reimbursements may not exceed the payment for order flow amount billed and collected in a given month.

The Exchange states that no other changes to the Exchange's payment for order flow program are being proposed at this time.<sup>29</sup>

This proposal would be in effect for trades settling on or after June 2, 2005 and would remain in effect as a pilot program that is scheduled to expire on May 27, 2006, the same date as the one-year pilot period in effect in connection with Directed Orders.<sup>30</sup>

Below is the text of the proposed rule change. Proposed new language is in *italics*; proposed deletions are in [brackets].

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#### **SUMMARY OF EQUITY OPTION CHARGES (p. 3/6)**

For any top 120 option listed after February 1, 2004 and for any top 120 option acquired by a new specialist unit\*\* within the first 60-days of operations, the following thresholds will apply, with a cap of \$10,000 for the first 4 full months of trading per

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<sup>29</sup> For example, the 500-contract cap per individual cleared side of a transaction would continue to be imposed. The Exchange would also continue to implement a quality of execution program.

<sup>30</sup> See Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91).

month per option provided that the total monthly market share effected on the Phlx in that top 120 Option is equal to or greater than 50% of the volume threshold in effect:

First full month of trading:	0% national market share
Second full month of trading:	3% national market share
Third full month of trading:	6% national market share
Fourth full month of trading:	9% national market share
Fifth full month of trading (and thereafter):	12% national market share

\*\* A new specialist unit is one that is approved to operate as a specialist unit by the Options Allocation, Evaluation, and Securities Committee on or after February 1, 2004 and is a specialist unit that is not currently affiliated with an existing options specialist unit as reported on the member organization's Form BD, which refers to direct and indirect owners, or as reported in connection with any other financial arrangement, such as is required by Exchange Rule 783.

**REAL-TIME RISK MANAGEMENT FEE**

\$.0025 per contract for firms/members receiving information on a real-time basis

**EQUITY OPTION PAYMENT FOR ORDER FLOW FEES\*(1) (2)**

Registered Option Trader [(on-floor)] \*\*+

QQQ (NASDAQ-100 Index Tracking Stock<sup>SM</sup>) \$1.00 per contract

Remaining Equity Options, except FXI Options \$0.40 per contract

See Appendix A for additional fees.

\*Assessed on transactions resulting from customer orders, subject to a 500-contract cap, per individual cleared side of transaction

\*\*Any excess payment for order flow funds billed but not reimbursed to specialists will be returned to the applicable ROTs (reflected as a credit on the monthly invoices) and distributed on a pro rata basis.



+Only incurred when the specialist or Directed ROT elects to participate in the payment for order flow program.

(1) For orders delivered electronically (a) Assessed on ROTs and Directed ROTs when the specialist unit opts into the program;(b) assessed on specialists and ROTs when a Directed ROT opts into the program

(2) For orders not delivered electronically, the above-referenced fees are assessed on all ROTs, including Directed ROTs, and specialists if two or more specialist/ROTs have elected to participate in the Exchange's payment for order flow program.

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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, 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 Exchange represents that the purpose of the proposed rule change is to adopt a competitive payment for order flow program that incorporates the Directed Order trading model. Payment for order flow programs are in place at each of the other options exchanges in varying amounts and covering various options. The Exchange states that the revenue generated by the payment for order flow fee, as outlined in this proposed rule change, is intended to be used by Participating specialist units and Directed ROTs to

compete for order flow in equity options listed for trading on the Exchange. The Exchange believes that, in today's competitive environment, changing its payment for order flow program to compete more directly with other options exchanges is important and appropriate.

The Exchange further represents that the purpose of modifying the time periods in which to elect to participate or not to participate in the Exchange's payment for order flow program is to accommodate Participating Specialists and Directed ROTs who would make individual payment for order flow arrangements.

## 2. Statutory Basis

The Exchange believes that its proposal to amend its schedule of dues, fees, and charges is consistent with Section 6(b) of the Act<sup>31</sup> in general, and furthers the objectives of Sections 6(b)(4) and 6(b)(5) of the Act<sup>32</sup> in particular, in that it is an equitable allocation of reasonable fees among Phlx members and that it is designed to enable the Exchange to compete with other markets in attracting customer order flow. Because the payment for order flow fees are collected only from member organizations respecting customer transactions, the Phlx believes that there is a direct and fair correlation between those members who fund the payment for order flow fee program and those who receive the benefits of the program. The Exchange states that Participating specialists and Directed ROTs potentially benefit from additional customer order flow. In addition, the Phlx believes that the proposed payment for order flow fees would serve to enhance the competitiveness of the Phlx and its members and that this proposal therefore is consistent

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<sup>31</sup> 15 U.S.C. 78f(b).

<sup>32</sup> 15 U.S.C. 78f(b)(4)-(5).

with and furthers the objectives of the Act, including Section 6(b)(5) thereof,<sup>33</sup> which requires the rules of exchanges to be designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system. The Exchange believes that attracting more order flow to the Exchange, should, in turn, result in increased liquidity, tighter markets, and more competition among Exchange members.

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

The foregoing proposed rule change has been designated as a fee change pursuant to Section 19(b)(3)(A)(ii) of the Act<sup>34</sup> and Rule 19b-4(f)(2)<sup>35</sup> thereunder, because it establishes or changes a due, fee, or other charge imposed by the Exchange.

Accordingly, the proposal will take effect upon filing with the Commission. At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

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<sup>33</sup> 15 U.S.C. 78f(b)(5).

<sup>34</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>35</sup> 17 CFR 240.19b-4(f)(2).

#### IV. 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:

##### 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](mailto:rule-comments@sec.gov). Please include File Number SR-Phlx-2005-37 on the subject line.

##### Paper comments:

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

All submissions should refer to File Number SR-Phlx-2005-37. 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 make available publicly. All submissions should refer to File Number SR-Phlx-2005-37 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>36</sup>

J. Lynn Taylor  
Assistant Secretary

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<sup>36</sup> 17 CFR 200.30-3(a)(12).