

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-52568; File No. SR-Phlx-2005-58)

October 6, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change and Amendment No. 1 Thereto Relating to Its October 2005 Equity Options Payment for Order Flow Program

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 September 29, 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. On October 3, 2005, the Phlx submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> 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>4</sup> and Rule 19b-4(f)(2) thereunder,<sup>5</sup> which renders the proposal, as amended, effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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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> In Amendment No. 1, the Exchange revised the proposed text to correct typographical errors contained in the proposed Schedule of Fees and to reflect that options on the Nasdaq-100 Index Tracking Stock<sup>SM</sup> are now traded under the symbol "QQQQ."

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>5</sup> 17 CFR 240.19b-4(f)(2).

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

The Phlx proposes to amend its equity options payment for order flow program in a number of ways, as described in detail below.

A. Equity Option Payment for Order Flow Program Prior to October 1, 2005

Pursuant to the Exchange's payment for order flow program in effect for transactions settling on or after July 1, 2005,<sup>6</sup> only orders that are delivered electronically, over AUTOM, are assessed a payment for order flow fee to a Registered Options Trader ("ROT") or a Directed ROT,<sup>7</sup> but not a specialist,<sup>8</sup> if the specialist elects to opt into the payment for order flow program

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<sup>6</sup> The program that took effect on July 1, 2005 is a pilot program that is scheduled to expire on May 27, 2006, the same date the one-year pilot program in connection with Directed Orders is due to expire. See Securities Exchange Act Release Nos. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91) and 52114 (July 22, 2005), 70 FR 44138 (August 1, 2005) (SR-Phlx-2004-44).

<sup>7</sup> Directed ROTs are either Streaming Quote Traders ("SQTs") or Remote Streaming Quote Traders ("RSQTs") that receive Directed Orders. An SQT is an Exchange 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 1080l. 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). The term "Directed Order" means any customer order to buy or sell, which has been directed to a particular specialist, RSQT, or SQT by an Order Flow Provider (defined below). The provisions of Exchange Rule 1080(l) are in 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>8</sup> The Exchange uses the terms "specialist" and "specialist unit" interchangeably herein.

for that option. For those orders that are not delivered electronically, i.e. represented by a floor broker, a payment for order flow fee is not assessed on those equity option transactions.<sup>9</sup>

If the specialist unit opts into the program, the Exchange charges a payment for order flow fee to ROTs of \$0.60 on all equity options traded against a customer order on the Exchange that are delivered electronically over AUTOM, other than options on the Nasdaq-100 Index Tracking Stock<sup>SM</sup> traded under the symbol QQQQ (“QQQQ”),<sup>10</sup> which are assessed a payment for order flow fee of \$0.75. FXI Options are not assessed a payment for order flow fee.

1. Directed ROTs and ROTs

For Directed Orders received over AUTOM, Directed ROTs may elect to be assessed or not to be assessed a payment for order flow fee for orders directed to them when the specialist has elected to participate in the payment for order flow program for that option. Directed ROTs may not request reimbursement for payment for order flow paid to Order Flow Providers.<sup>11</sup>

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<sup>9</sup> Electronically-delivered orders do not include orders delivered through the Floor Broker Management System pursuant to Exchange Rule 1063.

<sup>10</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 Philadelphia Stock 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>. 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. The Exchange proposes to modify the symbol “QQQ” in its Fee Schedule to “QQQQ” to reflect that the options on the Nasdaq-100 Index Tracking Stock are currently traded under the symbol “QQQQ.” See Amendment No. 1.

<sup>11</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).

Directed ROTs must notify the Exchange of the election to pay or not to pay the payment for order flow fee for Directed Orders in writing no later than five business days prior to the start of the month for which the payment for order flow fee is to be assessed.<sup>12</sup>

However, the payment for order flow fee is assessed on any ROT (but not the Directed ROT for that transaction when the Directed ROT has opted out of the payment for order flow program) if the ROT participates in the allocation of any remaining contracts after the Directed ROT receives its trade allocation. The Exchange states that the payment for order flow fee applies, in effect, to equity option transactions between a ROT (and Directed ROT who has elected to be assessed a payment for order flow fee) and a customer.<sup>13</sup>

## 2. Specialists

Specialists are not assessed a payment for order fee.<sup>14</sup> Consistent with current practice, the Exchange must be notified of the election to participate or not to participate in the payment

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<sup>12</sup> Directed ROTs are required to notify the Exchange in writing to either elect to pay the payment for order flow fee or not to pay the fee when the specialist has elected to opt into the payment for order flow program for that option. The Directed ROT does not need to notify the Exchange in writing to either elect to pay the payment for order flow fee or not to pay the fee if the specialist for that option does not participate in the Exchange's payment for order flow program. Once an election to pay the payment for order flow fee or not to pay the payment for order flow fee in a particular month has been made, no notice to the Exchange is required in a subsequent month unless there is a change in participation status.

<sup>13</sup> Thus, the 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. For purposes of the payment for order flow program, a firm is defined as a proprietary account of a member firm, and not the account of an individual member and a broker-dealer orders are orders entered from other than the floor of the Exchange, for any account (i) in which the holder of beneficial interest is a member or non-member broker-dealer or (ii) in which the holder of beneficial interest is a person associated with or employed by a member or non-member broker-dealer. This includes orders for the account of an ROT entered from off-the-floor.

<sup>14</sup> For purposes of assessing payment for order flow fees, the Exchange does not differentiate between specialists and specialists who receive Directed Orders.

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 will be requested.<sup>15</sup>

The Exchange states that 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 specialist 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 will be precluded from entering in its entirety in the payment for order flow program for the next three months.

Specialists 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.

Specialists may only opt into or out of the Exchange's payment for order flow program one time in any given month.

Thus, if at any time during a month, a specialist opts into the payment for order flow program for a particular option, a payment for order flow fee is assessed for that portion of the month. For example, a payment for order flow fee is 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.

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<sup>15</sup> Specialists must 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 specialist elected to participate in the program and provided the Exchange with the appropriate notice, that specialist 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.

Payment for order flow charges apply to ROTs (or Directed ROTs that have elected to be assessed the payment for order flow fee) as long as the specialist unit for that option elects to participate in the Exchange's payment for order flow program.

The payment for order flow fee is billed and collected on a monthly basis. Because the specialists are not charged the payment for order flow fee, they may not request reimbursement for order flow funds in connection with any transactions to which they were a party.

The Exchange states that specialists may request payment for order flow reimbursements on an option-by-option basis. The collected funds are to be used by each specialist 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. Specialists receive their respective funds only after submitting an Exchange certification form identifying the amount of the requested funds.<sup>16</sup>

The Exchange states that the amount a specialist may receive in reimbursement is limited. For a specialist who elects to participate in the Exchange's payment for order flow program for electronically delivered orders, the amount of reimbursement is limited to the percentage of ROT and Directed ROT monthly volume to total participating specialist, Directed ROT and ROT monthly volume in the equity option payment for order flow program.

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<sup>16</sup> The Exchange states that Specialists are given instructions as to when the certification forms are required to be submitted. 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 will provide to the Exchange on an Exchange form certain information as required by the Exchange, which may include what firms they paid for order flow, the amount of the payment and the price paid per contract.

### 3. Specialist Calculation

Funds collected from the payment for order flow program are available to the specialist participating in the payment for order flow program. The amount of funds that are available are determined by a specific specialist calculation.<sup>17</sup>

The Exchange states that any excess funds (funds remaining after reimbursement requests are processed) for a particular month that are not requested by the participating specialist are returned, by option, to the ROTs and Directed ROTs (who have opted to pay the payment for

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<sup>17</sup> For example, if a specialist unit in the payment for order flow program has a payment for order flow arrangement with various Order Flow Providers to pay the Order Flow Providers \$0.50 per contract for order flow routed to the Exchange, including for order flow sent to Directed ROTs, and those Order Flow Providers send 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 Providers, to pay the Order Flow Providers \$45,000 for that month. Assuming that the 90,000 represents 30,000 specialist contracts, 30,000 total ROT and Directed ROT contracts (comprised of 10,000 ROT contracts, 10,000 Directed ROT “A” contracts, 7,000 Directed ROT “B” contracts and 3,000 Directed ROT “C” contracts), and 30,000 contracts from firms, broker-dealers and other customers, the specialist may request reimbursement of up to 50% (30,000 ROT and Directed ROT contracts/60,000, which is comprised of 30,000 ROT and Directed ROT contracts + 30,000 specialist contracts) of the amount paid ( $\$45,000 \times 50\% = \$22,500$ ). Because the ROTs and Directed ROTs will have paid a total of \$18,000 (30,000 contracts x \$.60 per contract) into the payment for order flow fund for that month, the specialist may collect up to \$18,000 of its \$22,500 reimbursement request.

Assuming, however, that Directed ROT “B” elects not to be assessed a payment for order flow fee and has notified the Exchange pursuant to the requirements set forth above, then the specialist is obligated to pay for 83,000 contracts (or \$41,500 (83,000 x \$.50 per contract)). The ROTs and Directed ROTs “A” and “C” will have paid \$13,800 (23,000 contracts x \$.60 per contract) into the payment for order flow fund for that option for that month. Thus, the amount the specialist may collect is up to \$13,800 of its \$20,750 ( $\$41,500 \times 50\%$ ) reimbursement request. (For purposes of this example, the Directed ROTs have elected to be assessed the payment for order flow fee by notifying the Exchange in writing, consistent with the notification requirements previously discussed).

If all Directed ROTs have notified the Exchange that they elect not to be assessed a payment for order flow fee in the above-referenced example, then the specialist is obligated to pay for 70,000 contracts (or \$35,000 (70,000 x \$.50 per contract)). The ROTs will have paid \$6,000 (10,000 contracts x \$.60 per contract) into the payment for order flow fund for that option for that month. Thus, the amount the specialist may collect is up to \$6,000 of its \$17,500 ( $\$35,000 \times 50\%$ ) reimbursement request.

order flow fee) who have been charged payment for order flow fees. The excess funds are reflected as a credit on the monthly invoices and rebated on a pro rata basis by option to the ROTs and Directed ROTs who were billed payment for order flow charges for that same month.

Participating specialists may not receive more than the payment for order flow amount billed and collected in a given month.

In addition, a 500-contract cap per individual cleared side of a transaction is imposed. The Exchange also implements a quality of execution program. Further, the Exchange may audit a specialist's payments to Order Flow Providers to verify the use and accuracy of the payment for order flow funds remitted to the specialists based on their certification form.<sup>18</sup>

B. This Proposal: Equity Options Payment for Order Flow Program to Be in Effect for Transactions Settling On or After October 1, 2005

The proposal, as discussed below, would be in effect for trades settling on or after October 1, 2005 and would remain in effect as a pilot program that is scheduled to expire on May 27, 2006, the same date that the one-year pilot program relating to Directed Orders is due to expire.<sup>19</sup>

The payment for order flow rate would remain unchanged under the program to be in effect for transactions settling on or after October 1, 2005 ("October program"). Specifically, the following rates would continue to apply: (1) equity options other than QQQQ and FXI Options will be assessed \$0.60 per contract; (2) options on QQQQ will be assessed \$0.75 per contract; and (3) no payment for order flow fee will be assessed on FXI Options. Consistent with the current program, trades resulting from either Directed or non-Directed Orders that are delivered

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<sup>18</sup> See Exchange Rule 760.

<sup>19</sup> See Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91).



electronically over AUTOM and executed on the Exchange would be assessed a payment for order flow fee, while non-electronically-delivered orders (i.e., represented by a floor broker) would not be assessed a fee.<sup>20</sup>

However, the following aspects of the October program would be new or different: (1) assessing the payment for order flow fee; (2) allowing Directed ROTs to elect to participate or not to participate in the payment for order flow program; (3) establishing separate pools of funds for each Directed ROT and each specialist unit that participates in the Exchange's payment for order flow program, with the funds no longer being pooled on an option-by-option basis; (4) eliminating the reimbursement process whereby specialists requested funds to reimburse them for payments made to Order Flow Providers; (5) allowing the Exchange to make payments directly to Order Flow Providers at the direction of the Directed ROT or specialist unit; (6) carrying forward each month excess funds (funds not requested by specialist units or Directed ROTs to be paid to Order Flow Providers), up to a certain amount or, at the direction of the specialist unit or Directed ROT rebating the excess funds on a pro-rata basis; and (7) establishing a payment for order flow advisory group, which would conduct periodic reviews to assist in determining the effectiveness of the Exchange's payment for order flow program.

Assessment of the Payment for Order Flow Fee and Participation in the Payment for Order Flow Program

Specialist and Directed ROTs who participate in the Exchange's payment for order flow program would be assessed a payment for order flow fee, in addition to ROTs. Therefore, the payment for order flow fee would be assessed, in effect, on equity option transactions between a customer and an ROT, a customer and a Directed ROT, or a customer and a specialist. The

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<sup>20</sup> For purposes of this proposal, electronically-delivered orders do not include orders delivered through the Floor Broker Management System pursuant to Exchange Rule 1063.

payment for order flow fees would be assessed when the specialist, or Directed ROT to whom the order is directed, participates in the Exchange's payment for order flow program.

Specialist units would continue to be permitted to opt into or out of the Exchange's payment for order flow program. The Exchange also proposes to allow Directed ROTs to be permitted to opt into or out of the Exchange's payment for order flow program for orders directed to them.

For both specialist units and Directed ROTs, 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 date on which the payment for order flow fee will be assessed.<sup>21</sup> Specialist units and Directed ROTs may only opt into or out of the Exchange's payment for order flow program one time in any given month. The Exchange represents that the result of electing not to participate in the program would be a waiver of the right to direct the Exchange to make payments to Order Flow Providers. If a specialist unit or Directed ROT opts into the program and does not direct the Exchange to make any payment for order flow payments to Order Flow Providers more than two times in a six-month period, it would be precluded from entering into the payment for order flow program for the next three months.

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<sup>21</sup> Specialist units and Directed ROTs 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 would be required in a subsequent month, as described above, unless there is a change in 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. Specialist units and Directed ROTs who currently participate in the Exchange's payment for order flow program in effect beginning July 1, 2005, would not need to notify the Exchange again regarding their participation status, unless there is a change from their current status.

If at any time during a month, a specialist unit or Directed ROT opts into the payment for order flow program, a payment for order flow fee would be assessed for that portion of the 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 or if a ROT is designated as a Directed ROT mid-month.

The amount a specialist unit or Directed ROT may request that the Exchange pay to Order Flow Providers would be limited to the amount billed and collected for that month,<sup>22</sup> plus any excess funds that were carried over from previous months (funds collected but not requested by a specialist unit or Directed ROT). However, specialist units or Directed ROTs, would be able to request that any excess funds be rebated on a pro-rata basis to the applicable members (i.e., the applicable ROT, Directed ROT or specialist)<sup>23</sup> who paid into that pool of funds. If excess funds are rebated, they would be reflected as a credit on the invoices.<sup>24</sup>

The available payment for order flow funds would be disbursed by the Exchange according to the instructions of the specialist units and Directed ROTs.<sup>25</sup> Specialist units and Directed ROTs would be given instructions as to how to submit their payment directions. The

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<sup>22</sup> The Exchange intends to have the National Securities Clearing Corporation collect the payment for order flow fees, along with other Exchange fees, on behalf of the Exchange on a monthly basis.

<sup>23</sup> See Amendment No. 1, note 3, supra.

<sup>24</sup> If a specialist unit or a Directed ROT leaves the Exchange mid-month, any excess funds in that specialist unit or Directed ROT pool would be rebated to the applicable Exchange members on a pro rata basis. This process would occur automatically without any request having to be made by any party. Per Telephone call between Michou H.M. Nguyen, Commission and Cynthia K. Hoekstra, Exchange on October 4, 2005.

<sup>25</sup> A specialist unit or a Directed ROT would certify to the Exchange that payment for order flow funds directed by either of them to be paid to Order Flow Providers reflect payment

Exchange would not be involved in the determination of the terms governing the orders that qualify for payment or the amount of any payment. The Exchange would provide administrative support for the program in such matters as maintaining the funds, keeping track of the number of qualified orders each specialist unit and Directed ROT directs to the Exchange, and making payments to the Order Flow Providers on behalf of, and at the direction of, the specialist units or Directed ROT.

Separate pools of funds would be available to each specialist unit and Directed ROT solely for those trades where the payment for order flow fee was assessed and would be aggregated for use by each specialist unit and each Directed ROT to attract customer orders to the Exchange from Order Flow Providers that accept payment as a factor in making their order routing decisions. For Directed Orders, payment for order flow fees would be assessed on a per contract basis (when the specialist or Directed ROT opts into the program) and would be aggregated into separate pools of funds for use by each specialist unit or Directed ROT. For non-directed electronically-delivered orders, payment for order flow fees would continue to be assessed on a per contract basis and would be allocated for use by the participating specialist.

The Exchange is also proposing to establish a payment for order flow advisory group, which would conduct periodic reviews to assist in determining the effectiveness of the Exchange's payment for order flow program.<sup>26</sup>

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arrangements entered into by the specialist unit or Directed ROT and the Order Flow Provider.

<sup>26</sup> In connection with determining the effectiveness of the Exchange's payment for order flow program, the advisory group would review whether excess funds should continue to be carried over from previous months (in instances where specialist units and Directed ROTs do not request that excess funds be rebated to the applicable members who paid into the payment for order flow pools).

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>27</sup>

Below is the text of the proposed rule change, as amended. 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 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.

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<sup>27</sup> See Exchange Rule 760.

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\*\*+]

(1) For trades resulting from either Directed or non-Directed Orders that are delivered electronically and executed on the Exchange: Assessed on ROTs, specialists and Directed ROTs on those trades when the specialist unit or Directed ROT elects to participate in the payment for order flow program.\*\*\*

(2) No payment for order flow fees will be assessed on trades that are not delivered electronically.

QQQQ (NASDAQ-100 Index Tracking Stock<sup>SM</sup>)                      \$0.75 per contract

Remaining Equity Options, except FXI Options                      \$0.60 per contract

\*Assessed on transactions resulting from customer orders, subject to a 500-contract cap, per individual cleared side of transaction. This proposal will be in effect for trades settling on or after October 1, 2005 and will remain in effect as a pilot program that is scheduled to expire on May 27, 2006.

\*\*\*Any excess payment for order flow funds billed but not utilized by the specialist or Directed ROT [reimbursed to specialists] will be carried forward unless the Directed ROT or specialist elects to have those funds rebated to the applicable ROT, Directed ROT or specialist on a pro rata basis, reflected as a credit on the monthly invoices. [returned to the applicable ROTs and Directed ROTs who have elected to be assessed a payment for order flow fee (reflected as a credit on the monthly invoices) and distributed on a pro rata basis.]

[+Only incurred when the specialist elects to participate in the payment for order flow program.]

[(1) For orders delivered electronically: Assessed on ROTs when the specialist unit opts into the program. ROTs who receive Directed Orders may elect to be assessed the payment for order flow fee on customer orders directed to and executed by them.

(2) No payment for order flow fees will be assessed on orders that are not delivered electronically]

See Appendix A for additional fees.

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, as amended, and discussed any comments it received on the proposed rule change, as amended. 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 proposal, as amended, is to adopt a more competitive and administratively efficient payment for order flow program. This proposal would give both specialist units and Directed ROTs the ability to compete for order flow by allowing them to elect to participate or not to participate in the Exchange's payment for order flow program. The proposal would also establish separate pools of payment for order flow funds for each specialist and each Directed ROT. The proposal would permit the specialist units and Directed ROTs to instruct the Exchange as to how to distribute the available payment for order flow funds directly to order flow providers.

According to the Phlx, the Exchange's trading environment has changed. Now, ROTs must submit their orders electronically through streaming quote devices. Therefore, particular trading crowds are not relevant in that ROTs may stream from anywhere on the trading floor or off the trading floor.<sup>28</sup> ROTs have unlimited access to stream any and all equity option issues without limitations, with participation spread among various issues and specialists.<sup>29</sup>

The Exchange believes that the "pooling" of payment for order flow fees collected by the Exchange is similar to the practices currently in effect at the Chicago Board Options Exchange, Inc. ("CBOE"), the International Securities Exchange ("ISE"), Inc and the Pacific Exchange, Inc ("PCX").<sup>30</sup> Payment for order flow funds generated from this proposal originate from electronic orders – generally the same type of orders for which Order Flow Providers expect payment. Only specialists, Directed ROTs and ROTs that stream quotes will be assessed the payment for order flow fee, as floor-brokered orders are not part of the program.

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<sup>28</sup> A ROT is either a SQT or a RSQTs, as defined in footnote 7, *supra*. A SQT may only stream from the floor. A RSQT may only stream from off the floor. Per Telephone call among Michou H.M. Nguyen, Commission, Cynthia K. Hoekstra, Exchange and William N. Briggs, Exchange on October 4, 2005.

<sup>29</sup> Exchange Rule 507 places no limit on the number of qualifying ROTs that may become SQTs or RSQTs; any applicant that is qualified as an ROT in good standing and that satisfies the technological readiness and testing requirements shall be approved as an SQT. RSQTs must also demonstrate additional qualifications. *See* Exchange Rule 507, Application for Assignment in Streaming Quote Options.

<sup>30</sup> *See* Securities Exchange Act Release Nos. 52474 (September 20, 2005), 70 FR 56520 (September 27, 2005) (SR-CBOE-2005-72) (all funds generated by CBOE's "marketing fee" are collected by CBOE and recorded according to the Designated Primary Market-Maker ("DPM") station and class where the options subject to the fee are traded); 48568 (September 30, 2003), 68 FR 57720 (October 6, 2003) (SR-ISE-2003-23) (ISE has divided the options it trades into ten groups, with one Primary Market Maker assigned to each group. The ISE maintains a payment for order flow fund for each group, consisting of the fees collected from market makers trading options in that group); and 48175 (July 14, 2003), 68 FR 43245 (July 21, 2003) (SR-PCX-2003-30) (PCX collects and segregates the "marketing fee" proceeds by trading post).



According to the Exchange, it has further added supplementary administrative practices that are necessary to remain competitive with other options exchanges and should help to ease the accounting burden on membership. This is achieved by eliminating the reimbursement process and by having the Exchange act as the program administrator remitting payments directly to Order Flow Providers per the instructions of the specialist unit or Directed ROT in a manner, which the Exchange believes is substantially similar to that of other options exchanges.<sup>31</sup>

## 2. Statutory Basis

The Exchange believes that its proposal, as amended, is consistent with Section 6(b) of the Act<sup>32</sup> in general, and furthers the objectives of Sections 6(b)(4) and 6(b)(5) of the Act<sup>33</sup> in particular, in that it is an equitable allocation of reasonable dues, fees, and other charges among the Phlx's members.

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

The Exchange does not believe that the proposed rule change, as amended, will impose any inappropriate burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

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<sup>31</sup> See Securities Exchange Act Release Nos. 51650 (May 3, 2005), 70 FR 24663, (May 10, 2005) (SR-CBOE-2005-34) (the "marketing fee" collected by CBOE is disbursed by CBOE according to the instructions of the DPM); and 48175 (July 14, 2003), 68 FR 43245 (July 21, 2003) (SR-PCX-2003-30) (PCX collects and segregates the fee proceeds by trading post and makes the funds available to Lead Market Makers("LMM"). The LMMs determine the specific terms governing the orders that qualify for payment and the amounts to be paid).

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

<sup>33</sup> 15 U.S.C. 78f(b)(4)-(5).

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, as amended, 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, as amended, 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.<sup>36</sup>

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

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

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

<sup>36</sup> The effective date of the original proposed rule change is September 29, 2005, the effective date of Amendment No. 1 is October 3, 2005. For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposal, the Commission considers the period to commence on October 3, 2005, the date on which the Exchange submitted Amendment No. 1.

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-Phlx-2005-58 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-2005-58. 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, as amended, 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-2005-58 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>37</sup>

Jonathan G. Katz  
Secretary

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<sup>37</sup> 17 CFR 200.30-3(a)(12).