

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-48875; File No. SR-Phlx-2003-75)

December 4, 2003

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. to Adopt Commentary .04 of its Rule 1064 to Allow the Concurrent Representation of Hedging Stock Positions with Option Facilitation Orders in the Trading Crowd

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 November 17, 2003, 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 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 Exchange proposes to adopt Commentary .04 to Phlx Rule 1064, Crossing, Facilitation, and Solicited Orders, to allow the concurrent representation of hedging stock positions with option facilitation orders in the trading crowd (“Stock Tied Up Orders”). The text of the proposed rule change is set forth below. Text in italics indicates material to be added.

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**Crossing, Facilitation and Solicited Orders**

**Rule 1064.** (a) - (c) No change.

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

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

(d) No member organization or person associated with a member or member organization who has knowledge of the material terms and conditions of a solicited order, an order being facilitated, or orders being crossed, the execution of which are imminent, shall enter, based on such knowledge, an order to buy or sell an option for the same underlying security; an order to buy or sell the security underlying such class; or an order to buy or sell any related instrument until (i) the terms and conditions of the order and any changes in the terms of the order of which the member, member organization or person associated with a member or member organization has knowledge are disclosed to the trading crowd, or (ii) the trade can no longer reasonably be considered imminent in view of the passage of time since the order was received. For purposes of this Rule, an order to buy or sell a “related instrument” means, in reference to an index option, an order to buy or sell securities comprising 10% or more of the component securities in the index or an order to buy or sell a futures contract on an economically equivalent index.

**Commentary:**

.01 - .03. No change.

.04. Rule 1064(d) does not prohibit a member or member organization from buying or selling a stock position following receipt of a customer’s options order but prior to announcing such order to the trading crowd, provided that:

(a) such member or member organization shall create a written record that it is engaging in a “Stock Tied Up Order” (as described below) prior to buying or selling any shares of the underlying stock in the hedging stock position;

(b) such hedging stock position is: (i) comprised of the same underlying stock applicable to the option order; (ii) announced concurrently with the option order in the

crowd; (iii) offered to the crowd in its entirety; and (iv) offered, at the stock execution price received by the member organization introducing the order, to any option crowd participant who has established parity or priority for the related options;

(c) the hedging stock position does not exceed the options order on a *delta* basis;

and

(d) the hedging stock order is transacted promptly upon receipt of the option order and, if brought to the Exchange, is brought without undue delay to the crowd.

Crowd participants may participate in the option transaction without participating in the hedging stock position. Combination option and stock positions offered in reliance upon this Commentary .04 shall be referred to as “Stock Tied Up Orders.”

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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 Exchange 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 Exchange 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 Phlx represents that the purpose of the proposed rule change is to expressly adopt into Exchange rules concerning the handling of certain option orders, Stock Tied

Up Orders, to bring clarity to the practice of representing hedging stock positions in conjunction with option orders in the trading crowd.

In a Stock Tied Up Order, Exchange members would be permitted to hedge a customer options order with the underlying security, and then forward the customer order and hedging stock position to a Floor Broker with instructions to represent the customer order together with the hedging stock position in the underlying security to the options crowd. Under the proposal, the trading crowd would have the choice to participate in the option portion of the transaction or both the option and stock hedging position.

The proposal would also include a number of conditions which must be satisfied both prior to the time a Stock Tied Up Order is represented to the options trading crowd, and concurrently with the representation of a Stock Tied Up Order in the trading crowd.

Currently, Exchange market participants trading options employ a number of strategies that involve multiple securities, including non-option components. For example, Exchange Rule 1066 permits Exchange members to engage in the trading of

spread<sup>3</sup> and combination<sup>4</sup> orders, as well as synthetic options.<sup>5</sup> The Stock Tied Up Order would also include an option component and a stock component.

The proposed rule would require members and member organizations to satisfy certain conditions prior to representing Stock Tied Up Orders in the crowd. First, members or member organizations would be required to create a written record that it is engaging in a Stock Tied Up Order prior to buying or selling any shares of the underlying stock in the hedging stock position. The Exchange states that the purpose of this provision is to create a record to ensure that stock trades would be appropriately

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<sup>3</sup> A spread order is an order to buy a stated number of option contracts and to sell the same number of option contracts, in a different series of the same class of options. In the case of adjusted stock option contracts, a spread order need not consist of the same number of put and call contracts if such contracts both represent the same number of underlying shares or foreign currency at option, in a different series of the same class of options. See Exchange Rule 1066(f)(1).

<sup>4</sup> A combination order is an order involving a number of call option contracts and the same number of put option contracts in the same underlying security and representing the same number of shares at option (if the underlying security is a stock or Exchange-Traded Fund Share) or the same number of foreign currency units (if the underlying security is a foreign currency). A combination order includes a conversion (generally, buying a put, selling a call, and buying the underlying stock or Exchange-Traded Fund Share) and a reversal (generally, selling a put, buying a call, and selling the underlying stock or Exchange-Traded Fund Share). In the case of adjusted option contracts, a combination order need not consist of the same number of shares at option. See Exchange Rule 1066(f)(3).

<sup>5</sup> A synthetic option order is an order to buy or sell a stated number of option contracts and buy or sell the underlying stock or Exchange-Traded Fund Share in an amount that would offset (on a one-for-one basis) the option position. For example:

- (i) Buy-write: an example of a buy-write is an order to sell one call and buy 100 shares of the underlying stock or Exchange-Traded Fund Share.
- (ii) Synthetic put: an example of a synthetic put is an order to buy one call and sell 100 shares of the underlying stock or Exchange-Traded Fund Share.
- (iii) Synthetic call: an example of a synthetic call is an order to buy (or sell) one put and buy (or sell) 100 shares of the underlying stock or Exchange-Traded Fund Share. See Exchange Rule 1066(g).

associated with the related options order. The Exchange believes that this requirement should enable the Exchange to surveil for compliance with the requirements of proposed Commentary .04(b) of Phlx Rule 1064, as discussed below, by identifying the specific purchase or sell orders relating to the hedging stock position.

Secondly, proposed Commentary .04(b) of Phlx Rule 1064 would require that members and member organizations that have decided to engage in Stock Tied Up Orders for representation in the trading crowd would have to ensure that the hedging stock position associated with the Stock Tied Up Order is comprised of the same underlying stock applicable to the option order. For example, if the option component of the Stock Tied Up Order overlies XYZ stock, then the hedging stock position associated with the order would have to be XYZ stock. The Exchange states that the purpose of this provision is to ensure that the hedging stock position would be for the same stock as the overlying option, thus allowing crowd participants who may be considering participation in a Stock Tied Up Order to adequately evaluate the risk associated with the option as it relates to the actual underlying stock. Occasionally, crowd participants hedge option positions with stock that is related to the option, such as the stock of an issuer in the same industry, but not the actual stock associated with the option. The proposed rule change would not allow such a “related” hedging stock position, but would require the hedging stock position to be the actual security underlying the option.

The proposal would require that the hedging stock position be announced concurrently with the option order in the crowd, offered to the crowd in its entirety, and offered at the stock execution price received by the member organization introducing the order to any option crowd participant who has established parity or priority for the related

options. The Phlx states that the purpose of these requirements is to ensure that the hedging stock position represented to the crowd would be a good faith effort to provide crowd participants with the same opportunity as the member or member organization introducing the Stock Tied Up Order to compete for the option order. For example, if the member or member organization introducing the Stock Tied Up Order were to offer 1,000 XYZ option contracts to the crowd (overlying 100,000 shares of XYZ stock) and concurrently offers only 30,000 shares of the underlying stock, crowd participants might only be willing or able to participate in 300 of the option contracts offered, if the hedging stock position cannot be obtained at a price as favorable as the stock hedging position offering price, if at all. The Exchange states that the effect of this would be to place the crowd at a disadvantage relative to the introducing member firm for the remaining 700 option contracts in the Stock Tied Up Order, and thus create a disincentive for the crowd to bid or offer competitively for the remaining 700 option contracts. The Exchange believes that the requirement to present the hedging stock position concurrently with the option order in the crowd and offered to the crowd in its entirety at the stock execution price received by the member organization introducing the order should ensure that the crowd would be competing on a level playing field with the introducing member or member organization to provide the best price to the customer.

In addition, the proposal would require that the hedging stock position not exceed the options order on a delta basis.<sup>6</sup> For example, in the situation where a Stock Tied Up

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<sup>6</sup> The price of an option is not completely dependent on supply and demand, nor on the price of the underlying security. Specialists and ROTs price options based on basic measures of risk as well. One of these such measures, delta, is the rate of change in the price of an option as it relates to changes in the price of the underlying security. The delta of an option is measured incrementally based on

Order involves the simultaneous purchase of 100 shares of XYZ stock and the sale of 1 XYZ call contract (known as a “buy-write”), and the delta of the option is 100, it would be considered “hedged” by 100 shares of stock. Accordingly, the proposed rule would not allow the introducing member firm to purchase more than 100 shares of stock in the hedging stock position. The Exchange believes that it is reasonable to require that the hedging stock position be in amounts equivalent to the size of the related options order on a delta basis, and not for a greater number of shares of stock. The Exchange believes that the proposed rule change would support its view that the member or member organization introducing the Stock Tied Up Order be guided by the notion that any excess hedging activity could be detrimental to the eventual execution price of the customer order. Consequently, while delta estimates may vary slightly, the introducing member or member organization would be required to assume hedging stock positions not to exceed the equivalent size of the options order on a delta basis.

The proposed rule change would also require that the hedging stock order be transacted by the member or member organization introducing the Stock Tied Up Order promptly upon receipt of the option order, and, if brought to the Exchange, such order would be required to be brought without undue delay to the crowd. The Exchange believes that in many circumstances the member or member organization introducing the Stock Tied Up Order would best serve the interest of the customer by establishing the

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movement in the price of the underlying security. For example, if the price of an option increases or decreases by \$1.00 for each \$1.00 increase or decrease in the price of the underlying security, the option would have a delta of 100. If the price of an option increases or decreases by \$.50 for each \$1.00 increase or decrease in the price of the underlying security, the option would have a delta of 50. See, e.g., Securities Exchange Act Release No. 45575 (March 15, 2002), 67 FR 13395 (March 22, 2002) (SR-Phlx-2001-25).

hedging stock position over a brief period of time, rather than by way of a block-sized market order that could be of high-impact to the stock price. However, the Exchange states that the “prompt” requirement of the proposed rule is intended to ensure that this working period be brief so that the hedging stock position could be brought to the Floor under optimal circumstances for crowd participants to compete most effectively. To accomplish this, the Exchange believes that the hedging stock position must be reasonably related to the price of the option order upon receipt of the option order. In the event a delay does occur and the stock price becomes unattractive as a hedge, the proposed rule would provide that the crowd participants could elect to participate in the option order without participating in the hedging stock position.

Finally, while the particular circumstances surrounding each transaction on the Exchange’s options floor are different, the Exchange does not believe, as a general proposition, that the Stock Tied Up Order would be inherently harmful or detrimental to customers. The fact that the parties to such a trade end up fully hedged may contribute to the best execution of the orders, and, in any event, participants continue to be governed by, among other things, their best execution responsibilities.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act<sup>7</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>8</sup> in particular, because it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to

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<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest, by establishing rules governing Stock Tied Up Orders, which include specific requirements and procedures to be followed prior to and during representation of such orders in the crowd.

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 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 Exchange 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.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. In particular, the Commission seeks commenters' specific views on whether the proposed rule change is consistent with the Act. What would be

the impact under the proposed rule change of allowing Phlx members to hedge large options orders while avoiding pressures on the market for the underlying securities that can result from the reporting of such options transactions to the tape? Would the proposed rule change violate prohibitions on front running? Should the proposed rule change provide specific standards to determine when a member's hedging stock position does not exceed the options order on a delta basis?

Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-Phlx-2003-75. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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 will also be available for inspection and copying at the principal office of the Phlx.

All submissions should refer to file number SR-Phlx-2003-75 and should be submitted by [insert date 21 days from date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>9</sup> 17 CFR 200.30-3(a)(12).