

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49459; File No. SR-Phlx-2004-21)

March 23, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to the Extension of a Pilot Program Regarding the Book Sweep Function of the Exchange's Automated Options Market System

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹, and Rule 19b-4² thereunder, notice is hereby given that on March 17, 2004, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III, below, which Items have been prepared by the Phlx. The Phlx filed the proposal pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6) thereunder,⁴ 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 extend a pilot program concerning a feature of the Exchange's Automated Options Market ("AUTOM") System,⁵ designed to automatically execute limit orders

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ 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. Orders delivered through AUTOM may be executed manually, or certain orders are eligible for AUTOM's automatic execution features. Equity option and index option specialists are required by the Exchange to participate in AUTOM and its features and enhancements. Option orders entered by

on the book when the specialist's quotation locks or crosses a limit order on the book, thus rendering such limit order marketable. This feature, governed by Exchange Rule 1080(c)(iii), is called "Book Sweep." Book Sweep is currently operating as a six-month pilot.⁶

The pilot is scheduled to expire on March 31, 2004. The Exchange notes that it has submitted a proposed rule change requesting permanent approval of the Book Sweep feature.⁷ The instant proposal is intended to extend the pilot from April 1, 2004 until the earlier of July 1, 2004 or such time as the Commission approves the Book Sweep feature on a permanent basis.

The text of the proposed rule change is available at the principal offices of the Phlx and at the Commission. The proposed rule change does not alter the text of the pilot language in Rule 1080(c)(iii).

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.

Exchange members into AUTOM are routed to the appropriate specialist unit on the Exchange trading floor.

⁶ In September, 2003, the Commission approved the Exchange's Book Sweep proposal on a six-month pilot basis. See Securities Exchange Act Release No. 48563 (September 29, 2003), 68 FR 57724 (October 6, 2003) (SR-Phlx-2003-30).

⁷ See Securities Exchange Act Release No. 49365 (March 4, 2004), 69 FR 11690 (March 11, 2004) (SR-Phlx-2004-18).

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

1. Purpose

The purpose of the proposed rule change is to continue to further automate options order handling by extending a current pilot enhancement to the Exchange's AUTOM system, called Book Sweep, that allows certain orders resting on the limit order book⁸ to be automatically executed in the situation where the bid or offer generated by the Exchange's Auto-Quote⁹ system (or by a proprietary quoting system called "Specialized Quote Feed" or "SQF")¹⁰ locks (i.e., \$1.00 bid, \$1.00 offer) or crosses (i.e., \$1.05 bid, \$1.00 offer) the Exchange's best bid or offer in a particular series as established by an order on the limit order book. Orders executed by the Book Sweep feature are allocated among crowd participants participating on the Wheel.¹¹

The Exchange believes that the Book Sweep feature provides for more timely and efficient executions of marketable limit orders on the limit order book. Prior to the deployment of Book Sweep, when the Auto-Quote or SQF bid or offer locked or crossed a booked order, the specialist handled the execution manually after being alerted by the system that one or more limit orders on the book have become marketable and are due an execution. This situation could

⁸ The electronic "limit order book" is the Exchange's automated specialist limit order book, which automatically routes all unexecuted AUTOM orders to the book and displays orders real-time in order of price-time priority. Orders not delivered through AUTOM may also be entered onto the limit order book. See Exchange Rule 1080, Commentary .02.

⁹ Auto-Quote is the Exchange's electronic options pricing system, which enables specialists to automatically monitor and instantly update quotations. See Exchange Rule 1080, Commentary .01(a).

¹⁰ See Exchange Rule 1080, Commentary .01(b)(i).

¹¹ The "Wheel" is a feature of AUTOM that allocates contra-party participation respecting automatically executed trades among the specialist and Registered Options Traders ("ROTs") signed onto the Wheel for that listed option. See Exchange Rule 1080(g). See also Option Floor Procedure Advice ("OFPA") F-24.

occur for several series in the same option, which prior to the deployment of Book Sweep required multiple executions of booked limit orders in each such series to be carried out by the specialist. Book Sweep automates the execution of such orders.

Book Sweep Size

Book Sweep automatically executes a number of contracts not to exceed the size associated with the quotation that locks or crosses a limit order on the book. The purpose of this provision is to make automatic executions in the Book Sweep function consistent with the Exchange's rules relating to AUTO-X, the automatic execution feature of AUTOM. The Exchange no longer has an artificial "AUTO-X guarantee" applicable to an option. Instead, the Exchange currently provides automatic executions for eligible orders¹² delivered via AUTOM at the Exchange's disseminated price, up to the disseminated size, for both customer and broker-dealer orders.¹³ Because the Exchange's disseminated size (and thus its guaranteed AUTO-X size) is dependent on the size displayed when an order is received, and thus is fluid, in order to achieve consistency, the number of contracts to be executed via Book Sweep is equal to the size associated with the quote that locks or crosses the limit order on the book.

When a quotation generated by Auto-Quote or SQF locks or crosses a limit order on the book, there are three possible scenarios that may occur. First, if such a quotation is for a number of contracts that is equal to the size associated with the limit order on the book, the entire limit order would be executed. For example, if a limit order is resting on the book with a size of 200

¹² For a list of circumstances in which orders otherwise eligible for AUTO-X are instead manually handled by the specialist, see Exchange Rule 1080(c)(iv). See also Securities Exchange Act Release No. 45927 (May 15, 2002), 67 FR 36289 (May 23, 2002) (SR-Phlx-2001-24).

¹³ See Securities Exchange Act Release No. 47646 (April 8, 2003), 68 FR 17976 (April 14, 2003) (SR-Phlx-2003-18).

contracts, and the size associated with the quotation that locks or crosses such a limit order is 200 contracts, the entire limit order on the book would be executed, and Auto-Quote or SQF would thereafter refresh the quotation (including the size associated with such a quotation).

The second possible scenario is that the size associated with a quotation that locks or crosses a limit order on the book could be for a greater number of contracts than the size associated with the booked limit order. In such a situation, the entire size of the limit order would be executed. For example, if a limit order is resting on the book with a size of 200 contracts, and size associated with the quotation that locks or crosses such a limit order is 300 contracts, the entire limit order would be executed. Following the execution, Auto-Quote or SQF would thereafter refresh the quotation (including the size associated with such a quotation).

The third possible scenario is that the size associated with the quote that locks or crosses a limit order on the book would be for fewer contracts than the size associated with the booked limit order. In this situation, the limit order would be partially executed automatically at the size associated with the quote that locks or crosses the limit order,¹⁴ and Auto-Quote or SQF would refresh the quotation. For example, if a limit order is resting on the book with a size of 200 contracts, and the size associated with the quote that locks or crosses such a limit order is 100 contracts, Book Sweep would generate an automatic execution for 100 contracts, leaving 100 contracts resting on the limit order book, and Auto-Quote or SQF would refresh the quote. If the refreshed quote locks or crosses the remaining contracts in the limit order resting on the book, Book Sweep would initiate another automatic execution for the size associated with the refreshed quote. If the refreshed bid or offer is for a price that is inferior to the remaining contracts in the

¹⁴ Exchange Rule 1082(b) provides that all quotations made available by the Exchange and displayed by quotation vendors shall be firm for customer and broker-dealer orders at the

limit order on the book, such that the limit order represents the Exchange's best bid or offer, the price and size of the limit order would be disseminated by the Exchange. If the refreshed bid or offer is for a price that is superior to the price of the remaining limit order, the Exchange would disseminate the refreshed bid or offer, and the remaining limit order would rest on the limit order book until it becomes due for execution or is cancelled.

Manual Book Sweep

Book Sweep would be engaged when AUTO-X is engaged, and would be disengaged when AUTO-X is disengaged.¹⁵ However, the Exchange proposes to allow specialists to engage Book Sweep manually when orders are received when AUTO-X is disengaged, and Auto-Quote

disseminated price in an amount up to the disseminated size. See also Rule 11Ac1-1 under the Act, 17 CFR 240.11Ac1-1.

¹⁵ Exchange Rule 1080(c)(iv) provides that an order otherwise eligible for AUTO-X will instead be manually handled by the specialist in the following situations:

- (A) the Exchange's disseminated market is crossed (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange;
- (B) one of the following order types: stop, stop limit, market on closing, market on opening, or an all-or-none order where the full size of the order cannot be executed;
- (C) the AUTOM System is not open for trading when the order is received (which is known as a pre-market order);
- (D) the disseminated market is produced during an opening or other rotation;
- (E) when the specialist posts a bid or offer that is better than the specialist's own bid or offer (except with respect to orders eligible for "Book Match" as described in Rule 1080(g));
- (F) if the NBBO Feature, described in Exchange Rule 1080(c)(i), is not engaged, and the Exchange's bid or offer is not the NBBO;
- (G) when the price of a limit order is not in the appropriate minimum trading increment pursuant to Rule 1034;
- (H) when the bid price is zero respecting sell orders; and
- (I) when the number of contracts automatically executed within a 15 second period in an option (subject to a pilot program until November 30, 2004) exceeds the specified disengagement size, a 30 second period ensues during which subsequent orders are handled manually.

or SQF matches or crosses the Exchange's best bid or offer in a particular series as established by an order on the limit order book. The purpose of this provision is to enable the specialist to execute limit orders on the book that are due for execution more efficiently by manually initiating Book Sweep (rather than executing such orders individually), thus providing more efficient executions and ensuring that the specialist may maintain a fair and orderly market when such orders become due for execution.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act¹⁶ in general, and furthers the objectives of Section 6(b)(5) of the Act¹⁷ in particular, in that it is designed to perfect the mechanisms of a free and open market and a national market system, and to protect investors and the public interest. The Exchange believes that Book Sweep helps provide faster executions for investors, while reducing the burden on the Exchange's specialists with respect to the manual execution of booked orders.

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.

¹⁶ 15 U.S.C. 78f(b).

¹⁷ 15 U.S.C. 78f(b)(5).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not:

- (i) significantly affect the protection of investors or the public interest;
- (ii) impose any significant burden on competition; and
- (iii) become operative for 30 days from the date on which it was filed, or such shorter

time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁸ and Rule 19b-4(f)(6) thereunder.¹⁹ At any time within 60 days of the filing of the 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.

The Exchange has requested that the Commission waive the five-day pre-filing notice requirement and the 30-day operative delay. The Commission believes waiving the five-day pre-filing notice and the 30-day operative delay is consistent with the protection of investors and the public interest. Such waivers will allow the Book Sweep feature to operate without interruption until the earlier of July 1, 2004 or Commission approval of the Book Sweep feature on a permanent basis. For these reasons, the Commission designates the proposal to be effective and operative upon filing with the Commission.²⁰

¹⁸ 15 U.S.C. 78s(b)(3)(A).

¹⁹ 17 CFR 240.19b-4(f)(6).

²⁰ For purposes only of waiving the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

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. 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. All comment letters should refer to File No. SR-Phlx-2004-21. 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, comments should be sent in hard copy 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 No. SR-Phlx-2004-21 and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

Margaret H. McFarland
Deputy Secretary

²¹ 17 CFR 200.30-3(a)(12).