

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50722; File No. SR-Phlx-2004-72)

November 23, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to its 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 November 1, 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 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 revise its equity options payment for order flow program that is scheduled to be in effect beginning with trades settling on or after November 1, 2004 ("November Program")<sup>5</sup> to credit Registered Options Traders ("ROT's") for payment for order flow fees assessed for trades settling November 1, 2004 through

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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> See SR-Phlx-2004-68 (October 29, 2004).

November 12, 2004 in options ranked greater than the top 150 options.<sup>6</sup> The Exchange states that ROTs would not be assessed payment for order flow fees for the specified time period in those options, because the Exchange proposes to charge the fee and then credit the same amount. If a specialist unit who has elected to participate in the November Program requests reimbursement for payment for order flow funds expended in connection with any options ranked greater than the top 150 options, the Exchange itself would fund and distribute for this time period to the requesting specialist units the amount that otherwise should have been collected from ROTs.

### Background

Pursuant to the November Program, the Exchange will assess a payment for order flow fee of \$0.40 on all equity options, except: (1) options on the iShares FTSE/Xinhua China 25 Index Fund ("FXI Options"),<sup>7</sup> an exchange-traded fund, which will not be assessed an equity options payment for order flow fee; and (2) options on the Nasdaq-100 Index Tracking Stock<sup>SM</sup> traded under the symbol QQQ,<sup>8</sup> which will continue to be

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<sup>6</sup> The top 150 options are calculated based on the most actively traded equity options in terms of the total number of contracts that are traded nationally based on volume statistics provided by The Options Clearing Corporation ("OCC") and that are also traded on the Exchange. For example, if two of the most actively traded equity options, based on volume statistics provided by the OCC, are not traded on the Exchange, then the next two most actively traded equity options that are traded on the Exchange will be selected. (For example, if the list of the top 150 options includes two options that are not traded on the Exchange, then the options ranked 151 and 152 will be included in the Exchange's top 150, assuming those options are traded on the Exchange.)

<sup>7</sup> On October 19, 2004, the Exchange began listing FXI Options, a product that is an equity option, but which is assessed fees pursuant to the Exchange's Summary of Index Option and FXI Options Charges. See SR-Phlx-2004-67.

<sup>8</sup> QQQ is currently the most actively-traded equity option. 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")

assessed \$1.00 per contract. In addition, pursuant to the November Program, any excess payment for order flow funds billed but not requested to be used for reimbursement by the options specialist unit<sup>9</sup> will be rebated to the ROTs, which will appear as a credit on the same payment for order flow invoice that reflects the payment for order flow fees to be assessed for that month.<sup>10</sup>

### Proposal

The Exchange proposes to amend the November Program in one respect--to credit ROTs for payment for order flow fees assessed for trades settling November 1, 2004 through November 12, 2004 in options ranked greater than the top 150 options.<sup>11</sup> The Exchange states that this change is intended to allow ROTs additional time to close out existing positions in options ranked greater than the top 150 options in the event that a ROT no longer wishes to trade an option that becomes subject to the payment for order

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and have been licensed for use for certain purposes by the Phlx pursuant to a License Agreement with Nasdaq. The Nasdaq-100 Index® ("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.

<sup>9</sup> The Exchange uses the terms "specialist" and "specialist unit" interchangeably herein.

<sup>10</sup> 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 own transactions, they may not request reimbursement in connection with any transactions to which they were a party. See SR-Phlx-2004-68 for additional information regarding the Exchange's November Program.

<sup>11</sup> The Exchange will note on its fee schedule that ROTs will be billed and credited payment for order flow fees (on the same invoice) for the period November 1, 2004 through November 12, 2004 for transactions in equity options ranked greater than the top 150 options and in which the specialist unit has elected to participate in the Exchange's November Program. The Exchange will delete the reference to

flow fee under the November Program. The Exchange believes that, going forward, some ROTs may wish to trade in a trading crowd where the specialist unit has elected not to participate in the Exchange's payment for order flow program. Nevertheless, a ROT may have an existing position in that option (for instance, own or be short calls or puts), and the Exchange has determined that it would be appropriate in such cases to provide additional time for ROTs to close those positions before the November Program takes full effect.

If a specialist unit who has elected to participate in the November Program<sup>12</sup> requests reimbursement for payment for order flow funds expended in connection with any options ranked greater than 150 respecting this time period, the Exchange would fund and distribute that requested amount to the specialist unit.<sup>13</sup> In effect, the Exchange would be satisfying the specialists' reimbursement request by paying from its funds the amount, or portion thereof, that should have been billed to and collected from ROTs.

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this "credit" from its fee schedule after the specified time period has expired pursuant to this proposed rule change.

<sup>12</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. If electing not to participate 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 will 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. 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. See Securities Exchange Act Release Nos. 50471 (September 29, 2004), 69 FR 59636 (October 5, 2004) (SR-Phlx-2004-60) and 50572 (October 20, 2004), 69 FR 62735 (October 27, 2004) (SR-Phlx-2004-61) and SR-Phlx-2004-68.

<sup>13</sup> If a specialist unit elects not to participate 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.

This proposal only applies to equity options ranked greater than the top 150 options that are subject to the November Program (i.e., only where a specialist unit has elected to participate in the November Program). Thus, payment for order flow fees would continue to be assessed, and not credited to ROTs, on options ranked 1 through 150 pursuant to the November Program.

Specialists request payment for order flow reimbursements on an option-by-option basis. The collected funds are 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 Phlx states that specialists receive their respective funds only after submitting an Exchange certification form identifying the amount of the requested funds.<sup>14</sup> Each specialist unit establishes the amounts that would be paid to order flow providers. Although the Exchange would, in effect, be paying the amount of payment for order flow funds that should have been collected from ROTs to the requesting specialist units, the Exchange states that it does so only to preserve the balance between allowing more time for ROTs to close positions while recognizing that specialist units may have relied on receiving these funds when making their equity options payment for order flow arrangements.

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<sup>14</sup> 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, including what firms they paid for order flow, the amount of the payment and the price paid per contract. 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 will be provided by the Exchange to assist the specialists.

The Phlx states that the issue of using Exchange fees to fund order flow payments to options order flow providers has been a topic of great concern at the Exchange. From the onset, the Exchange states that it has been, and continues to be, a vocal opponent to any payment for order flow programs. The Exchange, however, believes that, in this limited situation, paying for order flow is necessary in order to maintain its commitment to the specialist units who may have relied on its intention to implement a broader program, which was to become effective for trades settling on or after November 1, 2004.

Below is the text of the proposed rule change. Proposed new language is in italics.

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

#### **EQUITY OPTION PAYMENT FOR ORDER FLOW FEES\***

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<sup>\*\*\*</sup>

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

\*\*\* ROTs will be billed and credited payment for order flow fees (on the same invoice) for the period November 1, 2004 through November 12, 2004 for transactions in equity

options ranked greater than 150 and in which the specialist unit has elected to participate in the Exchange's November Program.

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

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 Phlx states that the purpose of the proposed rule change is to maintain a more competitive equity options payment for order flow program. Payment for order flow programs are in place at each of the other options exchanges in varying amounts and covering various options. According to the Phlx, the revenue generated by the \$1.00 or \$0.40 payment for order flow fees, as outlined in this proposal, is intended to be used by specialist units to compete for order flow in equity options listed for trading on the Exchange. The Exchange believes that, in today's competitive environment, maintaining a payment for order flow program is necessary to continue to compete more directly with other options exchanges.

2. 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>15</sup> in general, and furthers the objectives of Section 6(b)(4) of the Act<sup>16</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. The Phlx believes that the proposed payment for order flow fees would serve to maintain the competitiveness of the Phlx and its members and that this proposal therefore is consistent with and furthers the objectives of the Act, including Section 6(b)(5) thereof,<sup>17</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. 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.

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

<sup>16</sup> 15 U.S.C. 78f(b)(4).

<sup>17</sup> 15 U.S.C. 78f(b)(5).



### 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>18</sup> and Rule 19b-4(f)(2)<sup>19</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.

### 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-2004-72 on the subject line.

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<sup>18</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>19</sup> 17 CFR 240.19b-4(f)(2).

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-Phlx-2004-72. 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-2004-72 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>20</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>20</sup> 17 CFR 200.30-3(a)(12).