

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50723; File No. SR-Phlx-2004-68)

November 23, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of  
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 October 29, 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 by:  
(1) imposing a payment for order flow fee of \$0.40 on all equity options traded on the Phlx, other than options on the Nasdaq-100 Index Tracking Stock<sup>SM</sup> traded under the symbol QQQ ("QQQ"), currently the most actively traded equity option, and options on the iShares FTSE/Xinhua China Index Fund ("FXI Options"), an exchange-traded fund;

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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).

(2) returning to the Registered Options Traders ("ROTs"), by option, any excess equity options payment for order flow funds billed to those ROTs but not reimbursed to specialist units;<sup>5</sup> (3) clarifying the assessment of the payment for order flow fee when an equity option is reallocated mid-month; and (4) making other corresponding changes to the Exchange's equity options payment for order flow program, which occur as a result of the above-referenced proposal.

#### Equity Options Payment for Order Flow Program in Effect Prior to November 1, 2004

The Exchange recently amended its payment for order flow program.<sup>6</sup> Pursuant to the September/October Program, the Exchange assessed a payment for order flow fee as follows when ROTs trade against a customer order: (1) \$1.00 per contract for options on the QQQ, currently the most actively traded equity option,<sup>7</sup> and (2) \$0.40 per contract for the remaining top 150 equity options, other than the QQQs.<sup>8</sup> The payment for order

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<sup>5</sup> The Exchange uses the terms "specialist" and "specialist unit" interchangeably herein.

<sup>6</sup> 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) (collectively, "September/October Program").

<sup>7</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 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>8</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

flow fee applies, in effect, to equity option transactions between a ROT and a customer.<sup>9</sup>  
In addition, a 500 contract cap per individual cleared side of a transaction is imposed.<sup>10</sup>

Specialist units elect to participate or not to participate in the program in all options in which they are acting as a specialist by notifying the Exchange in writing no later than five business days prior to the start of the month.<sup>11</sup> If a specialist unit elects not

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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>9</sup> Thus, the ROT payment for order flow fee is not assessed on transactions between: (1) a specialist and a ROT; (2) a ROT and a ROT; (3) a ROT and a firm; and (4) a ROT and a broker-dealer. The ROT payment for order flow fee does not apply to index options or foreign currency options. Accordingly, the ROT payment for order flow fees applies, in effect, to equity option transactions between a ROT and a customer.

<sup>10</sup> Thus, the applicable payment for order flow fee is imposed only on the first 500 contracts, per individual cleared side of a transaction. For example, if a transaction consists of 750 contracts by one ROT, the applicable payment for order flow fee would be applied to, and capped at, 500 contracts for that transaction. Also, if a transaction consists of 600 contracts, but is equally divided among three ROTs, the 500 contract cap would not apply to any such ROT and each ROT would be assessed the applicable payment for order flow fee on 200 contracts, as the payment for order flow fee is assessed on a per ROT, per transaction basis. See Securities Exchange Act Release Nos. 47958 (May 30, 2003), 68 FR 34026 (June 6, 2003) (proposing SR-Phlx-2002-87); 48166 (July 11, 2003), 68 FR 42450 (July 17, 2003) (approving SR-Phlx-2002-87); and 50471 (September 29, 2004), 69 FR 59636 (October 5, 2004) (SR-Phlx-2004-60).

<sup>11</sup> A specialist unit must notify the Exchange in writing to either elect to participate or not to participate in the program. Once a specialist unit has either elected to participate or not to participate in the Exchange's payment for order flow program in a particular month, it is not required to notify the Exchange in a subsequent month if it does not intend to change its participation status. For example, if a specialist unit elected to participate in the program and provided the Exchange with the appropriate notice, that specialist unit would not be required to notify the Exchange in the subsequent month(s) if it intends to continue to participate in the program. However, if it elects not to participate (a change from its current status),

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.<sup>12</sup> 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 firms that 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>13</sup> Each specialist unit establishes the amounts that would be paid to order flow providers.

Pursuant to the Exchange's September/October Program, any excess payment for order flow funds are carried forward to the next month by option and may not be applied retroactively to past deficits, which may be incurred when the specialist requests more than the amount collected.<sup>14</sup> Thus, excess funds are not rebated to ROTs except in the

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it would need to notify the Exchange in accordance with the requirements stated above.

<sup>12</sup> For any month (or part of a month where an option is allocated mid-month) the specialist unit has elected to opt out of the program, no ROT equity options payment for order flow fee will apply.

<sup>13</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.

<sup>14</sup> Specialists may not receive more than the payment for order flow amount billed and collected in a given month; however, the amount specialists receive may include excesses, if any, for that option, carried forward from prior months, up to the payment for order flow amount billed and collected in such month.

limited situation discussed below, nor are deficits carried forward to subsequent months. ROTs may, however, receive a rebate of excess funds in a particular option for a particular month if the specialist unit did not request reimbursement by option of at least 50% of the total amount of payment for order flow funds billed to and collected from ROTs for each option in which that specialist unit was acting as specialist, as more fully described below.

Specialists units may opt out entirely from the program as long as they notify the Exchange in writing by the 15<sup>th</sup> of the month, or the next business day if the 15<sup>th</sup> of the month is not a business day. If a specialist unit opts out of the program by the 15<sup>th</sup> of the month, no payment for order flow charges would be incurred for either the specialist unit or ROTs for transactions in the affected options for that month.

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

If a specialist unit opts into the program (and does not opt out of the program entirely by the 15<sup>th</sup> day of the month or by option by the third business day after the end of the month) and does not request reimbursement by option of at least 50% of the total amount of payment for order flow funds billed to and collected from ROTs for each

option in which that specialist unit is acting as the specialist, then any excess payment for order flow funds remaining after the specialist has been reimbursed would be rebated, on a pro rata basis, to the affected ROTs for those particular options in which the 50% threshold was not met.<sup>15</sup>

The payment for order flow fee is billed and collected on a monthly basis. Because the specialists are not being charged the equity options payment for order flow fee for their own transactions, they may not request reimbursement for order flow funds in connection with any transactions to which they were a party.<sup>16</sup>

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<sup>15</sup> For example, if a specialist unit requests \$10,000 in reimbursement for one option and the total amount billed and collected from the ROTs was \$30,000, then the specialist unit did not satisfy the 50% threshold, given the fact that it did not request reimbursement of at least \$15,000. Therefore, the remaining amount of \$20,000 will be rebated to the ROTs on a pro rata basis. If ROT A was assessed \$15,000 in payment for order flow fees, it would receive a rebate of \$10,000 ( $\$15,000/\$30,000 = 50\%$ , and 50% of \$20,000 is \$10,000). If ROT B was assessed \$8,000 in payment for order flow fees, it would receive \$5,333.33, which represents 26.67% ( $\$8,000/\$30,000$ ) of \$20,000. If ROT C was assessed \$7,000 in payment for order flow fees, it would receive \$4,666.67, which represents 23.33% ( $\$7,000/\$30,000$ ) of \$20,000.

<sup>16</sup> The amount a specialist may receive in reimbursement is limited to the percentage of ROT monthly volume to total specialist and ROT monthly volume in the equity options payment for order flow program. For example, if a specialist unit has a payment for order flow arrangement with an order flow provider to pay that order flow provider \$0.70 per contract for order flow routed to the Exchange and that order flow provider sends 90,000 customer contracts to the Exchange in one month for one option, then the specialist would be required, pursuant to its agreement with the order flow provider, to pay the order flow provider \$63,000 for that month. Assuming that the 90,000 represents 30,000 specialist transactions, 20,000 ROT transactions and 40,000 transactions from firms, broker-dealers and other customers, the specialist may request reimbursement of up to 40% ( $20,000/50,000$ ) of the amount paid ( $\$63,000 \times 40\% = \$25,200$ ). However, because the ROTs will have paid \$8,000 into the payment for order flow fund for that month, the specialist may collect only \$8,000 (20,000 contracts  $\times$  \$0.40 per contract) of its \$25,200 reimbursement request plus, if applicable, any excess funds for that particular option carried over from a prior month up to the specialist's \$25,200 reimbursement request.

The Exchange may audit a specialist's payments to payment-accepting firms to verify the use and accuracy of the payment for order flow funds remitted to the specialists based on their certification.<sup>17</sup>

The Exchange continues to implement a quality of execution program.<sup>18</sup>

Proposed Equity Options Payment for Order Flow Program Commencing November 1, 2004

The Exchange proposes to charge a payment for order flow fee of \$0.40 on all equity options traded on the Phlx, other than options on the QQQs, which would continue to be assessed \$1.00, and FXI Options. The Exchange is not proposing to assess a payment for order flow fee on FXI Options because the Exchange is not currently seeking to garner order flow in this product from other exchanges, because FXI Options do not currently trade on other exchanges. Attracting order flow from other exchanges is the principal goal of the payment for order flow program.

Specialists would continue to request payment for order flow reimbursements on an option-by-option basis. According to the Exchange, the collected funds would be used by each specialist unit to reimburse it for monies expended to attract options orders to the Exchange by making payments to order flow providers who provide order flow to the Exchange. The Phlx states that specialists would receive their respective funds only after submitting an Exchange certification form identifying the amount of the requested funds.<sup>19</sup>

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<sup>17</sup> See Supplemental Material .01 of Exchange Rule 760.

<sup>18</sup> See e.g. Securities Exchange Act Release No. 43436 (October 11, 2000), 65 FR 63281 (October 23, 2000) (SR-Phlx-00-83).

<sup>19</sup> See supra note 13. Specialist units are given instructions as to when the certification forms are required to be submitted.

Specialist units would continue to elect to participate or not to participate in the program in all options in which they are acting as a specialist by notifying the Exchange in writing no later than five business days prior to the start of the month.<sup>20</sup> 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 would 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. 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.

The Exchange also proposes to return to ROTs, by option, any excess payment for order flow funds billed but not reimbursed to specialists.<sup>21</sup> According to the Phlx, excess

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<sup>20</sup> See supra note 11.

<sup>21</sup> In the September/October Program, any excess payment for order flow funds are carried forward to the next month by option and may not be applied retroactively to past deficits, which may be incurred when the specialist requests more than the amount collected. Thus, excess funds generally are not rebated to ROTs. However, under the September/October Program, excess funds may be rebated in the limited situation where a specialist unit opts into the program (and does not opt out of the program entirely by the 15<sup>th</sup> day of the month or by option by the third business day after the end of the month) and does not request reimbursement by option of at least 50% of the total amount of payment for order flow funds billed to and collected from ROTs for each option in which that specialist unit is acting as the specialist, then any excess payment for order flow funds remaining after the specialist has been reimbursed is rebated, on a pro rata basis, to the affected ROTs for those particular options in which the 50% threshold was not met. This separate rebate requirement would no longer be necessary because, pursuant to this proposal, any excess payment for order flow funds that have been billed, but not requested by specialist, will be returned to the applicable ROTs on a pro rata basis. For example, if a ROT is assessed a payment for order flow fee of \$10,000 for the month of November and \$2,000 was to be returned to the ROT because it represented the amount of funds not requested by specialists, that

funds would be returned to the ROTs (reflected as a credit on the monthly invoices) and distributed on a pro rata basis to the applicable ROTs.<sup>22</sup> Thus, excess funds would no longer be carried forward.

The Phlx states that no other changes to the Exchange's payment for order flow program are being proposed at this time.<sup>23</sup>

The payment for order flow fees as set forth in this proposal would be in effect for trades settling on or after November 1, 2004.

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

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amount would appear on the same November invoice. Thus, the ROT would submit \$8,000 in payment for order flow fees for the month of November.

<sup>22</sup> For example, if a specialist unit requests \$10,000 in reimbursement for one option and the total amount billed and collected from the ROTs was \$30,000, the remaining \$20,000 will be rebated to the ROTs on a pro rata basis. If ROT A was assessed \$15,000 in payment for order flow fees, he would receive a rebate of \$10,000 ( $\$15,000/\$30,000 = 50\%$  and 50% of \$20,000 is \$10,000). If ROT B was assessed \$8,000 in payment for order flow fees, it would receive \$5,333.33, which represents 26.67% ( $\$8,000/\$30,000$ ) of \$20,000. If ROT C was assessed \$7,000 in payment for order flow fees, it would receive \$4,666.67, which represents 23.33% ( $\$7,000/\$30,000$ ) of \$20,000. The Exchange does not know at this time whether there will be any excess payment for order flow funds from the September/October Program because billing and collecting for the September/October Program will not be completed until after November 2004 and because of the different reimbursement procedures applicable to the Exchange's equity options payment for order flow program in effect prior to this proposal. Telephone conversation between Cynthia K. Hoekstra, Counsel, Phlx, and David Liu, Attorney, Division of Market Regulation, Commission, on November 23, 2004. Therefore, the Exchange intends to file a separate proposed rule change, if necessary, to address the handling of any excess payment for order flow funds generated from the September/October Program.

<sup>23</sup> Accordingly, the calculation of the top 150 options as described in note 8, supra, would no longer be necessary because the new program extends beyond the top 150 options.

## 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 [Top 150] Equity Options, except FXI Options \$0.40 per contract

\* 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 will be carried forward to the next month by option and will not be rebated to ROTs. ROTs may, however, receive a rebate of any excess funds in a particular option for a particular month if the specialist unit does not request reimbursement by option of at least 50% of the total amount of payment for order flow funds billed and collected from ROTs for each option in which that specialist unit is acting as specialist.] Any excess payment for order flow funds billed but not reimbursed to specialists will be returned to the applicable ROTs (reflected as a credit on the monthly invoices) and distributed on a pro rata basis.

+ Only incurred when the specialist 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 adopt a more competitive equity options payment for order flow program. Equity options payment for order flow programs are in place at each of the other options exchanges in varying amounts and covering various options. The Phlx states that 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, changing its payment for order flow program to compete more directly with other options exchanges is important and appropriate. Accordingly, the Exchange proposes to expand its program beyond the top 150 options. The Exchange also proposes to modify the program to return excess ROT fees rather than carry those excesses forward. The Phlx believes that returning any excess payment for order flow funds to ROTs on a pro rata basis should help to minimize the financial impact to them in connection with the collection of the Exchange payment for order flow fee.

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>24</sup> in general, and furthers the objectives of Section 6(b)(4) of the Act<sup>25</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

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<sup>24</sup> 15 U.S.C. 78f(b).

<sup>25</sup> 15 U.S.C. 78f(b)(4).

compete with other markets in attracting customer order flow. Because the payment for order flow fees are collected only from member organizations respecting customer transactions, the Phlx believes that there is a direct and fair correlation between those members who fund the equity options payment for order flow fee program and those who receive the benefits of the program. The Exchange states that ROTs also potentially benefit from additional customer order flow. In addition, the Phlx believes that the proposed payment for order flow fees would serve to enhance the competitiveness of the Phlx and its members and that this proposal therefore is consistent with and furthers the objectives of the Act, including Section 6(b)(5) thereof,<sup>26</sup> which requires the rules of exchanges to be designed to promote just and equitable principles of trade, and to remove impediments to and perfect the mechanism of a free and open market and a national market system. The Phlx believes that attracting more order flow to the Exchange should, in turn, result in increased liquidity, tighter markets and more competition among exchange members.

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

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

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<sup>26</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>27</sup> and Rule 19b-4(f)(2)<sup>28</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-2004-68 on the subject line.

#### Paper comments:

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

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<sup>27</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>28</sup> 17 CFR 240.19b-4(f)(2).

All submissions should refer to File Number SR-Phlx-2004-68. 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-2004-68 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>29</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>29</sup> 17 CFR 200.30-3(a)(12).