

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50728; File No. SR-Phlx-2004-74)

November 23, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 by the Philadelphia Stock Exchange, Inc. Relating to \$5 Bid/Ask Differentials in Options Traded on the Exchange's Electronic Trading Platform, Phlx XL

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 3, 2004, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On November 10, 2004, the Phlx filed Amendment No. 1 to the proposed rule change, which changed the proposal from a filing made pursuant to Section 19(b)(2) of the Act to a filing made pursuant to Section 19(b)(3)(A) of the Act,<sup>3</sup> and Rule 19b-4(f)(6) thereunder.<sup>4</sup> Accordingly, the proposed rule change became effective upon filing of Amendment No. 1.<sup>5</sup> 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> 15 U.S.C. 78s(b)(3)(A).

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

<sup>5</sup> The 60-day period within which the Commission may summarily abrogate the proposed rule change under Section 19(b)(3)(C) of the Act commenced on November 10, 2004, the date the Phlx filed Amendment No. 1 to the proposal.

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

The Phlx proposes to adopt new Phlx Rule 1014(c)(i)(A)(2), which would relax the quotation spread requirements for Streaming Quote Options traded on the Exchange's new electronic trading platform, Phlx XL.<sup>6</sup> Specifically, the proposal would allow Streaming Quote Options trading on Phlx XL to be quoted electronically with a difference not to exceed \$5 between the bid and offer, regardless of the price of the bid. The text of the proposed rule change appears below. Proposed additions are in italics.

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Rule 1014.

Obligations and Restrictions Applicable to Specialists and Registered Options Traders

(a) – (b) No change.

(c) In Classes of Option Contracts to Which Assigned --Affirmative Obligations. With respect to classes of option contracts to which his assignment extends, a Specialist and an ROT, whenever the ROT enters the trading crowd in other than a floor brokerage capacity or is called upon by a Floor Official or a Floor Broker, to make a market, are expected to engage, to a reasonable degree under the existing circumstances, in dealing for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between option contracts of the same class. Without limiting the

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<sup>6</sup> See Securities Exchange Act Release No. 50100 (July 27, 2004), 69 FR 46612 (August 3, 2004) (order approving File No. SR-Phlx-2003-59).

foregoing, a Specialist and an ROT is expected to perform the following activities in the course of maintaining a fair and orderly market:

(i) Options on Equities (including Exchange-Traded Fund Shares).

(A) (1) Quote Spread Parameters (Bid/Ask Differentials)--Bidding and/or offering so as to create differences of no more than \$.25 between the bid and the offer for each option contract for which the prevailing bid is less than \$2; no more than of \$.40 where the prevailing bid is \$2 or more but less than \$5; no more than \$.50 where the prevailing bid is \$5 or more but less than \$10; no more than \$.80 where the prevailing bid is \$10 or more but less than \$20; and no more than \$1 where the prevailing bid is \$20 or more, provided that the bid/ask differentials stated above shall not apply to in-the-money series where the market for the underlying security is wider than the differentials set forth above. For such series, the bid/ask differentials may be as wide as the quotation for the underlying security on the primary market, or its decimal equivalent rounded up to the nearest minimum increment. The Exchange may establish differences other than the above for one or more series or classes of options.

(2) Streaming Quote Options trading on Phlx XL may be quoted electronically with a difference not to exceed \$5 between the bid and offer regardless of the price of the bid. The \$5 bid/ask differentials only apply to Streaming Quote Options trading on Phlx XL and only following the opening rotation in each security (i.e., the bid/ask differentials specified in sub-paragraph (c)(i)(A)(1) above shall apply during opening rotation). Quotations provided in open outcry in Streaming Quote Options may not be made with \$5 bid/ask differentials and instead must comply with the bid/ask differential requirements described in sub-paragraph (c)(i)(A)(1) above and not in this sub-paragraph (c)(i)(A)(2).

(B) No change.

(d) – (h) No change.

Commentary: No change.

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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 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 purpose of the proposed rule change is to reduce the market making risk, especially in volatile markets, by relaxing the quotation spread requirements for Streaming Quote Options traded on the Exchange's new electronic trading platform, Phlx XL. According to the Phlx, the primary purpose of the current quote spread requirements set forth in Phlx Rule 1014(c)(i)(A) is to help to maintain narrow spreads in options. The Phlx believes that these requirements can have the unintended consequence of requiring those making markets to quote at prices that are unnecessarily narrow, thereby exposing them to great risk if markets move quickly.

The proposed \$5 bid/ask differential would apply only to electronic quotations submitted in Streaming Quote Options traded on Phlx XL. The current bid/ask differential requirements

contained in Phlx Rule 1014(c)(i)(A)(1) would continue to apply to quotations in Streaming Quote Options made in open outcry, and to quotations in non-Streaming Quote Options.

The Exchange believes that given the competitive market making structure of Phlx XL and the existence of vigorous inter-market competition, the mandatory quote spread requirements may not be necessary to ensure narrow and competitive spreads in options. In this regard, the Phlx believes that the Phlx XL market structure creates strong incentives for specialists, Registered Options Traders (“ROTs”) and other market participants to disseminate competitive prices. The Exchange notes that in Phlx XL, each specialist and Streaming Quote Trader quotes independently, and customers, off-floor broker-dealers, and ROTs can enter limit orders at prices that improve the Exchange’s disseminated bid or offer.<sup>7</sup> The Exchange automatically collects this trading interest information, calculates the Phlx best bid and offer, and disseminates that value to the Options Price Reporting Authority. Accordingly, the Phlx believes that its Phlx XL market is competitive, accessible and transparent.

In addition, the Phlx believes that market participants in Phlx XL have strong incentives to quote competitively. The Exchange currently allocates incoming orders based on the price and size of orders and quotes resting in the book. Under the Exchange's trade allocation rules applicable to options trading on Phlx XL, the larger the size of a market maker's quote at the best price, the greater the size of the allocation he or she receives.<sup>8</sup> Conversely, if a market participant does not quote at the best price, the market participant will not participate in any

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<sup>7</sup> The Phlx clarified this sentence in a telephone conversation. Telephone conversation between Richard Rudolph, Director and Counsel, Phlx, and Yvonne Fraticelli, Special Counsel, Division of Market Regulation, Commission, on November 23, 2004.

<sup>8</sup> See Phlx Rule 1014(g)(vii).

electronic trade allocations. The Phlx believes, moreover, that given NBBO protections in place at each exchange, as well as under Plan for the Purpose of Creating an Options Intermarket Linkage (the “Linkage Plan”), market participants have even stronger incentives to quote at the best price, lest incoming orders be filled away. Thus, the Phlx believes that both inter-market and intra-market competitive forces provide strong incentives for market participants to quote competitively and to enter quotes and orders that improve the price and depth of the market.

For these reasons, Phlx proposes to expand the allowable spread in Streaming Quote Options traded on Phlx XL to \$5 for options quoted electronically. The proposed quote spread requirements will apply after the opening trading rotation. During the opening trading rotation, market makers will be required to quote in accordance with the traditional bid/ask width requirements. The \$5 quotation requirements would become operative immediately following the opening rotation.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>9</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>10</sup> in particular, in that it is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest.

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<sup>9</sup> 15 U.S.C. 78f(b).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

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.

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

The Exchange has designated the proposed rule change as a “non-controversial” rule change<sup>11</sup> pursuant to Section 19(b)(3)(A) of the Act<sup>12</sup> and subparagraph (f)(6) of Rule 19b-4 thereunder.<sup>13</sup> Consequently, because the foregoing rule change: (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, and the Phlx provided the Commission with written notice of its intent to file the proposed rule change at least five days prior to the filing date, it has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>14</sup> and Rule 19b-4(f)(6) thereunder.<sup>15</sup>

A proposed rule change filed under Rule 19b-4(f)(6) normally does not become operative prior to 30 days after the date of filing. However, Rule 19b-4(f)(6)(iii) permits the Commission

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<sup>11</sup> See Amendment No. 1.

<sup>12</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>13</sup> 17 CFR 240.19b-4(f)(6).

<sup>14</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>15</sup> 17 CFR 240.19b-4(f)(6).

to designate a shorter time if such action is consistent with the protection of investors and the public interest. The Exchange has requested that the Commission waive the 30-day operative delay specified in Rule 19b-4(f)(6) in order to remain competitive with other exchanges with similar rules in effect. In this regard, the Phlx notes that its proposal is based on Chicago Board Options Exchange, Inc. (“CBOE”) Rule 8.7(b)(iv)(A),<sup>16</sup> International Securities Exchange, Inc. (“ISE”) Rule 803(b)(4),<sup>17</sup> and Pacific Exchange, Inc. (“PCX”) Rule 6.37(b)(1)(G).<sup>18</sup>

The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest.<sup>19</sup> Specifically, the Commission believes that allowing the Phlx to implement \$5 quotation spread parameters will help the Phlx to compete with other options exchanges that have adopted similar rules. The Commission believes that the Phlx’s proposal raises no new issues or regulatory concerns that the Commission did not consider in approving the ISE and CBOE proposals. For these reasons, the Commission designates that the proposal become operative immediately.

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that the action is

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<sup>16</sup> See Securities Exchange Act Release No. 50079 (July 26, 2004), 69 FR 45858 (July 30, 2004) (order approving File No. SR-CBOE-2004-44).

<sup>17</sup> See Securities Exchange Act Release No. 50015 (July 14, 2004), 69 FR 43872 (July 22, 2004) (order approving File No. SR-ISE-2003-22).

<sup>18</sup> See Securities Exchange Act Release No. 50538 (October 14, 2004), 69 FR 62105 (October 22, 2004) (notice of filing and immediate effectiveness of SR-PCX-2004-89).

<sup>19</sup> For purposes only of waiving the operative delay for this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).



necessary or appropriate in the public interest, for the protection of investors, or would otherwise further 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-2004-74 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.

All submissions should refer to File Number SR-Phlx-2004-74. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of this 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-2004-74 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).