

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50788; File No. SR-Phlx-2004-57)

December 3, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendments No. 1, 2, 3, and 4 Thereto by the Philadelphia Stock Exchange, Inc. Relating to the Trade Allocation Algorithm Applicable to 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<sup>2</sup> thereunder, notice is hereby given that on August 16, 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 and II, below, which Items have been prepared by the Exchange. On October 8, 2004, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On October 20, 2004, the Exchange filed Amendment No. 2 to the proposed rule change.<sup>4</sup> On November 3, 2004, the Exchange filed Amendment No. 3 to the

---

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

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

<sup>3</sup> See letter from Richard S. Rudolph, Counsel, Phlx, to Marc F. McKayle, Special Counsel, Division of Market Regulation ("Division"), Commission, dated October 7, 2004 ("Amendment No. 1"). In Amendment No. 1, Phlx amended the proposed rule change to: (1) clarify that a Phlx XL Participant would be entitled to receive an allocation of a number of contracts only up to its disseminated size; (2) clarify that options subject to the Enhanced Specialist Participation are described in Phlx Rules 1014(g)(ii) - (iv); (3) clarify that the proposed rule would apply only to electronically executed and allocated Streaming Quote Options that trade on Phlx XL; and (4) make technical amendments to the presentation of the allocation algorithm described in proposed Phlx Rule 1014(g)(vii)(B)(1)(b).

<sup>4</sup> See letter from Richard S. Rudolph, Counsel, Phlx, to Molly M. Kim, Attorney, Division, dated October 20, 2004 ("Amendment No. 2"). In Amendment No. 2, Phlx amended the proposed rule change to correct a typographical error in the numbering of the proposed rule text.

proposed rule change.<sup>5</sup> Finally, on December 2, 2004, the Exchange filed Amendment No. 4 to the proposed rule change.<sup>6</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons and is approving the proposed rule change on an accelerated basis.

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

Phlx proposes to adopt a new trade allocation algorithm for trades executed electronically on the Exchange's electronic options trading platform, Phlx XL. Brackets indicate deletions; italics indicate new text:

\* \* \* \* \*

**Obligations And Restrictions Applicable To Specialists And Registered Options Traders**

**Rule 1014.** (a) – (f) No change.

(g)(i) – (vi) No change.

(vii) Allocation of Automatically Executed Trades in Streaming Quote Options. Solely with respect to Streaming Quote Options approved by the Exchange to be traded on Phlx XL by Streaming Quote Traders (“SQTs”) pursuant to Exchange Rule 1080(k), after public customer

---

<sup>5</sup> See letter from Richard S. Rudolph, Counsel, Phlx, to Deborah Lassman Flynn, Assistant Director, Division, Commission, dated November 2, 2004 (“Amendment No. 3”). In Amendment No. 3, Phlx amended the proposed rule change to: (1) delete the phrase “if the specialist is quoting at the Exchange’s disseminated price” from Rule 1014(g)(vii)(B)(1); (2) delete current Rule 1014(g)(vii)(B)(2); and (3) clarify the definition of “Phlx XL Participant” to include the specialist, an SQT or a non-SQT ROT that has placed a limit order on the limit order book.

<sup>6</sup> See Amendment No. 4 from Richard S. Rudolph, Counsel, Phlx, dated December 2, 2004 (“Amendment No. 4”). In Amendment No. 4, Phlx amended the proposed rule change to clarify that, if specialists are not quoting at the Exchange’s disseminated price, orders for 5 contracts or fewer will be allocated to Phlx XL Participants on parity.

market and marketable limit orders have been executed, trades automatically executed in such options shall be allocated automatically in the following manner:

(A) If [one] the specialist, an SQT or a non-SQT ROT that has placed a limit order on the limit order book (“Phlx XL [p]Participant”) is quoting alone at the disseminated price and their quote is not matched by another Phlx XL participant prior to execution, such Phlx XL [p]Participant shall be entitled to receive a number of contracts up to the size associated with his/her quotation.

(B) Parity. Quotations entered electronically by the specialist or an SQT that do not cause an order resting on the limit order book to become due for execution may be matched at any time by quotations entered electronically by the specialist and/or other SQTs, and by ROT limit orders entered via electronic interface and shall be deemed to be on parity, subject to the requirement that orders of controlled accounts must yield priority to customer orders as set forth in Rule 1014(g)(i)(A).

(1) [if the specialist is quoting at the Exchange’s disseminated price:]

(a) orders for 5 contracts or fewer shall be allocated first to the specialist, provided, however, that on a quarterly basis, the Exchange will evaluate what percentage of the volume executed on the Exchange is comprised of orders for 5 contracts or fewer allocated to specialists, and will reduce the size of the orders included in this provision if such percentage is over 25%. In order to be entitled to receive the 5 contract or fewer order preference set forth in this sub-paragraph (B)(1)(a), the specialist must be quoting at the Exchange’s disseminated price, and shall not be entitled to receive a number of contracts that is greater than the size that is associated with its quote. If the specialist is

not quoting at the Exchange's disseminated price at the time of execution, orders for 5 contracts or fewer shall be allocated to Phlx XL Participants on parity as set forth in paragraph (b) below.

(b) Respecting orders for greater than 5 contracts (regardless of whether the specialist is quoting at the Exchange's disseminated price), or orders for 5 contracts or fewer when the specialist is not quoting at the Exchange's disseminated price, inbound electronic orders shall be allocated pursuant to the following allocation algorithm:

[, the specialist shall be entitled to receive a number of contracts that is the greater of: (i) the proportion of the aggregate size associated with the specialist's quote, SQT quotes, and non-SQT ROT limit orders entered on the book via electronic interface at the disseminated price represented by the size of the specialist's quote, or (ii) 60% of the contracts to be allocated if the specialist is on parity with one SQT or one non-SQT ROT that has placed a limit order on the book via electronic interface at the Exchange's disseminated price; (iii) 40% of the contracts to be allocated if the specialist is on parity with two SQTs or non-SQT ROTs that have placed a limit order on the book via electronic interface at the Exchange's disseminated price; and (iv) 30% of the contracts to be allocated if the specialist is on parity with three or more SQTs or non-SQT ROTs that have placed a limit order on the book via electronic interface at the Exchange's disseminated price. In order to be entitled to receive the number of contracts set forth in this sub-paragraph (B)(1)(b), the specialist must be quoting at the Exchange's disseminated price, and shall not be entitled to receive a number of contracts that is greater than the size that is associated with its quote.

(c) Thereafter, SQTs quoting at the disseminated price and non-SQT ROTs that have placed limit orders on the limit order book via electronic interface at the Exchange's disseminated price shall be entitled to receive a number of contracts that is the proportion of the total remaining aggregate size associated with SQT quotes and non-SQT ROT limit orders on the book entered via electronic interface at the disseminated price represented by the size of the SQT's quote or, in the case of a non-SQT ROT, by the size of the limit order they have placed on the limit order book via electronic interface. Such SQT(s) and non-SQT ROTs shall not be entitled to receive a number of contracts that is greater than the size associated with their quotation or limit order.]

$$\begin{array}{l}
 \text{Equal percentage based} \\
 \text{on the number of Phlx XL} \\
 \text{Participants quoting or} \\
 \text{with limit orders at BBO} \\
 \text{(Component A)}
 \end{array}
 \pm
 \begin{array}{l}
 \text{Pro rata percentage} \\
 \text{based on size of} \\
 \text{Phlx XL participant} \\
 \text{quotes/limit orders} \\
 \text{(Component B)}
 \end{array}
 \times
 \begin{array}{l}
 \text{Incoming Order Size}
 \end{array}$$

---

2

Where:

Component A: The percentage to be used for Component A shall be an equal percentage, derived by dividing 100 by the number of Phlx XL participants quoting at the BBO.

Component B: Size Pro Rata Allocation. The percentage to be used for Component B of the allocation algorithm formula is that percentage that the size of each Phlx XL Participant's quote at the best price represents relative to the total number of contracts in the disseminated quote.

Final Weighting: The final weighting formula for equity options, which shall be determined by a three-member special committee of the Board of Governors, chaired by the Chairman of the Board, and including the Chairman of the Options Committee and one on-floor Governor (the “Special Committee”), and apply uniformly across all equity options, shall be a weighted average of the percentages derived for Components A and B multiplied by the size of the incoming order. Initially, the weighting of components A and B shall be equal, represented mathematically by the formula: (Component A Percentage + Component B Percentage)/2) \* incoming order size.

The final weighting formula for index options and options on Exchange Traded Fund Shares (as defined in Rule 1000(b)(42.)) shall be established by the Special Committee and may vary by product. Changes made to the percentage weightings of Components A and B shall be announced to the membership via Regulatory Circular at least one day before implementation of the change.

(c) Enhanced Specialist Participation: For options subject to the Enhanced Specialist Participation as set forth in Rules 1014(g)(ii) - (iv), the specialist shall be entitled to receive a number of contracts (not to exceed the size of the specialist’s quote) that is the greater of the amount he would be entitled to receive pursuant to Rules 1014(g)(ii) – (iv), or the amount he would otherwise receive pursuant to the operation of the algorithm described above.

(d) Broker-dealer Orders: If any contracts remain to be allocated after the [specialist, SQTs and non-SQT ROTs with limit orders on the limit order book] Phlx XL Participants have received their respective allocations, off-floor broker-dealers (as

defined in Rule 1080(b)(i)(C)) that have placed limit orders on the limit order book which represent the Exchange's disseminated price shall be entitled to receive a number of contracts that is the proportion of the aggregate size associated with off-floor broker-dealer limit orders on the limit order book at the disseminated price represented by the size of the limit order they have placed on the limit order book. Such off-floor broker-dealers shall not be entitled to receive a number of contracts that is greater than the size that is associated with each such limit order.

(e) No Phlx XL Participant shall be entitled to receive a number of contracts that is greater than the size that is associated with their quotation or limit order.

(2) [If the specialist is not quoting at the Exchange's disseminated price, SQTs quoting at the disseminated price and non-SQT ROTs that have placed limit orders on the limit order book via electronic interface which represent the Exchange's disseminated price shall be entitled to receive a number of contracts equal to the proportion of the aggregate size associated with SQT quotes and non-SQT ROT limit orders on the book entered via electronic interface at the disseminated price represented by the size of the SQT's quote or, in the case of a non-SQT ROT, by the size of the limit order they have placed on the limit order book via electronic interface. Thereafter, off-floor broker-dealers that have placed limit orders on the limit order book which represent the Exchange's disseminated price shall be entitled to receive a number of contracts as specified in paragraph (1)(d) above.

(3) No Split-Price Executions in Streaming Quote Options. If the size associated with a market order or an electronic quotation to be executed in a Streaming Quote Option is received for a greater number of contracts than the Exchange's disseminated size, the portion of such an

order or quotation executed automatically at the Exchange's disseminated size shall be allocated automatically in accordance with Rule 1014(g)(vii). Contracts remaining in such an order shall be represented by the specialist and handled in accordance with Exchange rules.

([4]3) Notwithstanding the first sentence of Rule 1014(g)(i), neither Rule 119(a)-(d) and (f), nor Rule 120 (insofar as it incorporates those provisions by reference) shall apply to the allocation of automatically executed trades in Streaming Quote Options.

(h) No change.

**Commentary:** No change.

\* \* \* \* \*

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

In its filing with the Commission, 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 III below. 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 adopt a new trade allocation algorithm for trades executed electronically on Phlx XL,<sup>7</sup> to establish a weighted formula that would provide an equal allocation of a certain percentage of executed contracts among Phlx XL Participants on

---

<sup>7</sup> See Securities Exchange Act Release No. 50100 (July 27, 2004), 69 FR 46612 (August 3, 2004) (SR-Phlx-2003-59).

parity,<sup>8</sup> and an allocation of contracts based on a size pro rata formula for the remaining contracts. The proposed allocation algorithm would allocate orders based on two separate components: parity (i.e., multiple participants quoting at the best price) and depth of liquidity (i.e., size pro rata). The two components would be weighted on a percentage basis as described below. Under the proposal, all equity options traded on Phlx XL would be subject to the same weighted percentage, while each index option traded on Phlx XL could be weighted differently, on a product-by-product basis.

#### Component A

Component A of the allocation algorithm is the parity component, which would treat all Phlx XL Participants quoting at the relevant best bid or best offer as equal. Accordingly, the percentage used for Component A is an equal percentage, derived by dividing 100 by the number of market participants quoting at the best price, except as provided in Phlx Floor Procedure Advice F-11.<sup>9</sup>

#### Component B

Component B of the allocation algorithm is the size pro-rata component designed to reward market participants who quote with size. The percentage used for Component B is the percentage that the size of each market participant's quote at the best price represents relative to the total number of contracts in the disseminated quote (i.e., size pro rata).

---

<sup>8</sup> Pursuant to Phlx Floor Procedure Advice F-11, ROTs of the same Firm, dually affiliated or financially affiliated ROTs, when bidding or offering at the same price for the same option, are to be treated as one interest for purpose of splitting an order in the trading crowd.

<sup>9</sup> Id.

### Weighting of Each Component

The final weighting formula for equity options would be determined by a three-member special committee of the Phlx Board of Governors and would apply uniformly across all equity options. The committee will be chaired by the Chairman of the Phlx Board and will include the Chairman of the Phlx Options Committee and one on-floor Phlx Governor (“Special Committee”).<sup>10</sup> Each index traded on the Exchange could be weighted differently by the Special Committee, on a product-by-product basis. Initially, the Exchange proposes to assign equal weighting to Components A and B for all Exchange-traded products. The assigned weightings of Components A and B would be multiplied by the percentages derived for Components A and B, respectively, and then would be multiplied by the size of the incoming order.

### Additional Features

Public customer priority. Public customer orders on the limit order book and at the Exchange’s Best Bid or Offer (“BBO”) would continue to have priority.<sup>11</sup> Multiple public customer orders on the limit order book at the same price would be ranked based on time priority. If a public customer order on the limit order book matches, or is matched by, a Phlx XL Participant’s quote, the public customer order would have priority, and the balance of the electronic order, if any, would be allocated based on the new allocation algorithm.

---

<sup>10</sup> Phlx By-Law Article IV, Section 4-4(b)(xviii) authorizes a majority of the Phlx Board of Governors to designate one or more ad hoc or special committees, each to consist of two (2) or more Governors, to have such duties, powers and authority as the Board of Governors determines.

<sup>11</sup> Phlx rules currently provide that equity option and index option orders of “controlled accounts” are required to yield priority to customer orders when competing at the same price. A “controlled account” includes any account controlled by or under common control with a broker-dealer. Customer accounts are all other accounts. See Phlx Rule 1014(g)(i)(A).

Quoting alone. A Phlx XL Participant quoting alone at the BBO would continue to have priority and would be entitled to receive a number of contracts executed against inbound quotes or orders up to the size of its quote.<sup>12</sup>

Enhanced Specialist Participation. For options subject to the Enhanced Specialist Participation,<sup>13</sup> the specialist would be entitled to receive a number of contracts (not to exceed the size of the specialist's quote) that is the greater of the amount he would be entitled to receive pursuant to the Enhanced Specialist Participation described in Phlx Rules 1014(g)(ii) – (iv), or the amount he would otherwise receive pursuant to the operation of the new algorithm.

Off-floor broker-dealer orders and orders that are handled manually by the specialist will continue to be handled in accordance with Phlx Rules 1014(g)(i)(A) and 1080(b)(i)(C) and Commentary .05 thereto.

## 2. Statutory Basis

The Exchange believes that its proposal, as amended, is consistent with Section 6(b) of the Act,<sup>14</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>15</sup> in particular, in that it is designed to perfect the mechanisms of a free and open market and the national market system, protect investors and the public interest and promote just and equitable principles of trade by expressly providing a mechanism to allocate trades among Phlx XL Participants on parity.

---

<sup>12</sup> See Phlx Rule 1014(g)(vii)(A).

<sup>13</sup> The Enhanced Specialist Participation is a percentage of an order to which the specialist is entitled after limit orders with priority over the specialist have been executed. See Phlx Rules 1014(g)(ii) - (iv).

<sup>14</sup> 15 U.S.C. 78f(b).

<sup>15</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. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2004-57 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-2004-57. 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 such filing also will be available for inspection and copying at the principal offices of the Exchange. 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-2004-57 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder, applicable to a national securities exchange,<sup>16</sup> and, in particular, with the requirements of Section 6(b) of the Act<sup>17</sup> and the rules and regulations thereunder. The Commission finds that the proposed rule change, which establishes a new allocation algorithm, is consistent with Section 6(b)(5) of the Act,<sup>18</sup> which requires that the rules of the an exchange 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 securities system, and, in general, protect investors and the public interest.

Specifically, the Commission believes that the proposed allocation algorithm may enhance incentives to quote competitively by providing all market participants with the opportunity to participate in the allocation of trade, regardless of their disseminated size, if they

---

<sup>16</sup> In approving this rule, the Commission notes that it has considered its impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

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

<sup>18</sup> 15 U.S.C. 78f(b)(5).

are quoting at the disseminated price. The proposal also should provide incentives for Phlx XL participants to quote in greater size to obtain a larger allocation under Component B of the proposed allocation algorithm.

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>19</sup> for approving the proposed rule change prior to the thirtieth day after the date of publication of the notice of the filing thereof in the Federal Register. The Commission notes that the proposal is substantially similar to the Chicago Board Options Exchange, Inc. Rule 6.45A,<sup>20</sup> which was previously approved by the Commission after notice and comment, and, therefore, does not raise any new regulatory issues.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>21</sup> that the proposed rule change and Amendments Nos. 1, 2, 3, and 4 thereto (SR-Phlx-2004-57) are hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>22</sup>

Margaret H. McFarland  
Deputy Secretary

---

<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</sup> See Securities Exchange Act Release No. 47959 (May 30, 2003), 68 FR 34441 (June 9, 2003) (SR-CBOE-2002-05).

<sup>21</sup> 15 U.S.C. 78s(b)(2).

<sup>22</sup> 17 CFR 200.30-3(a)(12).