

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51820; File No. SR-Phlx-2005-28)

June 10, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto Relating to Split Price Priority

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 April 28, 2005, 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 Phlx. On May 23, 2005, the Exchange amended the proposed rule change (“Amendment No. 1”).<sup>3</sup> The Exchange filed the proposal pursuant to Section 19(b)(3)(A) of the Act,<sup>4</sup> and Rule 19b-4(f)(6) thereunder,<sup>5</sup> which renders the proposal effective upon filing with the Commission.<sup>6</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> In Amendment No. 1, the Exchange made a few technical corrections to the purpose section and the rule text of the proposed rule change and marked the box on the cover page of Form 19b-4 to indicate that the proposed rule change is subject to a pilot program.

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>5</sup> 17 CFR 240.19b-4(f)(6).

<sup>6</sup> The Exchange requested the Commission to waive the five-day pre-filing notice requirement and the 30-day operative delay, as specified in Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

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(g)(i)(C) governing purchase or sale priority for orders of 100 option contracts or more. The proposed rule would afford priority to members that purchase (sell) fifty or more contracts at a particular price at the next lower (higher) price in purchasing (selling) the equivalent number of contracts in the same series. Such priority would only apply to orders that represent the same transaction or order as the previous purchase (sale), and would only apply to transactions in equity options and options overlying Exchange Traded Fund Shares (“ETFs”) that are effected in open outcry. The proposal is subject to a pilot program until December 31, 2005.

The text of the proposed rule change, as amended, is set forth below. Proposed new language is in italics.

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**Obligations and Restrictions Applicable to Specialists and Registered Options Traders**

**Rule 1014.** (a) - (f) No change.

(g) Equity Option and Index Option Priority and Parity

(i) (A) - (B) No change.

(C) Purchase or sale priority for orders of 100 contracts or more. If a member purchases (sells) 50 or more option contracts of a particular series at a particular price or prices, he shall, at the next lower (higher) price have priority in purchasing (selling) up to the equivalent number of option contracts of the same series that he purchased (sold) at

the higher (lower) price or prices, but only if his bid (offer) is made promptly and the purchase (sale) so effected represents the opposite side of a transaction with the same order or offer (bid) as the earlier purchase or purchases (sale or sales). The Options Committee may increase the “minimum qualifying order size” above 100 contracts for all products under its jurisdiction. Announcements regarding changes to the minimum qualifying order size shall be made via an Exchange circular. This paragraph shall only apply to transactions in equity options and options overlying Exchange Traded Fund Shares (“ETFs”) and only to such transactions that are effected in open outcry.

(ii) - (vii) No change.

(h) No change.

Commentary: .01 - .18 No change.

.19 Floor brokers are able to achieve split price priority in accordance with Rule 1014(g)(i)(C), provided, however, that a floor broker who bids (offers) on behalf of a non-market-maker Phlx member broker-dealer (“Phlx member BD”) must ensure that the Phlx member BD qualifies for an exemption from Section 11(a)(1) of the Exchange Act or that the transaction satisfies the requirements of Exchange Act Rule 11a2-2(T), otherwise the floor broker must yield priority to orders for the accounts of non-members.

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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, as amended, 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, as amended, is to establish rules that would facilitate the execution of large orders, which by virtue of their size and the need to execute them at multiple prices may be difficult to execute without a limited exception to current Exchange priority rules.

The proposed rule change, adopting Rule 1014(g)(i)(C), would establish a new priority rule regarding open outcry split price transactions in equity options and options overlying ETFs generally to permit a member who is responding to an order<sup>7</sup> for at least 100 contracts<sup>8</sup> who buys (sells) at least 50 contracts at a particular price to have priority over all others in purchasing (selling) up to an equivalent number of contracts of the same order at the next lower (higher) price without being required to yield to existing customer interest in the limit order book. Absent this proposed rule, such orders would be required to yield priority.<sup>9</sup>

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<sup>7</sup> Clarification provided in telephone conference call on June 8, 2005, among Richard Rudolph, Vice President and Counsel, Phlx, and Ira Brandriss, Special Counsel, Ann Leddy, Special Counsel, and Mitra Mehr, Staff Attorney, Division of Market Regulation (“Division”), Commission (“June 8<sup>th</sup> Telephone Conference”).

<sup>8</sup> Orders for a size of less than 100 contracts would not be affected by this proposed rule.

<sup>9</sup> See, e.g., Phlx Rule 119(a).

For example, when a floor broker (“Floor Broker”) is representing a customer’s order for 100 contracts and a member executes a purchase of 50 of those contracts at a price of \$.30, the member would have priority over all market participants to purchase the remaining 50 contracts in the order at \$.25.<sup>10</sup> Two trades would be reported to the tape, one a purchase of 50 contracts at \$.30, and the other a purchase of 50 contracts at \$.25. The effect to the customer would be a net purchase price of \$.275 for 100 contracts. The Exchange believes that the proposal should lead to more aggressive quoting by crowd participants, which in turn could lead to better executions. A crowd participant might be willing to trade at a better price for a portion of an order if he/she were assured of trading with the balance of the order at the next pricing increment. As a result, Floor Brokers representing orders in the trading crowd might receive better-priced executions.

Under the proposal, the Exchange’s Options Committee<sup>11</sup> would have the ability to increase the minimum qualifying order size to a number larger than 100 contracts. Any changes, which would have to apply to all products under the committee's jurisdiction, would be announced to the membership via an Exchange Circular.

One possible limitation on the ability of crowd participants to use the split price priority rule is the current requirement that orders for controlled accounts<sup>12</sup> must yield

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<sup>10</sup> Clarification provided in June 8<sup>th</sup> Telephone Conference.

<sup>11</sup> The Options Committee has general supervision of the dealings of members on the options trading floor. See Phlx By-Law Article X, Section 10-20.

<sup>12</sup> A controlled account includes any account controlled by or under common control with a broker-dealer. Customer accounts are all other accounts. Equity option and index option orders of controlled accounts are required to yield priority to customer orders when competing at the same price. Orders of controlled accounts generally are not required to yield priority to other controlled account orders. See Phlx Rule 1014(g)(i)(A).

priority to orders for customer accounts. Using the example above, if the \$.25 represents orders for customer accounts, those orders would have priority over orders for controlled accounts at \$.25. This means that a holder of a controlled account who is willing to trade at \$.30 and \$.25 may be unwilling to trade at the price of \$.30 if he/she cannot trade the balance of the order at \$.25 because of the requirement to yield to orders for customer accounts. The Exchange believes that this jeopardizes the member's willingness to execute the first part of the order at a price of \$.30 (using the above example), thereby potentially making it difficult to achieve price improvement for the Floor Broker's customer on the Phlx.<sup>13</sup> Instead, the order might trade at another exchange that has no impediments, i.e., no customer interest at those price levels. Accordingly, one significant purpose of this proposal is to adopt a limited exception to the existing priority requirement concerning controlled accounts.

The Exchange believes that it would be reasonable to make a limited exception to the rule requiring controlled accounts to yield priority to non-controlled accounts in order to allow split price trading. In this regard, the proposed exception would be similar in operation to the current limited "spread-type" priority exception<sup>14</sup> under Exchange rules. This exception (which is established in the rules of many options exchanges) was

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<sup>13</sup> Clarification provided in June 8<sup>th</sup> Telephone Conference.

<sup>14</sup> Currently, a member that executes at least one option leg of a spread order at a better price than the established bid or offer for that option contract, and no option leg of the spread order is executed at a price outside of the established bid or offer for that option contract, has priority over all other orders at the same price. See Phlx Rule 1033(d).

intended to facilitate the trading of spread, or “hedge” order,<sup>15</sup> which by virtue of their multi-legged composition could be more difficult to trade without a limited exception to the priority rule for one of the legs. The purpose behind the proposed split-price priority exception is the same — to bring about the execution of large orders, which by virtue of their size and the need to execute them at multiple prices may be difficult to execute without a limited exception to the priority rules. The proposed exception would operate in the same manner as the hedge order exception by allowing a member effecting a trade that betters the market to have priority on the balance of that trade at the next pricing increment, even if there are orders in the book at the same price.

In order to address potential concerns regarding Section 11(a) of the Act,<sup>16</sup> the Exchange proposes to adopt new Commentary .19 to Phlx Rule 1014. Section 11(a) of the Act generally prohibits members of national securities exchanges from effecting transactions for the member’s own account, absent an exemption. Under the proposal, there could be situations where because of the proposed limited exception to customer priority, orders on behalf of members could trade ahead of orders of nonmembers in violation of Section 11(a). Proposed Commentary .19 would make clear that Floor Brokers may avail themselves of the split-price priority rule, but that they would be obligated to ensure compliance with Section 11(a). Specifically, a Floor Broker bidding (offering) on behalf of a Phlx member broker-dealer that is not a specialist or Registered Options Trader (“ROT”) on the Exchange would be required to ensure that the order

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<sup>15</sup> The Exchange defines a “hedge order” as any spread type order for the same account. See Phlx Rule 1066(f).

<sup>16</sup> 15 U.S.C. 78k(a).

he/she represents qualifies for an exemption from Section 11(a)(1) of the Act or that the transaction satisfies the requirements of Rule 11a2-2(T)<sup>17</sup> under the Act.<sup>18</sup> Otherwise, the Floor Broker would be required to yield priority to order(s) for the account(s) of non-members.

## 2. Statutory Basis

The Exchange believes that its proposed rule change, as amended, is consistent with Section 6(b) of the Act<sup>19</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>20</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

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<sup>17</sup> 17 CFR 240.11a2-2T. Rule 11a2-2T generally states that a member of a national securities exchange (the “initiating member”) may not effect a transaction on that exchange for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion unless:

(i) the transaction is executed on the floor, or through use of the facilities, of the exchange by a member (the “executing member”) which is not an associated person of the initiating member;

(ii) the order for the transaction is transmitted from off the exchange floor;

(iii) neither the initiating member nor an associated person of the initiating member participates in the execution of the transaction at any time after the order for the transaction has been so transmitted; and

(iv) in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof retains any compensation in connection with effecting the transaction; provided, however, that this condition shall not apply to the extent that the person or persons authorized to transact business for the account have expressly provided otherwise by written contract referring to Section 11(a) of the Act and this section executed on or after March 15, 1978, by each of them and by such exchange member or associated person exercising investment discretion.

<sup>18</sup> The Exchange notes that there are other exemptions from the requirements of Section 11(a).

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

<sup>20</sup> 15 U.S.C. 78f(b)(5).

just and equitable principles of trade, by establishing a limited priority rule regarding split-price transactions.

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

The Exchange does not believe that the proposed rule change, as amended, 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

Because the foregoing proposed rule change, as amended, does not:

(i) significantly affect the protection of investors or the public interest;

(ii) impose any significant burden on competition; and

(iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, it has become effective pursuant to Section 19(b)(3)(A) of the Act,<sup>21</sup> and Rule 19b-4(f)(6) thereunder.<sup>22</sup> At any time within 60 days of the filing of the proposed rule change the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.<sup>23</sup>

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<sup>21</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>22</sup> 17 CFR 240.19b-4(f)(6).

<sup>23</sup> The effective date of the original proposal is April 28, 2005, and the effective date of the amendment is May 23, 2005. For purposes of calculating the 30-day operative delay and the 60-day period within which the Commission may

A proposed rule change filed under Rule 19b-4(f)(6)<sup>24</sup> normally does not become operative prior to 30 days after the date of filing. However, pursuant to Rule 19b-4(f)(6)(iii), the Commission may designate a shorter time if such action is consistent with the protection of investors and the public interest. The Exchange has asked the Commission to waive the five-day pre-filing notice requirement and the 30-day operative delay.<sup>25</sup> The Commission believes that such waiver is consistent with the protection of investors and the public interest because it would allow the Phlx to implement immediately a rule similar to rules already in place at other options exchanges and thus would permit the Exchange to be better able to compete for larger-sized orders. For these reasons, the Commission designates the proposed rule change, as amended, to be effective upon filing with the Commission.<sup>26</sup>

#### IV. 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:

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summarily abrogate the proposed rule change under Section 19(b)(3)(C) of the Act, the Commission considers that period to commence on May 23, 2005, the date the Exchange filed Amendment No. 1 to the proposed rule change. See 15 U.S.C. 78s(b)(3)(C).

<sup>24</sup> 17 CFR 240.19b-4(f)(6).

<sup>25</sup> 17 CFR 240.19b-4(f)(6)(iii).

<sup>26</sup> For purposes only of accelerating the operative date of this proposal, the Commission has considered the rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

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-2005-28 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303

All submissions should refer to File Number SR-Phlx-2005-28. 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 the 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-2005-28 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>27</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>27</sup> 17 CFR 200.30-3(a)(12).