

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-52114; File No. SR-Phlx-2005-44)

July 22, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to 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 July 1, 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, II, and III below, which Items have been prepared by the Exchange. On July 20, 2005, the Phlx submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On July 21, 2005, the Phlx submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> 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>5</sup> and Rule 19b-4(f)(2) thereunder,<sup>6</sup> which renders the proposal, as amended, effective upon filing with the Commission. 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: (1) revised the proposed rule text to clarify the provision on the return of any excess payment for order flow funds that are billed but not reimbursed to specialists; (2) revised the purpose section to clarify that Directed Registered Options Traders ("Directed ROTs") may elect to be assessed or not to be assessed a payment for order flow fee and to clarify the example of how payment for order flow reimbursement is calculated; and (3) made several technical corrections to the proposed rule change.

<sup>4</sup> In Amendment No. 2, the Exchange made a technical correction to the proposed rule text.

<sup>5</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>6</sup> 17 CFR 240.19b-4(f)(2).

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

The Phlx proposes to amend its equity options payment for order flow program as follows: (1) a payment for order flow fee will be assessed only on electronically delivered orders, thus payment for order flow fees will not be assessed on non-electronically delivered orders, i.e., floor brokered orders; (2) payment for order flow fees will increase from \$0.40 to \$0.60 per contract for all options other than Nasdaq-100 Index Tracking Stock<sup>SM</sup> traded under the symbol QQQQ ("QQQQ"),<sup>7</sup> and iShares FTSE/Xinhua China Index Fund ("FXI Options"), an exchange-traded fund; (3) the payment for order flow fee will decrease from \$1.00 to \$0.75 for options on QQQQ; (4) Directed ROTs may elect to be assessed or not to be assessed a payment for order flow fee for orders directed to them; and (5) Directed ROTs will no longer be able to request reimbursement for payment for order flow paid to order flow providers.

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<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 Philadelphia Stock Exchange 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>. The Exchange states that 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.

## Equity Options Payment for Order Flow Program in Effect Beginning June 2, 2005<sup>8</sup>

Beginning June 2, 2005, the Exchange established a payment for order flow program to take into account Directed Orders<sup>9</sup> pursuant to new Exchange Rule 1080(l).<sup>10</sup> Pursuant to Exchange Rule 1080(l), Exchange specialists,<sup>11</sup> SQTs<sup>12</sup> and RSQTs<sup>13</sup> trading on the Exchange's

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<sup>8</sup> On June 2, 2005, the Exchange filed to amend its payment for order flow program effective as a pilot program for trades involving payment for order flow and Directed ROTs settling on or after June 2, 2005 through May 27, 2006. See Securities Exchange Act Release No. 51909 (June 22, 2005), 70 FR 37484 (June 29, 2005) (SR-Phlx-2005-37). Although the Commission subsequently abrogated SR-Phlx-2005-37 on July 7, 2005, it was in effect until the filing of the current proposal, SR-Phlx-2005-44, on July 1, 2005. See Securities Exchange Act Release No. 51984 (July 7, 2005), 70 FR 40413 (July 13, 2005).

<sup>9</sup> The term "Directed Order" means any customer order to buy or sell which has been directed to a particular specialist, Remote Streaming Quote Trader ("RSQT") (as defined below), or Streaming Quote Trader ("SQT") (defined below) by an Order Flow Provider (as defined below). The provisions of Exchange Rule 1080(l) are in effect for a one-year pilot period to expire on May 27, 2006. See Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91).

<sup>10</sup> See Securities Exchange Act Release No. 51909 (June 22, 2005), 70 FR 37484 (June 29, 2005) (SR-Phlx-2005-37).

<sup>11</sup> The Exchange uses the terms "specialist" and "specialist unit" interchangeably herein.

<sup>12</sup> An SQT is an Exchange Registered Options Trader ("ROT") who has received permission from the Exchange to generate and submit option quotations electronically through an electronic interface with AUTOM via an Exchange approved proprietary electronic quoting device in eligible options to which such SQT is assigned. AUTOM is the Exchange's electronic order delivery, routing, execution and reporting system, which provides for the automatic entry and routing of equity option and index option orders to the Exchange trading floor. See Exchange Rules 1014(b)(ii) and 1080.

<sup>13</sup> An RSQT is an Exchange ROT that is a member or member organization of the Exchange with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically through AUTOM in eligible options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. An RSQT may only trade in a market making capacity in classes of options in which he is assigned. See Exchange Rule 1014(b)(ii)(B). See Securities Exchange Act Release Nos. 51126 (February 2, 2005), 70 FR 6915 (February 9, 2005) (SR-Phlx-2004-90) and 51428 (March 24, 2005), 70 FR 16325 (March 30, 2005) (SR-Phlx-2005-12).

electronic options trading platform, Phlx XL,<sup>14</sup> may receive Directed Orders from Order Flow Providers.<sup>15</sup>

The Exchange charges a payment for order flow fee of \$0.40 on equity options traded on the Phlx, other than options on the QQQQ, which are assessed a payment for order flow fee of \$1.00, and FXI Options, which are not assessed a payment for order flow fee.

Pursuant to Exchange Rule 1080, specialists, SQTs and RSQTs may receive Directed Orders in accordance with the provisions of Exchange Rule 1080(l). When a Directed Order is received, the specialist, SQT or RSQT to whom the order is directed (the "Directed Participant") is not assessed a payment for order flow fee.<sup>16</sup> For trades involving Directed Orders, the payment for order flow fee is assessed, however, on a specialist and ROT<sup>17</sup> when they are not Directed Participants for that transaction, as long as they are allocated any remaining contracts after the Directed Participant receives its trade allocation if the specialist or Directed ROT makes arrangements to pay for order flow and has elected to participate in the Exchange's payment for order flow program.<sup>18</sup> The Exchange states that thus, the payment for order flow fee is applied,

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<sup>14</sup> In July 2004, the Exchange began trading equity options on Phlx XL, followed by index options in December 2004. See Securities Exchange Act Release No. 50100 (July 27, 2004), 69 FR 46612 (August 3, 2004) (SR-Phlx-2003-59).

<sup>15</sup> The term "Order Flow Provider" means any member or member organization that submits, as agent, customer orders to the Exchange. See Exchange Rule 1080(l).

<sup>16</sup> The Exchange states that this is similar to previous Exchange payment for order flow programs where the payment for order flow fee was not assessed on the specialist because the specialist would be asking, in effect, for reimbursement of its own funds.

<sup>17</sup> References to ROTs include all ROTs, i.e., on-floor ROTs, SQTs, and RSQTs, other than an SQT or RSQT to whom an order is directed ("Directed ROT").

<sup>18</sup> For example, if an order is directed to an RSQT and the RSQT receives its trade allocation, after all public customers bidding or offering at the same price have received allocations, any contracts remaining from the Directed Order may be allocated to the specialist, SQTs, or RSQTs, as well as other ROTs in accordance with Exchange Rule 1014(g)(viii).

in effect, to equity option transactions between a ROT and a customer, and also to trades between a specialist and a customer when an order is directed to a Directed ROT.

For orders that are delivered electronically,<sup>19</sup> but are not directed to a Directed Participant, the specialist is not assessed a payment for order flow fee.<sup>20</sup> ROTs are assessed the applicable payment for order flow fee if the specialist participates in the Exchange's payment for order flow program.

For orders that are executed and not delivered electronically and thus not directed to a Directed Participant, such as orders represented by a floor broker, ("Non-Directed Orders"), a payment for order flow fee is assessed if the specialist or at least one Directed ROT participates in the Exchange's payment for order flow program for that option. If there are no Directed ROTs participating in the exchange's payment for order flow program, the specialist will not be billed a payment for order flow fee for that option if the specialist participates in the payment for order flow program. Also, if the specialist does not participate in the payment for order flow program and there is one Directed ROT who participates in the payment for order flow program for that option, the Directed ROT will not be charged a payment for order flow fee.<sup>21</sup>

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<sup>19</sup> The Exchange states that electronically-delivered orders do not include orders delivered through the Floor Broker Management System pursuant to Exchange Rule 1063.

<sup>20</sup> The Exchange states that this is similar to its equity options payment for order flow program in effect prior to June 2, 2005 where the payment for order flow fee was not assessed on the specialist because the specialist would be asking, in effect, for reimbursement of its own funds.

<sup>21</sup> The Exchange proposes to clarify the assessment of the payment for order flow fee for Non-Directed Orders as it appeared in the Exchange's previous filing. See supra note 10. The Exchange believes that specific examples should help to clarify when a payment for order flow fee is assessed in connection with Non-Directed Orders. Thus, for Non-Directed Orders: (1) a payment for order flow fee will be assessed on the specialist for equity option transactions between the specialist and customer if a Directed ROT participates in the Exchange's payment for order flow program in that option; (2) if the specialist does not participate in the payment for order flow program and there is one Directed ROT who participates in the payment for order flow program for that option, the

The Exchange must be notified of the election to participate or not to participate in the payment for order flow program in writing no later than five business days prior to the start of the month for which reimbursement for monies expended on payment for order flow will be requested.<sup>22</sup> The result of electing not to participate in the program is a waiver of the right to any reimbursement of payment for order flow funds for such month(s). If a specialist or Directed ROT opts into the program for all options and does not request any payment for order flow reimbursement more than two times in a six-month period, it will be precluded from entering in its entirety in the payment for order flow program for the next three months.

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Directed ROT will not be charged a payment for order flow fee; (3) a payment for order flow fee will be assessed on all ROTs, including Directed ROTs for equity option transactions between a ROT, including a Directed ROT, and a customer, if the specialist participates in the Exchange's payment for order flow program for that option, *i.e.*, if there are no Directed ROTs participating in the Exchange's payment for order flow program, the specialist who is participating in the payment for order flow program will not be billed a payment for order flow fee for that option; and (4) a payment for order flow fee will be assessed on all ROTs, except the Directed ROT, for equity option transactions between a ROT and a customer if only one Directed ROT participates in the Exchange's payment for order flow program for that option. If the specialist and at least one Directed ROT participate in the program, then the specialist, Directed ROT(s), and ROT(s) will be assessed a payment for order flow fee. Also, if a specialist does not participate in the payment for order flow program, but more than one Directed ROT participates in the payment for order flow program, then the specialist, Directed ROT(s) and ROT(s) will be assessed a payment for order flow fee. No payment for order flow fee will be assessed if the specialist and all Directed ROTs elect not to participate in the Exchange's payment for order flow program for that option.

<sup>22</sup> Specialists and Directed ROTs are required to notify the Exchange in writing to either elect to participate or not to participate in the program. Once an election to participate or not to participate in the Exchange's payment for order flow program in a particular month has been made, no notice to the Exchange is required in a subsequent month, as described above, unless there is a change in participation status. For example, if a Directed ROT elected to participate in the program and provided the Exchange with the appropriate notice, that Directed ROT 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), it would need to notify the Exchange in accordance with the requirements stated above. Specialists and Directed ROTs who have notified the Exchange in writing as to whether they elected to participate or not to

Beginning with transactions settling on or after June 2, 2005, the Exchange modified the time periods during which specialists and Directed ROTs elect to participate in the program. Specialists and Directed ROTs may elect to participate or not to participate in the payment for order flow program on an option-by-option basis if they notify the Exchange in writing no later than three business days prior to entering into or opting out of the payment for order flow program. Specialists or Directed ROTs may only opt into or out of the Exchange's payment for order flow program by option one time in any given month.

Thus, if at any time during a month, a specialist or Directed ROT opts into the payment for order flow program for a particular option, a payment for order flow fee will be assessed that month. For example, a payment for order flow fee will 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. In addition, payment for order flow fees will be assessed, even beginning mid-month, if order flow is directed to a Directed ROT who has elected to participate in the Exchange's payment for order flow program, even if the specialist to whom the option is allocated has opted out of the program, as long as the required notice is given.

The payment for order flow fee is billed and collected on a monthly basis. Because the specialists and Directed ROTs in the payment for order flow program are not charged the payment for order flow fee for orders directed to them, they may not request reimbursement for order flow funds in connection with any transactions directed to them to which they were a party.

Payment for order flow reimbursements are requested on an option-by-option basis, consistent with the payment for order flow program in effect prior to June 2, 2005. The

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participate in the program that was in effect prior to June 2, 2005 did not need to notify the Exchange again, unless there was a change from their current status.

Exchange states that the collected funds are to be used as a reimbursement 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 Exchange states that the funds will be received only after submitting an Exchange certification form identifying the amount of the requested funds.<sup>23</sup>

The Exchange further states that the amount received in reimbursement will be limited. For a specialist who elects to participate in the Exchange's payment for order flow program ("participating specialist"), the amount of reimbursement is limited to the percentage of ROT monthly volume to total participating specialist and ROT monthly volume in the equity option payment for order flow program. For a Directed ROT, the amount of reimbursement is limited to the percentage of ROT and specialist monthly volume to total ROT, specialist and that Directed ROT's monthly volume in the payment for order flow program. Payment for order flow charges are assessed and reimbursed as described in detail below:

#### Participating Specialist Method

If a participating specialist unit has a payment for order flow arrangement with an Order Flow Provider to pay that Order Flow Provider \$0.50 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 participating specialist would be required, pursuant to its agreement with the Order Flow Provider, to pay the Order Flow Provider \$45,000 for that month. Assuming that the 90,000 represents 30,000 participating specialist contracts, 30,000 ROT contracts (which includes 10,000 from Directed ROTs who, in effect, are ROTs for that order)

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<sup>23</sup> The Exchange states that specialists and Directed ROTs are given instructions as to when the certification forms are required to be submitted. 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 and Directed ROTs in the payment for order flow program, they must provide to the Exchange on an Exchange form certain information as required by the Exchange.



and 30,000 contracts from firms, broker-dealers and other customers, the participating specialist may request reimbursement of up to 50% (30,000 ROTs contracts / 60,000, which is comprised of 30,000 ROT contracts + 30,000 specialist contracts)) of the amount paid ( $\$45,000 \times 50\% = \$22,500$ ). Although the ROTs will have paid a total of  $\$30,000$  (30,000 contracts  $\times$   $\$.40$  per contract, which equals  $\$12,000$ , +  $\$18,000$  Non-Directed Orders (as calculated below)) into the payment for order flow fund for that month, the participating specialist may collect up to  $\$22,500$  of its  $\$22,500$  reimbursement request. The excess funds (funds remaining after reimbursement requests are processed, which in this instance totals  $\$7,500$  ( $\$30,000 - \$22,500$ )) for that particular month are rebated on a pro rata basis by option to all those who were billed payment for order flow charges in that option for that same month.

#### Directed ROT Method

If a Directed ROT unit has a payment for order flow arrangement with an Order Flow Provider to pay that Order Flow Provider  $\$0.60$  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 Directed ROT would be required, pursuant to its agreement with the Order Flow Provider, to pay the Order Flow Provider  $\$54,000$  for that month. Assuming that the 90,000 represents 30,000 specialist contracts, 20,000 ROT contracts, 10,000 Directed ROT contracts and 30,000 contracts from firms, broker-dealers and other customers, the Directed ROT may request reimbursement of up to 83.33% (50,000 which is comprised of 30,000 + 20,000 / 60,000, which is comprised of 30,000 + 20,000 + 10,000) of the amount paid ( $\$54,000 \times 83.33\% = \$44,998.20$ ). However, because the specialist and ROTs will have paid  $\$26,000$  (50,000 contracts  $\times$   $\$.40$  per contract, which equals  $\$20,000$ , +  $\$6,000$  from the Non-Directed transactions (as calculated below)) into the payment for order flow fund for that month, the

Directed ROT may collect only \$26,000 of its \$44,998.20 reimbursement request. If there were any excess funds for that particular month, they would be rebated on a pro rata basis by option to all those who were billed payment for order flow charges in that option for that same month.

#### Non-Directed Order Method

The Exchange states that funds billed and collected for Non-Directed Orders are apportioned on a pro rata basis among those seeking reimbursement.<sup>24</sup> For example, if Order Flow Providers send 90,000 Non-Directed customer contracts to the Exchange's trading floor via a floor broker in one month for one option in which both the specialist and Directed ROT participate in the payment for order flow program, then the specialist and ROTs (including the Directed ROT) will be billed the applicable per contract payment for order flow fee on orders matching with a customer. Thus, assuming that the 90,000 represents 30,000 specialist contracts, 30,000 ROT contracts, and 30,000 contracts from firms, broker-dealers and other customers, the Exchange will bill payment for order flow charges of \$24,000 (30,000 specialist contracts x \$0.40 per contract = \$12,000 plus 30,000 ROT contracts x \$0.40 per contract = \$12,000) on these transactions.

#### Distribution of Available Funds

Funds collected from the payment for order flow program will be available as described below. The payment for order flow funds will be collected and distributed on a pro rata basis. Each specialist and Directed ROT in the payment for order flow program has an amount from which it can request payment for order flow funds. The participating specialist fund will contain payment for order flow funds as calculated by the participating specialist reimbursement method plus payment for order flow funds allocated to it from the Non-Directed allocation method. The

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<sup>24</sup> See supra note 21 for further details regarding the Non-Directed Order method.

Directed ROT fund will contain payment for order flow funds as calculated by the Directed ROT reimbursement method plus payment for order flow funds allocated to it from the Non-Directed method.

For example, the payment for order flow funds distributed from Non-Directed Orders to specialists and Directed ROTs in the payment for order flow program would be calculated as follows: assuming the activity in the month is 300,000 contracts for which the specialist traded 150,000 contracts and the Directed ROT traded 50,000 contracts and 100,000 contracts from firms, broker-dealers, ROTs and other customers, the participating specialist fund, which includes Directed Orders and Non-Directed Orders represents 75% ( $150,000 / 150,000 + 50,000$ ) of the total Non-Directed payment for order flow charges for that option \$24,000, which totals \$18,000 ( $75\% \times \$24,000$ ) and the Directed ROT fund represents 25% ( $50,000 / 150,000 + 50,000$ ) x \$24,000) of the total Non-Directed payment for order flow charges for that option (\$6,000). Thus, the Participating specialist fund will include \$18,000 ( $75\% (150,000 / 150,000 + 50,000) \times \$24,000$ ) from the Non-Directed calculation plus \$12,000 from the participating specialist calculation above and the Directed ROT fund will include \$6,000 ( $25\% (50,000 / 150,000 + 50,000) \times \$24,000$ ) from the Non-Directed calculation plus \$20,000 from the Directed ROT calculation above. As stated above, any excess funds for that particular month will be rebated on a pro rata basis by option to all those who were billed payment for order flow charges in that option for that same month.

The Exchange states that excess funds are reflected as a credit on the monthly invoices and rebated on a pro rata, option-by-option, basis to the specialists and ROTs who were billed payment for order flow charges for that same month.

The Exchange states that reimbursements may not exceed the payment for order flow amount billed and collected in a given month.<sup>25</sup>

Proposed Equity Options Payment for Order Flow Program to be in Effect for Transactions Settling on or After July 1, 2005

The Exchanges proposes that only orders that are delivered electronically, over AUTOM, would be assessed a payment for order flow fee if the specialist has elected to opt into the payment for order flow program for that option. For those orders that are not delivered electronically, i.e., represented by a floor broker, a payment for order flow fee would no longer be assessed on those equity option transactions.<sup>26</sup>

If the specialist unit opts into the program, the Exchange would charge a payment for order flow fee of \$0.60 on all equity options traded on the Exchange that are delivered electronically over AUTOM, other than options on the QQQQ, which would be assessed a payment for order flow fee of \$0.75. FXI Options would continue to not be assessed a payment for order flow fee.

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<sup>25</sup> The Exchange states that no other changes to the Exchange's payment for order flow program were made. For example, the 500 contract cap per individual cleared side of a transaction continued to be imposed. 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). In addition, the Exchange states that it also continued to implement a quality of execution program.

<sup>26</sup> Electronically-delivered orders do not include orders delivered through the Floor Broker Management System pursuant to Exchange Rule 1063.

### Directed ROTs and ROTs

The Exchange states that, for Directed Orders received over AUTOM, the Directed ROT would elect to be assessed or not to be assessed a payment for order flow fee for orders directed to them when the specialist has elected to participate in the payment for order flow program for that option. Directed ROTs would not be able to request reimbursement for payment for order flow paid to order flow providers.

Directed ROTs would be required to notify the Exchange of the election to pay or not to pay the payment for order flow fee in writing no later than five business days prior to the start of the month for which the payment for order flow fee is to be assessed.<sup>27</sup>

However, the payment for order flow fee would be assessed on any ROT (but not the Directed ROT for that transaction when the Directed ROT has opted out of the payment for order flow program) if the ROT participates in the allocation of any remaining contracts after the Directed ROT receives its trade allocation. The Exchange states that thus, consistent with current practice, the payment for order flow fee would be applied, in effect, to equity option transactions between a ROT (and Directed ROT who has elected to be assessed a payment for

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<sup>27</sup> For the month of July 2005, Directed ROTs must notify the Exchange by close of business on July 1, 2005. Directed ROTs would be required to notify the Exchange in writing to either elect to pay the payment for order flow fee or not to pay the fee when the specialist has elected to opt into the payment for order flow program for that option. The Directed ROT would not need to notify the Exchange in writing to either elect to pay the payment for order flow fee or not to pay the fee if the specialist for that option does not participate in the Exchange's payment for order flow program. Once an election to pay the payment for order flow fee or not to pay the payment for order flow fee in a particular month has been made, no notice to the Exchange would be required in a subsequent month unless there is a change in participation status.

order flow fee) and a customer.<sup>28</sup> Equity option transactions between a customer and ROT would continue to be assessed a payment for order flow fee.

### Specialists

Specialists would not be assessed a payment for order fee.<sup>29</sup>

The Exchange states that, consistent with current practice, the Exchange would have to be notified of the election to participate or not to participate in the payment for order flow program in writing no later than five business days prior to the start of the month for which reimbursement for monies expended on payment for order flow would be requested.<sup>30</sup> The Exchange states that the result of electing not to participate in the program would be a waiver of

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<sup>28</sup> Thus, the payment for order flow fee would not be 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 would not apply to index options or foreign currency options. For purposes of the payment for order flow program, a firm is defined as a proprietary account of a member firm, and not the account of an individual member and a broker-dealer orders are orders entered from other than the floor of the Exchange, for any account (i) in which the holder of beneficial interest is a member or non-member broker-dealer or (ii) in which the holder of beneficial interest is a person associated with or employed by a member or non-member broker-dealer. This includes orders for the account of an ROT entered from off-the-floor.

<sup>29</sup> For purposes of this filing and assessing payment for order flow fees, the Exchange does not differentiate between specialists and specialists who receive Directed Orders.

<sup>30</sup> The Exchange states that, consistent with the current practice, specialists would be required to notify the Exchange in writing to either elect to participate or not to participate in the program. Once an election to participate or not to participate in the Exchange's payment for order flow program in a particular month has been made, no notice to the Exchange is required in a subsequent month, as described above, unless there is a change in participation status. For example, if a specialist elected to participate in the program and provided the Exchange with the appropriate notice, that specialist 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), it would need to notify the Exchange in accordance with the requirements stated above. Specialists who have already notified the Exchange in writing as to whether they have elected to participate or not to participate in the program that was in effect prior to July 1, 2005 do not need to notify the Exchange again, unless there is a change from their current status.

the right to any reimbursement of payment for order flow funds for such month(s). If a specialist opts in its entirety into the program and does not request any payment for order flow reimbursement more than two times in a six-month period, it would be precluded from entering in its entirety in the payment for order flow program for the next three months.

Specialists would also be able to elect to participate or not to participate in the payment for order flow program on an option-by-option basis if they notify the Exchange in writing no later than three business days prior to entering into or opting out of the payment for order flow program. Specialists may only opt into or out of the Exchange's payment for order flow program by option one time in any given month.

Thus, if at any time during a month, a specialist opts into the payment for order flow program for a particular option, a payment for order flow fee would be assessed for that portion of the month. For example, 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.

Payment for order flow charges apply to ROTs or Directed ROTs that have elected to be assessed the payment for order flow fee as long as the specialist unit for that option has elected to participate in the Exchange's payment for order flow program.

The payment for order flow fee would continue to be billed and collected on a monthly basis. Because the specialists would not be charged the payment for order flow fee, they may not request reimbursement for order flow funds in connection with any transactions to which they were a party.

The Exchange states that specialists would request payment for order flow reimbursements on an option-by-option basis, consistent with the current practice. The

Exchange further states that the collected funds are to be used by each specialist as a reimbursement for monies expended to attract options orders to the Exchange by making payments to Order Flow Providers who provide order flow to the Exchange. Specialists would receive their respective funds only after submitting an Exchange certification form identifying the amount of the requested funds.<sup>31</sup>

The amount a specialist may receive in reimbursement would be limited. For a specialist who has elected to participate in the Exchange's payment for order flow program for electronically delivered orders, the amount of reimbursement would be limited to the percentage of ROT and Directed ROT monthly volume to total participating specialist, Directed ROT, and ROT monthly volume in the equity option payment for order flow program.

#### Specialist Calculation

Funds collected from the payment for order flow program would be available to the specialist participating in the payment for order flow program as described below:

If a specialist unit in the payment for order flow program has a payment for order flow arrangement with various Order Flow Providers to pay the Order Flow Providers \$0.50 per contract for order flow routed to the Exchange, including for order flow sent to Directed ROTs, and those Order Flow Providers send 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 Providers, to pay the Order Flow Providers \$45,000 for that month. Assuming that the

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<sup>31</sup> The Exchange states that, consistent with the current practice regarding specialist units, specialists would be given instructions as to when the certification forms are required to be submitted. While all determinations concerning the amount that would be paid for orders and which order flow providers shall receive these payments are made by the specialists, the specialists would provide to the Exchange on an Exchange form certain information as required by the Exchange, which may include what firms they paid for order flow, the amount of the payment and the price paid per contract.



90,000 represents 30,000 specialist contracts, 30,000 total ROT and Directed ROT<sup>32</sup> contracts (comprised of 10,000 ROT contracts, 10,000 Directed ROT "A" contracts, 7,000 Directed ROT "B" contracts, and 3,000 Directed ROT "C" contracts), and 30,000 contracts from firms, broker-dealers and other customers, the specialist would be able to request reimbursement of up to 50% (30,000 ROT and Directed ROT contracts / 60,000, which is comprised of 30,000 ROT and Directed ROT contracts + 30,000 specialist contracts) of the amount paid ( $\$45,000 \times 50\% = \$22,500$ ). Because the ROTs and Directed ROTs would have paid a total of  $\$18,000$  (30,000 contracts  $\times$   $\$.60$  per contract) into the payment for order flow fund for that month, the specialist may collect up to  $\$18,000$  of its  $\$22,500$  reimbursement request.

Assuming, however, that Directed ROT "B" elects not to be assessed a payment for order flow fee and has notified the Exchange pursuant to the requirements set forth above, then the specialist would be obligated to pay for 83,000 contracts (or  $\$41,500$  (83,000  $\times$   $\$.50$  per contract)). The ROTs and Directed ROTs "A" and "C" would have paid  $\$13,800$  (23,000 contracts  $\times$   $\$.60$  per contract) into the payment for order flow fund for that option for that month. Thus, the amount the specialist would be able to collect is up to  $\$13,800$  of its  $\$20,750$  ( $\$41,500 \times 50\%$ ) reimbursement request.

If all Directed ROTs have notified the Exchange that they elect not to be assessed a payment for order flow fee in the above-referenced example, then the specialist would be obligated to pay for 70,000 contracts (or  $\$35,000$  (70,000  $\times$   $\$.50$  per contract)). The ROTs would have paid  $\$6,000$  (10,000 contracts  $\times$   $\$.60$  per contract) into the payment for order flow

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<sup>32</sup> For purposes of this example, the Directed ROTs have elected to be assessed the payment for order flow fee by notifying the Exchange in writing, consistent with the notification requirements previously discussed.

fund for that option for that month. Thus, the amount the specialist may collect is up to \$6,000 of its \$17,500 (\$35,000 x 50%) reimbursement request.

The Exchange states that, consistent with current practice, any excess funds (funds remaining after reimbursement requests are processed) for a particular month that are not requested by the participating specialist would be returned to the ROTs and Directed ROTs (who have opted to pay the payment for order flow fee) by option who have been charged payment for order flow fees. The excess funds would be reflected as a credit on the monthly invoices and rebated on a pro rata, option-by-option, basis to the ROTs and Directed ROTs who were billed payment for order flow charges for that same month.

The Exchange states that participating specialists would not be able to receive more than the payment for order flow amount billed and collected in a given month.

In addition, a 500-contract cap per individual cleared side of a transaction would continue to be imposed. The Exchange states that it would also continue to implement a quality of execution program. Further, the Exchange may audit a specialist's payments to Order Flow Providers to verify the use and accuracy of the payment for order flow funds remitted to the specialists based on their certification form.<sup>33</sup>

This proposal would be in effect for trades settling on or after July 1, 2005 and would remain in effect as a pilot program that is scheduled to expire on May 27, 2006, the same date as the one-year pilot program in effect in connection with Directed Orders.<sup>34</sup>

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<sup>33</sup> See Exchange Rule 760.

<sup>34</sup> See supra note 8.

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

\* \* \* \* \*

**SUMMARY OF EQUITY OPTION CHARGES (p. 3/6)**

For any top 120 option listed after February 1, 2004 and for any top 120 option acquired by a new specialist unit\*\* within the first 60-days of operations, the following thresholds will apply, with a cap of \$10,000 for the first 4 full months of trading per month per option provided that the total monthly market share effected on the Phlx in that top 120 Option is equal to or greater than 50% of the volume threshold in effect:

|   |                           |
|---|---------------------------|
| First full month of trading:                  | 0% national market share  |
| Second full month of trading:                 | 3% national market share  |
| Third full month of trading:                  | 6% national market share  |
| Fourth full month of trading:                 | 9% national market share  |
| Fifth full month of trading (and thereafter): | 12% national market share |

\*\* A new specialist unit is one that is approved to operate as a specialist unit by the Options Allocation, Evaluation, and Securities Committee on or after February 1, 2004 and is a specialist unit that is not currently affiliated with an existing options specialist unit as reported on the member organization's Form BD, which refers to direct and indirect owners, or as reported in connection with any other financial arrangement, such as is required by Exchange Rule 783.

**REAL-TIME RISK MANAGEMENT FEE**

\$.0025 per contract for firms/members receiving information on a real-time basis

**EQUITY OPTION PAYMENT FOR ORDER FLOW FEES\*(1) (2)**

Registered Option Trader\*\*+

|  |                                     |
|--|-------------------------------------|
| QQQ (NASDAQ-100 Index Tracking Stock <sup>SM</sup> ) | [\$1.00] <u>\$0.75</u> per contract |
| Remaining Equity Options, except FXI Options         | [\$0.40] <u>\$0.60</u> per contract |

See Appendix A for additional fees.

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

\*\* Any excess payment for order flow funds billed but not reimbursed to specialists will be returned to the applicable ROTs and Directed ROTs who have elected to be assessed a payment for order flow fee (reflected as a credit on the monthly invoices) and distributed on a pro rata basis.

+ Only incurred when the specialist [or Directed ROT] elects to participate in the payment for order flow program.

(1) For orders delivered electronically: [(a)] Assessed on ROTs [and Directed ROTs] when the specialist unit opts into the program. ROTs who receive Directed Orders may elect to be assessed the payment for order flow fee on customer orders directed to and executed by them ; (b) assessed on specialists and ROTs when a Directed ROT opts into the program]

(2) No payment for order flow fees will be assessed on orders that are not delivered electronically [For orders not delivered electronically, the above-referenced fees are assessed on all ROTs, including Directed ROTs, and specialists if two or more specialist/ROTs have elected to participate in the Exchange's payment for order flow program.]

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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, as amended. 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 Exchange represents that the purpose of the proposal, as amended, is to adopt a competitive Exchange payment for order flow program. Payment for order flow programs are in place at each of the other options exchanges in varying amounts and covering various options. The Exchange states that the funds generated by the Exchange's payment for order flow fee are intended to be used to reimburse specialists for order flow payments made to order flow providers for equity options delivered to the Exchange or when Directed ROTs elect to be charged a payment for order flow fee, the specialists, based on the Exchange's understanding, may make the payment for order flow payment to the Order Flow Provider on behalf of the Directed ROT. The Exchange believes that this proposal should also allow Directed ROTs to make arrangements with Order Flow Providers who do not accept payment for order flow. 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.

In making these proposed modifications to the Exchange's payment for order flow program, the Exchange believes that the modified program would better facilitate both specialists' and Directed ROTs' existing business relationships with Order Flow Providers, while minimizing the existing administrative burdens on both the specialists and Directed ROTs and the Exchange. Additionally, the Exchange believes that the proposed program would simplify the reimbursement process by having only one reimbursement request processed for each equity option, rather than the multiple requests under the previous program and, when Directed ROTs

elect to be charged a payment for order flow fee, by having consolidated payments to Order Flow Providers.

## 2. Statutory Basis

The Exchange believes that its proposal, as amended, is consistent with Section 6(b) of the Act<sup>35</sup> in general, and furthers the objectives of Sections 6(b)(4) and 6(b)(5) of the Act<sup>36</sup> in particular, in that it is designed to provide for the equitable allocation of reasonable dues, fees, and other charges among the Phlx's members and is designed to enable the Exchange to compete with other markets in attracting customer order flow. Because the Exchange payment for order flow fees are collected only from member organizations respecting customer transactions delivered electronically, the Phlx believes that there is a direct and fair correlation between those members who fund the payment for order flow fee program and those who receive the benefits of the Exchange program. The Exchange believes that participating specialists, Directed ROTs, and ROTs potentially benefit from additional customer order flow. In addition, the Phlx believes that the proposed Exchange 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>37</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 Exchange believes that attracting more order flow to the Exchange, should, in turn, result in increased liquidity, tighter markets, and more competition among Exchange members.

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<sup>35</sup> 15 U.S.C. 78f(b).

<sup>36</sup> 15 U.S.C. 78f(b)(4)-(5).

<sup>37</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, 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

The foregoing proposed rule change, as amended, has been designated as a fee change pursuant to Section 19(b)(3)(A)(ii) of the Act<sup>38</sup> and Rule 19b-4(f)(2)<sup>39</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.<sup>40</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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<sup>38</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>39</sup> 17 CFR 240.19b-4(f)(2).

<sup>40</sup> The effective date of the original proposed rule change is July 1, 2005, the effective date of Amendment No. 1 is July 20, 2005, and the effective date of Amendment No. 2 is July 21, 2005. For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposal, the Commission considers the period to commence on July 21, 2005, the date on which the Exchange submitted Amendment No. 2.

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-2005-44 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-2005-44. 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, as amended, 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-2005-44 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>41</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>41</sup> 17 CFR 200.30-3(a)(12).