

2. Statutory Basis

The Exchange believes that the proposed rule change, as amended, is consistent with section 6(b) of the Act,⁹ in general, and furthers the objectives of section 6(b)(5),¹⁰ in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, enhance competition and to protect investors and the public interest.

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 burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

Written comments were neither solicited nor received.

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

The proposed rule change has been filed by the Exchange as a "non-controversial" rule change pursuant to section 19(b)(3)(A) of the Act¹¹ and rule 19b-4(f)(6) thereunder.¹² Because the foregoing proposed rule change, as amended: (1) Does not significantly affect the protection of investors or the public interest, (2) does not impose any significant burden on competition, and (3) by its terms does not become operative for 30 days after the date of this filing, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest, provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as the Commission may designate, it has become effective pursuant to section 19(b)(3)(A) of the Act¹³ and rule 19b-4(f)(6)¹⁴ thereunder.

The Exchange has requested that the Commission waive the 30-day operative delay requirement, to permit the Exchange to implement the proposal

immediately. Under rule 19b-4(f)(6)(iii), a proposed "non-controversial" rule change does not become operative for 30 days after the date of filing, unless the Commission designates a shorter time.

The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest. Acceleration of the operative date will allow for the continued operation of PCX's Auto-Ex Incentive Pilot Program without interruption.¹⁵ For this reason, the Commission designates the proposed rule change to be effective and operative upon its filing with the Commission. 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.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to the File No. SR-PCX-2002-78 and should be submitted by January 23, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Margaret H. McFarland,

Deputy Secretary.

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¹⁵ For the purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rules impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁶ 17 CFR 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47090; File No. SR-Phlx-2002-75]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto by the Philadelphia Stock Exchange, Inc. Relating to Its Payment for Order Flow Program

December 23, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹, and Rule 19b-4 thereunder,² notice is hereby given that on November 15, 2002, the Philadelphia Stock Exchange, Inc. ("Phlx") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III, below, which the Phlx has prepared. On December 23, 2002, the Phlx filed Amendment No. 1 to the proposed rule change, which replaced the original filing in its entirety. The Commission is publishing this notice to solicit comments from interested persons on the proposed rule change, as amended.

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

The Phlx proposes to amend its schedule of dues, fees, and charges to reinstate an options payment for order flow program. The text of the proposed rule change is available at the principal offices of the Phlx and at the Commission.

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

In its filing with the Commission, the Phlx included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it had received. The text of these statements may be examined at the places specified in Item IV below. The Phlx has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

The purpose of the proposed rule change is to generate a source of

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ 15 U.S.C. 78s(b)(3)(A).

¹² 17 CFR 240.19b-4(f)(6).

¹³ 15 U.S.C. 78s(b)(3)(A).

¹⁴ 17 CFR 240.19b-4(f)(6).

revenue that specialists may use to attract order flow to the Phlx, and to maintain and enhance the Phlx's competitive position. The Phlx notes that two other options exchanges currently have payment for order flow programs.³

The Phlx first instituted a payment for order flow fee in August 2000, imposing a \$1.00 per contract fee, with some exceptions, on transactions of Phlx specialists and ROTs in the top 120 options on the Phlx.⁴ The top 120 options were the 120 most actively traded equity options, based on national trading volume. The Phlx recalculated the list of top 120 options every six months, based on volume information that the Options Clearing Corporation provided.⁵ The payment for order flow fee did not apply to index or foreign currency options. The Phlx later suspended the imposition of payment for order flow fees.⁶

The Phlx is now proposing to impose a payment for order flow fee, per-contract, per-issue, on the transactions of Phlx Registered Options Traders ("ROTs"),⁷ as set forth in the Phlx's ROT Equity Option Payment for Order Flow Charges Schedule and subject to the exceptions listed below. The fee would be assessed on ROTs on the top 120 most actively traded equity options in terms of the total number of contracts that are traded nationally, based on volume statistics provided by the

³ The Phlx states that two other options exchanges currently have payment for order flow programs. See Securities Exchange Act Release Nos. 46485 (September 10, 2002), 67 FR 58668 (September 17, 2002) (SR-PCX-2002-59); and 45857 (May 1, 2002), 67 FR 30988 (May 8, 2002) (SR-ISE-2002-12).

⁴ See Securities Exchange Act Release No. 43177 (August 18, 2000), 65 FR 51889 (August 25, 2000) (SR-Phlx-00-77). Transactions in top 120 options that were excepted from the \$1.00 fee were transactions between: (1) a specialist and a ROT; (2) a ROT and a ROT; (3) a specialist and a firm; (4) a ROT and a firm; (5) a specialist and a broker-dealer; and (6) a ROT and a broker-dealer. See Securities Exchange Act Release Nos. 43177 (August 18, 2000), 65 FR 51889 (August 25, 2000) (SR-Phlx-00-77); 43480 (October 25, 2000), 65 FR 66275 (November 3, 2000) (SR-Phlx-00-86 and SR-Phlx-00-87); and 43481 (October 25, 2000), 65 FR 66277 (November 3, 2000) (SR-Phlx-00-88 and SR-Phlx-00-89).

⁵ For the period from April 2, 2001 through June 30, 2001, there was a total of 121 Options on the Exchange's list of the top 120 options when the QQQ options were added to the Exchange's payment for order flow fee program prior to the next six-month measuring period. See Securities Exchange Act Release No. 44237 (April 30, 2001), 66 FR 23308 (May 8, 2001) (SR-Phlx-2001-43).

⁶ See Securities Exchange Act Release No. 44716 (August 16, 2001), 66 FR 44393 (August 23, 2001) (SR-Phlx-2001-73).

⁷ ROT transactions include those identified as "on-floor ROT orders" entered through a hand-held device for execution on the Phlx trading floor. See Phlx Rule 1080.

Options Clearing Corporation.⁸ Initially, for trade months November, December, and January, the payment for order flow fee assessed on ROTs would be \$1.00 on the top-ranked option, the Nasdaq-100 Index Tracking StockSM (which trades under the symbol "QQQ").⁹ The fee on the next 49 options would be \$0.50, and the remaining top 120 options would be assessed \$0.00.¹⁰ After the January 2003 trade month, the Chairman of the Phlx would establish the fees in \$0.05 increments after receiving recommendations from a payment for order flow subcommittee of the Finance Committee and a payment for order flow subcommittee of the Options Committee.¹¹

In its original proposal, filed with the Commission on November 15, 2002, the Phlx proposed to impose a 500-contract cap per individual cleared side of a transaction. In this Amendment No. 1, which replaces the original filing in its entirety, the Phlx proposes to remove the 500 contract cap after December 31, 2002. Accordingly, the 500 contract cap would be in effect for trades executed on or after November 18, 2002 and settling through December 31, 2002. The Phlx believes that keeping the contract cap through December 31, 2002 should minimize member confusion as to the

⁸ The measuring periods for the top 120 options would be calculated every three months. For example, for trade months November, December, and January, the measuring period to determine the top 120 options would be based on volume statistics from July, August, and September. The subsequent measuring period would be October, November, and December for trade months February, March, and April. This cycle would continue every three months. Members would be notified of the top 120 options and applicable fees approximately two weeks before the beginning of a new three-month trading period.

⁹ The Nasdaq-100[®], Nasdaq-100 Index[®], Nasdaq[®], The Nasdaq Stock Market[®], Nasdaq-100 SharesSM, Nasdaq-100 TrustSM, Nasdaq-100 Index Tracking StockSM, and QQQSM 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[®] (the Index) is determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 TrustSM, or the beneficial owners of Nasdaq-100 SharesSM. The Phlx represents that Nasdaq has complete control and sole discretion in determining or calculating the Index or in modifying in any way its method for determining or calculating the Index in the future.

¹⁰ To avoid confusion, the ROT Equity Option Payment for Order Flow Charges Schedule reflects only those options being charged more than \$0.00.

¹¹ The Phlx will file with the Commission a proposed rule change addressed to any changes in its fee schedule. The subcommittees and Chairman of the Phlx may take into account the following factors when setting payment for order flow rates: (1) Trading volume per issue; (2) Phlx market share per option; (3) disposition of previous payment for order flow fees collected; (4) relative size of the trading crowd; and (5) other such information as deemed necessary.

applicable date for the contract cap and will avoid making costly changes to the billing system for the last six trading days of the month of December. The Phlx intends to file a separate proposal pursuant to Section 19(b)(2) of the Act to impose the 500 contract cap for trades settling on or after January 2, 2003.

The proposed payment for order flow fee would not apply to transactions between: (1) A specialist and a ROT; (2) a ROT and a ROT; (3) a ROT and a firm;¹² and (4) a ROT and a broker-dealer.¹³ The Phlx continues to believe that these are not the transactions the fee is designed to attract. Indeed, because the primary focus of the program is to attract order flow from customers, the proposed fee would not be imposed on the above-specified transactions. The payment for order flow fee would also not apply to index or foreign currency options.

The Phlx would bill and collect the fee on a monthly basis and account for the funds received from the ROTs by option. The specialist units would be able to use the funds collected in relation to a given option to make payments to order flow providers for the purpose of attracting options orders to the Phlx.¹⁴ The specialist units for each option would establish the amounts to be paid to order flow providers in respect of order flow for that option. The specialist units would receive these funds after submitting a Phlx form identifying the amount of the requested funds.¹⁵ Because the specialist units are not being charged the payment for order flow fee for their own transactions, they may not request reimbursement or payment for order flow funds in

¹² For purposes of this filing, a firm is defined as a proprietary account of a member firm, and not the account of an individual member. Therefore, if a ROT trades with a member firm that was effecting trades for its proprietary account and not on behalf of customers, the payment for order flow fee would not apply.

¹³ For purposes of this filing, broker-dealer orders are orders, entered from other than the floor of the Phlx, 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.

¹⁴ The Phlx is using the terms "specialist" and "specialist unit" interchangeably here.

¹⁵ The purpose of the form is to assist the Phlx in accurately accounting for and tracking funds transferred to specialists consistent with normal bookkeeping and auditing practices. The specialists will certify on the form that the funds requested and received are used to reimburse the specialist for payments made in connection with attracting order flow to the Phlx, consistent with this filing. However, as discussed below, all determinations concerning the amount that will be paid for orders and which order flow providers shall receive these payments will be made by specialists.

connection with any transactions to which they were a party.

Under the Phlx's proposed payment for order flow program, specialists would request reimbursement for funds that they have paid to order flow providers for order flow. Under the Phlx's original payment for order flow program, both specialists and ROTs paid the payment for order flow fee and then were reimbursed these funds at a later date.¹⁶ Under that program, the specialist both expended funds to pay for order flow and also paid into the payment for order flow pool by paying the payment for order flow fee, only to request reimbursement at a later date, thereby reimbursing themselves, in part, for funds collected from themselves. The Phlx believes that this resulted in an unfair and unnecessary burden on specialists because they expended funds twice, until they were able to claim reimbursement.

Under the proposed program, the Phlx would not charge the specialists the payment for order flow. The Phlx believes that the proposed program would achieve an economic effect similar to the old program, without the financial burden on specialists. Under the terms of the proposed program, specialists may request reimbursement for payment for order flow funds in connection with any transactions to which they were not a party, based on the percentage of ROT monthly volume to total specialist and ROT monthly volume. For example, if the monthly volume in an option to which the specialist was a party was 100,000 contracts and the monthly volume in that same option to which ROTs were a party was 75,000 contracts, the specialist may receive up to 43 percent of the total requested reimbursement amount (75,000/175,000). This amount may be further limited by the amount collected in the payment for order flow pool for that option, as specialists may not receive more than the amount collected from the ROTs. The Phlx believes that this methodology should help to ensure that ROTs are not unfairly burdened by paying the payment for order flow fee.

In the proposed program, the specialists would make all determinations concerning the amount to be paid for orders and the order flow providers that should receive the payments. The specialists would account to the Phlx for the use they make of the funds. The Phlx believes that this would help it to determine the

effectiveness of the proposed fee. In addition, the Phlx would provide certain administrative duties to assist the specialists, including keeping track of the number of qualified transactions¹⁷ that firms execute on the Phlx and performing any necessary accounting functions.

In addition, in connection with its payment for order flow program, the Phlx intends to rebate to ROTs, on a monthly basis, the amount of payment for order flow fees that the specialists have not requested for use in paying order flow providers.¹⁸ The amount to be refunded to each ROT would be based on the percentage of the total payment for order flow charges the ROT paid for each option during the rebate time period. The ROTs percentage of the total payment for order flow charges for each option would then be multiplied by the rebate amount. For example, if a ROT contributed 5% of the total payment for order flow charges for a particular option during the rebate time period, the ROT would receive 5% of that option's overall rebate amount for that month.

The Phlx will continue to implement a quality of execution program.¹⁹ Any changes to the options to which this proposed fee applies, to the rate or rates at which the fee is assessed, or to the Phlx's disposition of funds generated by the fee will be the subject of separate filings with the Commission. The Phlx intends to implement the payment for order flow fee for trades executed on and after November 18, 2002.²⁰

2. Statutory Basis

The Phlx believes that its proposal to amend its schedule of dues, fees, and charges is an equitable allocation of reasonable fees among Phlx members consistent with Section 6(b) of the Act²¹ and furthers the objectives of Sections 6(b)(4) and 6(b)(5) of the Act.²² The Phlx believes that the ROTs paying the proposed payment for order flow fee will also receive the benefits of increased order flow. Moreover, the Phlx believes that attracting more order

flow to the Phlx should result in increased liquidity, tighter markets, and more competition among exchange members, and thereby serve to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market, and protect investors and the public interest, consistent with Section 6(b)(5) of the Act.²³

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

The Phlx 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

The Phlx received a petition signed by various Phlx members who requested a formal vote of the Phlx Board of Governors on the appropriateness of implementing "payment for order flow" and "urge[d] the Board of Governors to vote against such implementation."²⁴ As stated above, the Executive Committee, pursuant to delegated authority, authorized the filing of this proposed rule change.

The Phlx also received a letter from a Phlx member who questioned the procedures relating to the accounting by specialists for the funds that they receive from the Phlx, including that this information is not publicly available, and the possible appearance that one group of members is being favored over another group.²⁵ The Phlx believes that its accounting and certification procedures as discussed herein are necessary and appropriate and that the individual relationships between the specialists and order flow providers should remain confidential in order to preserve the integrity of the contractual business relationship between those parties. In addition, the Phlx believes that the proposed fee is an equitable allocation of fees among Phlx ROTs because the ROTs paying the payment for order flow fee should also receive the benefits of increased order flow. Also, specialists are not allowed to request reimbursement for payment for order flow funds in connection with any transactions to which they were a party.

The Phlx states that it has been and continues to be a vocal opponent to any exchange-sponsored payment for order flow programs. The Phlx believes,

²³ 15 U.S.C. 78f(b)(5).

²⁴ Petition from Phlx members to the Chairman and the Board of Governors of the Phlx, dated October 2002.

²⁵ Correspondence from Gary R. Smolen to Meyer S. Frucher, dated November 12, 2002.

¹⁶ See Securities Exchange Act Release No. 43177 (August 18, 2000), 65 FR 51889 (August 25, 2000) (SR-Phlx-00-77).

¹⁷ The term "qualified transactions" refers to transactions by ROTs on which a payment for order flow fee is assessed.

¹⁸ The Phlx will not rebate more than the amount that has actually been collected from the ROTs.

¹⁹ See e.g., Securities Exchange Act Release No. 43436 (October 11, 2000), 65 FR 63281 (October 23, 2000) (SR-Phlx-2000-83).

²⁰ This fee is not eligible for the monthly credit of up to \$1,000 to be applied against certain fees, dues, and charges and other amounts that certain members owe to the Phlx. See Securities Exchange Act Release No. 44292 (May 11, 2001), 66 FR 27715 (May 18, 2001) (SR-Phlx-2001-49).

²¹ 15 U.S.C. 78f(b).

²² 15 U.S.C. 78f(b)(4) and 78f(b)(5).

however, that it must reinstate a payment for order flow program to remain competitive. As previously discussed, two exchanges currently have a payment for order flow program.

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

The Phlx has designated the proposal as changing a Phlx due, fee, or other charge. Accordingly, the proposed rule change, as amended, has become immediately effective upon filing with the Commission pursuant to Section 19(b)(3)(A)(ii) of the Act²⁶ and Rule 19b-4(f)(2) thereunder.²⁷ At any time within 60 days after the filing of Amendment No. 1 to the proposed rule change, the Commission may summarily abrogate the proposed rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. 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 will also be available for inspection and copying at the principal office of the Phlx. All submissions should refer to File No. SR-Phlx-2002-75 and should be submitted by January 23, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁸

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47086; File No. SR-Phlx-2002-81]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Index Option Charges

December 23, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

SUMMARY OF EQUITY OPTION CHARGES

Option Comparison Charge I (applicable to all trades—except specialist trades):

Registered Option Trader	\$.03 per contract.
Firm/Proprietary ⁶	\$.04 per contract.
Customer Executions	No charge.

Option Transaction Charge I:

Customer Executions	No charge.
Firm/Proprietary ⁷	\$.15 per contract.
Firm/Proprietary Facilitation Transaction ⁸	\$.08 per contract.
Registered Option Trader (on-floor)	\$.16 per contract.
Specialist	\$.18 per contract.
Broker/Dealer ⁹	\$.35 per contract.

Option Floor Brokerage Assessment I [5% of net floor brokerage income.]

Monthly Net Floor Brokerage Income:

First \$0—\$300,000	5.5%	<i>Assessment</i>
Next \$300,001—\$500,000	6.5% (excess over \$300,000).	
Balance—Over \$500,001	7.5% (excess over \$500,000).	

(“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 18, 2002, 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. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to amend its schedule of dues, fees and charges to increase the Options Floor Brokerage Assessment Fee (“Assessment Fee”) from 5% of a firm's monthly net floor brokerage income³ to a tiered rate ranging from 5.5% to 7.5% of a firm's monthly net floor brokerage income, and to institute a monthly \$100,000 cap on such assessment fee.⁴ The revised Assessment Fee is scheduled to be implemented respecting transactions settling on or after January 2, 2003.⁵ The text of the proposed rule change is set forth below. New text is in italics. Deleted text is in brackets.

²⁶ 15 U.S.C. 78(s)(b)(3)(A)(ii).

²⁷ 17 CFR 240.19b-4(f)(2).

²⁸ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Floor Brokerage Transaction Fee (for both Equity and Index Options) will continue to apply to floor brokers executing transactions for their own member firms.

⁴ See Exchange Rules 714 and 715.

⁵ The Assessment Fee will continue to be eligible for the monthly credit of up to \$1,000 to be applied against certain fees, dues and charges and other amounts owed to the Exchange by certain members. See Securities Exchange Act Release No. 44292 (May 11, 2001), 66 FR 27715 (May 18, 2001) (SR-Phlx-2001-49).