

Accelerating the operative date will allow the PCX to immediately implement rules similar to ones already in place at the American Stock Exchange LLC and the International Securities Exchange, Inc.,<sup>22</sup> and will simplify and clarify the process by which Members and Member Organizations accept exercise decisions from options holders and submit such decisions to the Exchange. For these reasons, the Commission designates the proposed rule change as effective and operative immediately. At any time within 60 days of the filing of the proposed rule change, as amended, the Commission may summarily abrogate such 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.<sup>23</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. 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 such filing will also be available for inspection and copying at the principal office of the PCX. All submissions should refer to File No. SR-PCX-2003-47 and should be submitted by November 13, 2003.

efficiency, competition, and capital formation.15 U.S.C. 78c(f).

<sup>22</sup> See Securities Exchange Act Release No. 47885 (May 16, 2003), 68 FR 28309 (May 23, 2003) (SR-Amex-2001-92) and 48505 (September 17, 2003), 68 FR 55680 (September 26, 2003) (SR-ISE-2003-20).

<sup>23</sup> For purposes of calculating the sixty-day abrogation period, the Commission considers the period to commence on October 9, 2003, the date at which the Exchange filed Amendment No. 2.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>24</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48648; File No. SR-Phlx-2003-37]

### Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. to Delete the Prohibition Against the Delivery of Electronically Generated Orders Via AUTOM

October 16, 2003.

#### I. Introduction

On May 19, 2003, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission"), 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> a proposed rule change to delete Phlx Rule 1080(i) ("Rule"), which prohibits the delivery of electronically generated orders via Phlx's AUTOM system. Notice of the proposed rule change was published for comment in the **Federal Register** on June 11, 2003.<sup>3</sup> The Commission received two comments regarding the proposal—one from Interactive Brokers Group LLC ("IB") supporting the proposal ("IB Letter"), and the other from Susquehanna International Group LLP ("SIG") opposing the proposal ("SIG Letter")<sup>4</sup>. The Phlx submitted a response to the SIG Letter ("Phlx Response").<sup>5</sup>

This order approves the proposed rule change.

#### II. Description of the Proposal

The Exchange is proposing to delete the Rule, which prohibits the delivery of electronically generated orders, *i.e.*, orders that were created and

communicated electronically without manual input,<sup>6</sup> via AUTOM.<sup>7</sup> According to the Exchange, it has enhanced its AUTOM and AUTO-X systems so that the concerns the Rule was intended to address have been minimized. For example, the Exchange modified its Auto-Quote<sup>8</sup> system to enable the Exchange to disseminate a firm quotation size of at least the sum of limit orders at the Exchange's disseminated price.<sup>9</sup> The Exchange has also expanded the order types<sup>10</sup> and delivery sizes<sup>11</sup> eligible for AUTOM delivery and automatic execution via AUTO-X.

#### III. Summary of Comments and Phlx's Response

##### 1. IB Letter

In its letter supporting the proposal, IB urged the Commission to approve the proposal because IB believes the Rule

<sup>6</sup> Specifically, the Rule required order entry to involve manual input such as entering the terms of the order into an order-entry screen or manually selecting a displayed order against which the off-setting order should be sent.

<sup>7</sup> 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. Orders delivered through AUTOM may be executed manually, and certain orders are eligible for AUTOM's automatic execution feature, AUTO-X. Equity option and index option specialists are required by the Exchange to participate in AUTOM. Option orders entered by Exchange members into AUTOM are routed to the appropriate specialist unit on the Exchange trading floor.

<sup>8</sup> Auto-Quote is the Exchange's electronic options pricing system, which enables specialists to automatically monitor and instantly update quotations.

<sup>9</sup> See Securities Exchange Act Release No. 46325 (August 8, 2002), 67 FR 53376 (August 15, 2002) (SR-Phlx-2002-15).

<sup>10</sup> In October 2002, the Commission permanently approved an Exchange pilot that allowed orders for the account(s) of broker-dealers to be delivered via AUTOM, and to be eligible for automatic execution via AUTO-X. See Securities Exchange Act Release No. 46660 (October 15, 2002), 67 FR 64951 (October 22, 2002) (SR-Phlx-2002-50). The Exchange then adopted rules providing for automatic executions for eligible orders at the Exchange's disseminated size, subject to a minimum and maximum eligible size range to be determined by the specialist, on an issue-by-issue basis. See Securities Exchange Act Release No. 46886 (November 22, 2002), 67 FR 72015 (December 3, 2002) (SR-Phlx-2002-39). Most recently, the Exchange adopted rules providing an equal firm quotation size and equal AUTO-X guaranteed size for both customer and broker-dealer orders. See Securities Exchange Act Release No. 47646 (April 8, 2003), 68 FR 17976 (April 14, 2003) (SR-Phlx-2003-18).

<sup>11</sup> In March 2003, the Exchange adopted rules to increase the eligible AUTOM order delivery size for off-floor broker-dealer orders from 200 contracts to 1,000 contracts for all options. At the same time, the Exchange determined to allow delivery of Immediate or Cancel orders via AUTOM. See Securities Exchange Act Release No. 47543 (March 20, 2003), 68 FR 14737 (March 26, 2003) (SR-Phlx-2003-11).

<sup>24</sup> 17 CFR 200.30-3(a)(29).

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

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

<sup>3</sup> Securities Exchange Act Release No. 47977 (June 4, 2003), 68 FR 35049.

<sup>4</sup> See letters to Jonathan G. Katz, Secretary, SEC, from David M. Battan, Vice President and General Counsel, IB, dated July 22, 2003; and Gerald D. O'Connell, Director of Compliance, SIG, dated July 9, 2003.

<sup>5</sup> See letter from Richard S. Rudolph, Director and Counsel, Phlx, to Jonathan G. Katz, Secretary, SEC, dated October 6, 2003.

“hinders the public’s access to the Exchange and serves only to protect those market participants who have not invested the proper time and capital to ensure that their trading systems are sufficiently robust and advanced.” IB also expressed the view that the Rule is difficult and expensive to enforce, and encourages traders to insert manual steps in their trading processes that increase the chance of error. IB concluded that removal of the Rule will enable customers to post competitive limit orders more quickly; force specialists to upgrade their operations and update prices faster; and thus improve the quality of the options National Best Bid and Offer (“NBBO”) and enhance the linkage system.

## 2. SIG Letter

In its letter opposing the proposal, SIG stated that the concerns and conditions that prompted adoption of the Rule have not changed. SIG contended that removal of the Rule will “unfairly place specialists at a competitive disadvantage [vis-a-vis] professional customers and broker-dealers who generate and send orders electronically.” Further, SIG expressed the view that adoption of the proposal will discourage liquidity providers from quoting deep markets, “as occasional errors or delays in quote updates will be instantaneously met with economic loss from electronic pick-off orders of professionals.”

SIG stated that the likelihood that Phlx will adopt a hybrid trading system will further compound the problems arising from electronically generated orders. Specifically, SIG believes that increased quoting by market makers in a hybrid system will create more instances of quote errors and anomalies, which will increase the opportunities for professional traders to pick off liquidity providers. Accordingly, SIG believes that any withdrawal of the Rule should be accompanied by adoption of an effective decrementation feature or other means to address quote clogging once a hybrid system is introduced.

In addition, SIG believes that recent enhancements to Phlx’s AUTOM and AUTO-X systems—such as a change to Auto-Quote that enables Phlx to disseminate a firm quote size of at least the sum of limit orders at Phlx’s disseminated price—do not warrant removal of the Rule. Rather, SIG stated that the enhancements exacerbate the disadvantages to specialists and market makers from electronically generated orders.

Finally, SIG argued that the Rule should be bolstered rather than eliminated. Specifically, SIG believes

that regulators should enforce the human intervention requirement of the Rule by categorizing “queue-trading” (which occurs when an off-floor system is programmed to identify a quoting error or quote delay and then queues an order on the screen to be sent to the exchange with the stroke of a key) as electronically generated.

## 3. Phlx Response to SIG Letter

In its response to the SIG Letter, the Phlx reiterated its belief that the systems changes it has made to AUTOM and AUTO-X have “narrowed the gap with respect to any actual or perceived advantage an off-floor customer or broker-dealer could have over a specialist \* \* \*.” The Exchange also noted that it has developed and deployed new electronic technology that provides for the automatic execution of eligible inbound customer and off-floor broker-dealer limit orders against booked customer limit orders at the Exchange’s disseminated price (called “Book Match”), and a new component of AUTOM, “Book Sweep,” designed to automatically execute limit orders on the book when the Exchange’s electronic options pricing system, Auto-Quote, or a specialist’s quote sent to the Exchange via specialized quote feed locks or crosses a limit order on the book. Phlx stated that as a result of its technology changes and as a competitive initiative, it proposed to delete the Rule. However, the Exchange also stated that it will continue to surveil for, and enforce, compliance with Exchange rules that help specialists and ROTs in managing their risk while making markets on the Exchange. In addition, the Exchange represented that it expects to monitor the effects of the deletion of this prohibition in order to readily ascertain its effects on the risk management activities of on-floor members and member organizations. If the Exchange determines that such effects are detrimental to the risk management activities of on-floor members and member organizations, the Exchange expects to take appropriate action, including the filing of appropriate rules and/or systems changes, to address such a situation.

## IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>12</sup> Specifically, the

<sup>12</sup> In approving this proposal, the Commission has considered the proposed rule’s impact on

Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,<sup>13</sup> which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest. Specifically, the Commission believes that the proposal should permit faster entry and execution of orders on the Exchange, thereby providing investors with improved services. The Commission also believes the proposal should facilitate the entry by traders of competitive limit orders on the Exchange, which should narrow spreads and improve the quality of the NBBO. Finally, the Commission notes that the Exchange has addressed the possible risk exposure issue of specialists and ROTs by representing that it will surveil for and enforce Exchange rules designed to help specialists and ROTs manage risk.<sup>14</sup> The Commission expects the Exchange to monitor the effects of the proposal on the risk management activities of on-floor members and member organizations, and take appropriate action if necessary.

## V. Conclusion

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act<sup>15</sup>, that the proposed rule change (SR-Phlx-2003-37), be, and hereby is, approved.

efficiency, competition, and capital formation. 15 U.S.C. 78(c)(f).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> For example, the Exchange committed to continue to surveil for, and enforce, compliance with Phlx Rule 1080(c)(ii), which sets forth the obligations of an Exchange Order Entry Firm, defined as a member organization of the Exchange that is able to route orders to AUTOM, and a User, defined as any person or firm that obtains access to AUTO-X through an Order Entry Firm. Specifically, the rule requires Order Entry Firms to comply with all applicable Exchange options trading rules and procedures; provide written notice to all Users regarding the proper use of AUTO-X; and neither enter nor permit the entry of multiple orders in call options and/or put options in the same option issue within any 15-second period for an account or accounts of the same beneficial owner.

<sup>15</sup> *Id.*

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48639; File No. SR-Phlx-2003-65]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to the Manner in Which a Contrary Exercise Advice Is Submitted and To Extend by One Hour the Cut-Off Time To Submit Contrary Exercise Advices

October 16, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup>, and Rule 19b-4<sup>2</sup> thereunder, notice is hereby given that on October 14, 2003, 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 Phlx. The Exchange filed the proposed rule change under paragraph (f)(6) of Rule 19b-4 under the Act.<sup>3</sup> 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 Phlx proposes to amend Phlx Rule 1042 to simplify the manner in which a Contrary Exercise Advice ("CEA")<sup>4</sup> is submitted to the Exchange and to extend by one hour the cut-off time by which members and member organizations must submit CEAs to the Exchange. The proposal also indicates when the Exchange could modify (expand or reduce) the cut-off time for decisions whether to exercise an option or submit a CEA. Below is the text of the proposed rule change. Proposed new language is *italicized*; proposed deleted text is [bracketed].

\* \* \* \* \*

#### Rule 1042, Exercise of Equity Option Contract

Rule 1042. (a) Exercise Notices. [Subject to the restrictions established by the Exchange pursuant to Rule 1002 and to such other restrictions which may be imposed by the Exchange pursuant to Rules 1004 and 1005 or by the Options Clearing Corporation ("OCC") pursuant to the OCC Rules, an outstanding option contract may be exercised during the time period specified in the OCC Rules by the tender to the OCC of an exercise notice in accordance with OCC Rules.] *An outstanding option contract may be exercised by the tender to The Options Clearing Corporation ("OCC") of an exercise notice made during the periods, and using the procedures, specified in OCC rules.* An exercise notice may be tendered to OCC only by the clearing member in whose OCC account the option contract is carried. *Option exercises are also subject to restrictions that are established by or may be imposed by the Exchange in Rules 1002, 1004 and 1005, and in this rule.* Members and member organizations [shall] *may* establish fixed procedures as to the latest [hour at which] *time* they will accept exercise notices from their customers.

(b) [Exercise Cut-Off] *Exercise-by-Exception Procedure for Expiring Options.* [Final exercise decisions of option holders to either exercise or not exercise expiring equity options must be indicated to the Exchange by the respective member or member organization no later than 5:30 P.M. (EST) on the business day immediately prior to the expiration date ("exercise cut-off time") in either of the following manners.] *Special procedures apply to the exercise of equity options on the last business day before their expiration ("expiring options"). Unless waived by OCC, expiring options are subject to the Exercise-by-Exception ("Ex-by-Ex") procedure under OCC Rule 805. This rule provides that, unless contrary instructions are given, option contracts that are in-the-money by specified amounts shall be automatically exercised. In addition to OCC rules, the following Exchange requirements apply with respect to expiring options. Option holders desiring to exercise or not exercise expiring options must either:*

- (i) take no action and allow exercise determinations to be made in accordance with OCC's Rule 805 [exercise-by-exception] *Ex-by-Ex* procedure where applicable; or
- (ii) submit a Contrary Exercise Advice ("CEA") or *Advice Cancel to the Exchange by the deadline specified in*

*paragraph (c) below.* A CEA [Contrary Exercise Advice] is a *communication either* [form approved by the Exchange for use by a member or member organization to submit a final exercise decision committing an options holder] to not exercise an option [position which] *that would be* automatically [be] exercised pursuant to OCC's [exercise-by-exception] *Ex-by-Ex* procedure, or to exercise an [equity] option [position which] *that would not be* automatically [be] exercised pursuant to OCC's [exercise-by-exception] *Ex-by-Ex* procedure. A CEA [Contrary Exercise Advice] may be submitted by a [any] member or member organization [(1) either by using the Exchange's CEA Form, OCC's clearing system (ENCORE), or a CEA form of any other [at a place designated for that purpose by any] national [options] securities exchange of which they are a member and where the option is listed, or [(2) may be submitted to the Exchange via OCC in a form prescribed by OCC] via such other method as the Exchange may prescribe. A CEA may be canceled or resubmitted at any time up to the exercise cut-off time specified below.

(c) *Exercise Cut-Off Time.* *Option holders have until 5:30 p.m. (EST) on the business day immediately prior to the expiration date to make a final decision to exercise or not exercise an expiring option. For customer accounts, members and member organizations may not accept exercise instructions after 5:30 p.m. (EST) but have until 6:30 p.m. (EST) to submit a CEA. For non-customer accounts, members and member organizations may not accept exercise instructions after 5:30 p.m. (EST) but have until 6:30 p.m. (EST) to submit a CEA if such member or member organization employs an electronic submission procedure with an electronic time stamp (with fixed procedures to ensure security of the time stamp) to indicate the time of the submission of exercise instructions by option holders. Consistent with Commentary .04, members and member organizations are required to submit a CEA by 5:30 p.m. (EST) for non-customer accounts if such members and/or member organizations do not employ an electronic submission procedure with electronic time stamp for the submission of exercise instructions by option holders. [In those instances when the exercise by exception procedure has been waived by OCC (such that OCC will not for that expiration effect automatic exercise or non-exercise of expiring equity option positions), a Contrary Exercise Advice is still*

<sup>16</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> 17 CFR 240.19b-4(f)(6).

<sup>4</sup> The term CEA as used in the filing may also include Advice Cancels. Advice Cancels are documents used to cancel CEAs.