

on the options floor.⁶ In addition to addressing time priority, these rules provide that when bids or offers at the same price are made simultaneously, or when the order of time in which bids or offers were made cannot be determined, all such bids and offers will be on parity. Thus, parity means that none of the market participants bidding or offering at the best price has rights over the other members at that price in terms of trade participation. Although not specifically stated in Phlx rules currently, members on parity are generally entitled to receive equal shares of the contra-side participation.⁷

An "Enhanced Specialist Participation" is one type of exception to the general parity rules, allocating to the specialist a greater than equal share of the portion of an order that is divided among the specialist and any "controlled accounts" that are on parity.⁸ The Exchange currently has several Enhanced Specialist Participation programs, embodied in Phlx rule 1014(g) and described below. These programs establish specified percentages as the Enhanced Specialist

Participation, depending on the category of option.

i. *Enhanced Specialist Participation Programs.* The Enhanced Specialist Participation provided under rule 1014(g)(ii) currently entitles the specialist to 30% of the portion of the initiating order,⁹ divided among the specialist and controlled accounts when three or more controlled accounts are on parity with the specialist and more than five contracts are to be bought or sold.¹⁰ This is generally known as the "30% Enhanced Specialist Participation" or the "30% split." If two controlled accounts are on parity with the specialist, the specialist is entitled to receive 40%, and if only one controlled account is on parity with the specialist, the specialist is entitled to receive 60%.

Another Enhanced Specialist Participation program on Phlx, originally adopted in May 1994 and embodied in current Phlx rule 1014(g)(iii), is designed to encourage the establishment of new specialist units to trade options classes that have never been listed on the Exchange. For a period of six months following the commencement of trading in such a new options class, the new specialist unit is entitled to 50% of an order when one controlled account is on parity with the specialist, and 40% when two or more

controlled accounts are on parity with the specialist.¹¹

On July 1, 1999, still another enhanced participation program, the "New Product Enhanced Specialist Participation," was adopted.¹² Under Phlx rule 1014(g)(iv), a specialist who develops and trades a new product is entitled to receive an Enhanced Specialist Participation of 40% when three or more controlled accounts are on parity, and 60% if fewer than three controlled accounts are on parity. Currently, in either of these situations, if a customer is on parity, the customer may not receive a smaller participation than any other crowd participant, including the specialist.¹³

The Exchange represents that the purpose of these programs is to attract and retain highly capitalized specialist units who can capture order flow for the Exchange. Because the specialist unit is currently the key party responsible for marketing to attract order flow in particular options, the Exchange seeks to provide the appropriate encouragement to specialists to plan, invest in, and effect marketing strategies. Therefore, the Exchange believes that these programs provide specialists with the appropriate incentive to create more depth and liquidity. Phlx states that the Commission has regularly acknowledged the need for well-capitalized specialist units, burdens and costs borne by specialists, and how the Enhanced Specialist Participation is intended to compensate specialists for these costs and burdens.¹⁴

(ii) *Clarifying Amendments.* The Exchange proposes to make clarifying amendments to Phlx rule 1014(g) to state what portion of a trade a specialist on parity with other crowd participants "is entitled to" throughout the Enhanced Specialist Participation portions of the rule. Most of the provisions in Phlx rule 1014(g)(ii) state the Enhanced Specialist Participation in the form of an entitlement, but the provisions that erroneously do not are

⁶ Phlx rule 1067, which states that the highest bid and the lowest offer shall have precedence in all cases, does not address parity situations, nor does it address size precedence; thus, it is consistent with the proposal. Other Exchange rules, including Phlx rules 1017 and 1019, as well as Advices A-12 and A-14, deal with priority/parity on the opening.

⁷ The Exchange notes that option orders that are automatically executed by the Exchange's AUTO-X system are generally subject to a separate allocation system known as the "Wheel." Therefore, the Enhanced Specialist Participation programs described in this section apply only to non-AUTO-X trades. Non-AUTO-X trades include manually executed trades such as orders delivered by the AUTOM System, by the Floor Broker Order Entry ("FBOE") System as well as manually to the specialist. See *infra* note 26 and Securities Exchange Act Release No. 41524 (June 14, 1999), 64 FR 33127 (June 21, 1999) (SR-Phlx-99-11) (adopting the FBOE). See also Securities Exchange Act Release No. 45927 (May 15, 2002), 67 FR 36289 (May 23, 2002) (SR-Phlx-2001-24).

The Exchange further notes that rules relating to its "ROT Access" system, in which specialists and Registered Options Traders ("ROT's") may place price improving limit orders and matching orders directly onto the limit order book via electronic interface with AUTOM, contain Special Allocation rules particular to orders executed against such price improving and matching orders. See Securities Exchange Act Release No. 46763 (November 1, 2002), 67 FR 68898 (November 13, 2002) (SR-Phlx-2002-04).

⁸ A controlled account is currently defined as "any account controlled by or under common control with a broker-dealer." See Phlx rule 1014(g)(i). Thus, the definition of controlled account includes the account of an ROT. See also Securities Exchange Act Release No. 45114 (November 28, 2001), 66 FR 63277 (December 5, 2001) (SR-Phlx-2001-38) (re-defining "controlled account"). For other examples of exceptions to the general parity principle, see Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778 (SR-Phlx-00-01) at IV.B.2.

⁹ The proposal would specify that the specialist is entitled to receive an Enhanced Specialist Participation as a percentage of the "Remainder of the Order."

¹⁰ The 30% enhanced participation when three or more controlled accounts are on parity was approved by the Commission on April 18, 2000. See Securities Exchange Act Release No. 42700 (April 18, 2000), 65 FR 24246 (April 25, 2000) (SR-Phlx-99-39). The Enhanced Specialist Participation in Phlx rule 1014(g)(ii) was originally approved by the Commission as a one-year pilot program for equity options. See Securities Exchange Act Release No. 34606 (August 26, 1994), 59 FR 45741 (September 2, 1994) (SR-Phlx-94-12). It was later expanded to include index options. See Securities Exchange Act Release No. 35028 (November 30, 1994), 59 FR 63151 (December 7, 1994) (SR-Phlx-94-57). The pilot rule provided for a "two-for-one" split when the specialist was on parity with any number of controlled accounts, allocating to the specialist two contracts for every one allocated to a controlled account. The program was later revised to provide for the current 40% allocation when two controlled accounts are on parity and 60% allocation when one is on parity. See Securities Exchange Act Release No. 35429 (March 1, 1995), 60 FR 12802 (March 8, 1995) (SR-Phlx-94-59). The pilot was renewed unaltered on three occasions. See Securities Exchange Act Release Nos. 36122 (August 18, 1995), 60 FR 44530 (August 28, 1995) (SR-Phlx-95-54); 37254 (August 5, 1996), 61 FR 42080 (August 13, 1996) (SR-Phlx-96-29); and 38924 (August 11, 1997), 62 FR 44160 (August 19, 1997) (SR-Phlx-97-36). It was thereafter extended for another period with certain modifications. See Securities Exchange Act Release No. 39401 (December 4, 1997), 62 FR 65300 (December 11, 1997) (SR-Phlx-97-48). The pilot was approved as a permanent program on July 1, 1999. See Securities Exchange Act Release No. 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999) (SR-Phlx-98-56).

¹¹ See Securities Exchange Act Release No. 34109 (May 25, 1994), 59 FR 28570 (June 2, 1994) (SR-Phlx-93-29).

¹² See Securities Exchange Act Release No. 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999) (SR-Phlx-98-56).

¹³ The instant proposal would afford the customer absolute priority over all controlled accounts by requiring controlled accounts (that would otherwise have priority or be on parity) to yield to customer accounts. See *infra* Section A.(iii). Telephone conversation between Richard S. Rudolph, Director and Counsel, Phlx, and Ira L. Brandriss, Division, Commission, on December 30, 2002 ("Telephone conversation with Phlx").

¹⁴ See, e.g., Securities Exchange Act Release No. 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999) (SR-Phlx-98-56).