

proposed to be corrected. Specifically, the Exchange proposes to state in Phlx rule 1014(g)(ii) that where there is one controlled account on parity, the specialist is entitled<sup>15</sup> to receive 60% of the Remainder of the Order after customer orders that are on parity at the Exchange's best bid/offer, in accordance with rule 1014(g)(i).

In Phlx rule 1014(g)(ii)(C), which cross-references another Enhanced Specialist Participation program (discussed in the next sentence), the Exchange proposes to state that new specialist units trading new options classes shall *be entitled to* receive an Enhanced Specialist Participation. Lastly, in the New Product Enhanced Specialist Participation provisions of Phlx rule 1014(g)(iv), the proposal would require that entire provision to state that when a specialist unit develops and trades a new product, such specialist *is entitled to* receive an Enhanced Specialist Participation in that option such that, when the specialist is on parity with three or more controlled accounts in the crowd, the specialist *is entitled to* receive 40% of the contracts and the controlled accounts *are entitled to* receive the remaining 60%; when the specialist is on parity with less than three controlled accounts in the crowd, the specialist *is entitled to* receive 60% of the contracts and the controlled accounts *are entitled to* receive the remaining 40%.<sup>16</sup> The Exchange represents that all of these provisions were originally intended to be written in the permissive form, as evidenced by other types of Enhanced Specialist Participation programs.<sup>17</sup>

<sup>15</sup> The current rule text uses the phrase, "the specialist is entitled to" when referring to the 30% Enhanced Specialist Participation when three or more controlled accounts are on parity, and to the 40% Enhanced Specialist Participation when two controlled accounts are on parity. The Exchange represents that originally in the rule text submitted as File No. SR-Phlx-97-48, the portion of the text concerning the case where one controlled account is on parity also used the phrase, "the specialist is entitled to 60%"; and in SR-Phlx-98-56, the text of the rule was inadvertently changed to "receives 60%." Cf. Securities Exchange Act Release Nos. 39401 (December 4, 1997), 62 FR 65300 (December 11, 1997) (SR-Phlx-97-48); and 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999) (SR-Phlx-98-56). Telephone conversation with Phlx.

<sup>16</sup> See Securities Exchange Act Release No. 41588 (July 1, 1999), 64 FR 37185 (July 9, 1999) (SR-Phlx-98-56).

<sup>17</sup> The Exchange states that even Enhanced Specialist Participation programs proposed after the new product enhanced specialist participation used the language "is entitled to." See Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778 (August 9, 2000) (SR-Phlx-2001-01) at Exhibit A, proposing to adopt a 50% Enhanced Specialist Participation and an 80% Enhanced Specialist Participation.

Thus, Phlx states, the "entitlement" is not mandatory.

Second, the Exchange proposes to add a reference to the Enhanced Specialist Participation programs and an explanation of how the Enhanced Specialist Participation is calculated. Specifically, the Exchange proposes to expressly state in Phlx rule 1014(g)(i) that several programs provide an Enhanced Specialist Participation to specialists. These programs include a 30% (or, in certain situations, 40% or 60%) Enhanced Specialist Participation, New Unit/New Option Enhanced Specialist Participation,<sup>18</sup> and New Product Enhanced Specialist Participation.<sup>19</sup> The purpose of expressly listing these programs in Phlx rule 1014(g)(i) is to provide an introduction for ease of reference.

The Exchange also proposes to better define how the Enhanced Specialist Participation would be calculated by stating that the Enhanced Specialist Participation is a percentage of the Remainder of the Order to which the specialist is entitled, depending upon whether Phlx rule 1014 (g)(ii), (iii), or (iv) applies. "Remainder of the Order" is proposed to be defined in order to be clear as to which portion of an "Initiating Order" (which is also proposed to be defined) the proposed trade allocation rules would apply.

(iii) *Customer Priority*. Under the current structure of Phlx rule 1014(g), in applying the Enhanced Specialist Participation, when an incoming order arrives on the floor and only the specialist and controlled accounts are on parity, the specialist is entitled to the specified percentage of the order before the controlled accounts divide the rest. However, when a customer order also is being represented in the crowd at the same bid or offer as the specialist and controlled accounts, other rules currently must be taken into account. Specifically, Phlx rule 1014(g)(i) currently provides that orders of controlled accounts must yield priority to customer orders, but that specialists and ROTs closing in person are currently not required to yield priority to customer orders. Thus, currently, a

<sup>18</sup> See Securities Exchange Act Release No. 34109 (May 25, 1994), 59 FR 28570 (June 2, 1994) (SR-Phlx-93-29).

<sup>19</sup> Enhanced specialist participation programs, which determine the portion of an options trade available for allocation to the specialist on parity with controlled accounts, including the mechanical operation of all existing enhanced specialist programs, are described more fully in Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778 (August 9, 2000) (SR-Phlx-00-01). In that proposal, Phlx attempted to codify a similar introductory provision, but that proposed rule change was withdrawn.

specialist and a ROT closing in person are not required to yield to a customer order represented in the trading crowd while other controlled accounts are. Nonetheless, pursuant to the Enhanced Specialist Participation provisions, currently a customer may not receive a smaller participation than any trading crowd participant, including an ROT closing in person.<sup>20</sup>

The Exchange is proposing to delete the clause in Phlx rule 1014(g)(i) that allows specialists and ROTs closing in-person to be on parity with customer orders, and to make conforming changes to Phlx rules 1014(g)(ii), (iii), and (iv). The instant proposal would thus require the accounts of specialists and ROTs closing in-person to yield priority to all customer accounts. The purpose of this provision is to make the Exchange more attractive to customer orders.<sup>21</sup>

(iv) *Proposed New Rule 1014(g)(v)*. At this time, Phlx proposes to adopt new paragraph (g)(v) to Phlx rule 1014 to codify and detail how trade allocation functions for non-AUTO-X orders<sup>22</sup> subject to allocation under Phlx rule 1014(g).<sup>23</sup>

In order to explain how options trade allocation functions, it is necessary first to define and discuss the concepts of "stated size" and "Defined Participation."

a. *Stated Size*. Currently, in situations in which the specialist handles AUTOM-delivered<sup>24</sup> orders manually, the individual crowd participants do not in all cases quote a specific size prior to the execution of such an order, but rather the entire crowd is responsible for the disseminated price up to the disseminated size. The proposed rule change would, with one exception<sup>25</sup> require, on a trade-by-trade

<sup>20</sup> See Phlx rule 1014(g)(ii).

<sup>21</sup> See Amendment No. 5.

<sup>22</sup> For a discussion of situations in which incoming orders would not be eligible for automatic execution via AUTO-X, see Securities Exchange Act Release No. 45927 (May 15, 2002), 67 FR 36289 (May 23, 2002) (SR-Phlx-2001-24).

<sup>23</sup> See *supra* note 7.

<sup>24</sup> AUTOM is the Exchange's electronic order delivery 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, or 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 and its features and enhancements. Option orders entered by Exchange members into AUTOM are routed to the appropriate specialist unit on the Exchange trading floor.

<sup>25</sup> Proposed Phlx rule 1014(g)(v)(C)(3) would entitle the specialist to receive the Enhanced Specialist Participation for contracts executed in excess of the Exchange's disseminated size if the specialist does not state a size regarding such excess

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