

of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change relating to crossing, facilitation, and solicited orders. On May 2, 2002, July 24, 2002, and August 20, 2002, Phlx submitted Amendment Nos. 1, 2, and 3 to the proposed rule change, respectively.<sup>3</sup> On May 2, 2002, notice of the proposed rule change, as amended by Amendment Nos. 1, 2, and 3, was published in the **Federal Register**.<sup>4</sup> The Commission received no comments on the proposed rule change. On November 6, 2002, February 25, 2003, March 19, 2003, and April 23, 2003, Phlx submitted Amendment Nos. 4, 5, 6, and 7 to the proposed rule change, respectively.<sup>5</sup> This notice and order solicits comment on Amendment Nos. 4, 5, 6, and 7 and approves the proposed rule change, as amended, on an accelerated basis.

## II. Description of Proposal

The proposed rule change would amend Phlx Rule 1064, "Crossing, Facilitation and Solicited Orders," which governs the crossing of equity option orders by floor brokers. Rule 1064, among other things, sets forth the procedures by which a floor broker who holds a customer order ("original order") may cross such order with either another customer order or orders from the same originating firm, or with a contra side order provided by the

originating firm from its own proprietary account.<sup>6</sup>

As explained by the Phlx, under the current rule, a floor broker seeking to cross buy and sell orders for the same options series must first bring the transaction to the trading floor and request markets from the trading crowd for all components of the order. After providing the crowd with the opportunity to make such markets, the floor broker must announce that he or she holds an order subject to crossing or facilitation, and then must propose a price at which to cross the original order that improves upon the price provided by the crowd. However, before the floor broker can effect the cross, the registered options traders ("ROTs") in the crowd are given the opportunity to take all or part of the transaction at the proposed price.

Under these rules, if the crowd does not want to participate in the trade, the floor broker may proceed with the cross. If the crowd wants to participate in part of the order, however, the crowd has priority and the floor broker may cross only that amount remaining after the crowd has taken its portion. If the crowd wants to participate in the entire order, the floor broker will not be able to cross or facilitate any part of the order.

The Phlx proposes to adopt new Commentary .02 to Rule 1064 to entitle the floor broker, under certain conditions, to cross a specified percentage of an original order with another customer order or orders, or with an order of the originating firm, before ROTs in the crowd can participate in the transaction. The percentage of the floor broker's guarantee would depend upon whether the price at which the order is ultimately traded is at the crowd's best bid or offer in response to the floor broker's initial request, or at an improved price.

Where the floor broker proposes the cross at a price that improves the crowd's market, and the crowd then wants to take part in some or all of the order at the improved price, the floor broker would be entitled to cross 40% of the contracts.<sup>7</sup> Where the trade takes

place at the market provided by the crowd, the floor broker would be entitled to cross 20% of the contracts. These entitlements would apply only with respect to any portion of the original order that remained after all public customer orders in the limit order book and represented in the trading crowd at the time the market was established were satisfied.

The proposed rule change would apply to transactions in equity options and would initially apply to customer orders of a minimum size of 500 contracts. The Exchange's Options Committee would be authorized to determine, on an option by option basis, the eligible size for an order that could be transacted pursuant to the proposal. However, the eligible order size could not be less than 500 contracts. In the case of a complex order, such as a spread or a straddle, the proposed rule change would require that at least one leg of such an order, standing alone, would need to meet the eligible size requirement.

The proposed rule change also provides that if the same member organization of the Exchange is both the originating firm and the specialist for the option in which the transaction takes place, and the floor broker acting on behalf of the originating firm crosses or facilitates under the proposed rule, the specialist would not be entitled to any Enhanced Specialist Participation pursuant to Phlx Rule 1014(g)<sup>8</sup> with respect to the particular cross transaction.

If the specialist is not the same member organization as the originating firm, and the trade takes at the specialist's disseminated bid or offer when the specialist is on parity with one or more controlled accounts, the specialist may be entitled to an Enhanced Specialist Participation, but in no case would the specialist be guaranteed a percentage that, when combined with the percentage crossed by the floor broker, exceeds 40% of the original order after relevant public customer orders have been satisfied.

to cross 20% of the contracts. Telephone conversation between Richard S. Rudolph, Director and Counsel, Phlx, and Ira Brandriss, Special Counsel, and Frank N. Genco, Attorney, Division, Commission, on November 21, 2002.

<sup>8</sup> The Enhanced Specialist Participation programs in Phlx Rule 1014(g) allocate to the specialist, in certain options classes, a greater than equal share of the portion of the order that is divided among the specialist and any "controlled accounts" that are on parity. A "controlled account" is an account controlled by or under common control with a broker-dealer.

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

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

<sup>3</sup> See letters from Richard S. Rudolph, Director and Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated May 1, 2002 ("Amendment No. 1"); and to Ira Brandriss, Special Counsel, Division, Commission, dated July 23, 2002 ("Amendment No. 2"), and August 19, 2002 ("Amendment No. 3").

<sup>4</sup> See Securities Exchange Act Release No. 45824 (April 25, 2002), 67 FR 22144 ("Notice").

<sup>5</sup> See letters from Richard S. Rudolph, Director and Counsel, Phlx, to Ira Brandriss, Special Counsel, Division, Commission, dated November 5, 2002 ("Amendment No. 4"), February 24, 2003 ("Amendment No. 5"), March 18, 2003 ("Amendment No. 6"), and April 22, 2003 ("Amendment No. 7").

Amendment No. 4 replaced the text of the proposed rule change with new text that made revisions to proposed Commentary .03. The text of proposed Commentary .03 was further amended by Amendment Nos. 5, 6, and 7. As discussed *infra*, the final text of proposed Commentary .03 as set forth in Amendment No. 7 is intended to clarify that the provision would apply to any transaction in which a floor broker is crossing a public customer order with an order that is not a public customer order.

In Amendment No. 6, Phlx also amended proposed Commentary .02(i) to Phlx Rule 1064, as discussed *infra*, to reflect that the proposed provision to entitle a floor broker to cross a certain percentage of a customer order with a facilitation order from the originating firm would apply only to public customer orders, not all customer orders.

<sup>6</sup> When the contra side is provided by the originating firm from its own proprietary account, the transaction is known as a "facilitation."

<sup>7</sup> After the floor broker proposed to cross the order, he or she would be required again to give the crowd a reasonable opportunity to bid or offer for the order. Telephone conversation between Richard S. Rudolph, Director and Counsel, and Dawn Kelly Reim, Market Surveillance Investigator, Phlx, and Ira Brandriss, Special Counsel, and Frank N. Genco, Attorney, Division, Commission, on October 21, 2002. If the crowd improved upon the floor broker's price, and the floor broker then proposed to match the crowd's price, the floor broker would be entitled