

*option order and, if brought to the Exchange, is brought without undue delay to the crowd. Crowd participants may participate in the option transaction without participating in the hedging stock position. Combination option and stock positions offered in reliance upon this Commentary .04 shall be referred to as "Stock Tied Up Orders."*

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## 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 Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange 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 Phlx represents that the purpose of the proposed rule change is to expressly adopt into Exchange rules concerning the handling of certain option orders, Stock Tied Up Orders, to bring clarity to the practice of representing hedging stock positions in conjunction with option orders in the trading crowd.

In a Stock Tied Up Order, Exchange members would be permitted to hedge a customer options order with the underlying security, and then forward the customer order and hedging stock position to a Floor Broker with instructions to represent the customer order together with the hedging stock position in the underlying security to the options crowd. Under the proposal, the trading crowd would have the choice to participate in the option portion of the transaction or both the option and stock hedging position.

The proposal would also include a number of conditions which must be satisfied both prior to the time a Stock Tied Up Order is represented to the options trading crowd, and concurrently with the representation of a Stock Tied Up Order in the trading crowd.

Currently, Exchange market participants trading options employ a number of strategies that involve multiple securities, including non-

option components. For example, Exchange Rule 1066 permits Exchange members to engage in the trading of spread<sup>3</sup> and combination<sup>4</sup> orders, as well as synthetic options.<sup>5</sup> The Stock Tied Up Order would also include an option component and a stock component.

The proposed rule would require members and member organizations to satisfy certain conditions prior to representing Stock Tied Up Orders in the crowd. First, members or member organizations would be required to create a written record that it is engaging in a Stock Tied Up Order prior to buying or selling any shares of the underlying stock in the hedging stock position. The Exchange states that the purpose of this provision is to create a record to ensure that stock trades would be appropriately associated with the related options order. The Exchange believes that this requirement should enable the Exchange to surveil for compliance with the requirements of proposed Commentary .04(b) of Phlx Rule 1064, as discussed below, by identifying the specific purchase or sell orders relating to the hedging stock position.

Secondly, proposed Commentary .04(b) of Phlx Rule 1064 would require

<sup>3</sup> A spread order is an order to buy a stated number of option contracts and to sell the same number of option contracts, in a different series of the same class of options. In the case of adjusted stock option contracts, a spread order need not consist of the same number of put and call contracts if such contracts both represent the same number of underlying shares or foreign currency at option, in a different series of the same class of options. See Exchange Rule 1066(f)(1).

<sup>4</sup> A combination order is an order involving a number of call option contracts and the same number of put option contracts in the same underlying security and representing the same number of shares at option (if the underlying security is a stock or Exchange-Traded Fund Share) or the same number of foreign currency units (if the underlying security is a foreign currency). A combination order includes a conversion (generally, buying a put, selling a call, and buying the underlying stock or Exchange-Traded Fund Share) and a reversal (generally, selling a put, buying a call, and selling the underlying stock or Exchange-Traded Fund Share). In the case of adjusted option contracts, a combination order need not consist of the same number of shares at option. See Exchange Rule 1066(f)(3).

<sup>5</sup> A synthetic option order is an order to buy or sell a stated number of option contracts and buy or sell the underlying stock or Exchange-Traded Fund Share in an amount that would offset (on a one-for-one basis) the option position. For example:

(i) Buy-write: An example of a buy-write is an order to sell one call and buy 100 shares of the underlying stock or Exchange-Traded Fund Share.

(ii) Synthetic put: An example of a synthetic put is an order to buy one call and sell 100 shares of the underlying stock or Exchange-Traded Fund Share.

(iii) Synthetic call: An example of a synthetic call is an order to buy (or sell) one put and buy (or sell) 100 shares of the underlying stock or Exchange-Traded Fund Share. See Exchange Rule 1066(g).

that members and member organizations that have decided to engage in Stock Tied Up Orders for representation in the trading crowd would have to ensure that the hedging stock position associated with the Stock Tied Up Order is comprised of the same underlying stock applicable to the option order. For example, if the option component of the Stock Tied Up Order overlies XYZ stock, then the hedging stock position associated with the order would have to be XYZ stock. The Exchange states that the purpose of this provision is to ensure that the hedging stock position would be for the same stock as the overlying option, thus allowing crowd participants who may be considering participation in a Stock Tied Up Order to adequately evaluate the risk associated with the option as it relates to the actual underlying stock. Occasionally, crowd participants hedge option positions with stock that is related to the option, such as the stock of an issuer in the same industry, but not the actual stock associated with the option. The proposed rule change would not allow such a "related" hedging stock position, but would require the hedging stock position to be the actual security underlying the option.

The proposal would require that the hedging stock position be announced concurrently with the option order in the crowd, offered to the crowd in its entirety, and offered at the stock execution price received by the member organization introducing the order to any option crowd participant who has established parity or priority for the related options. The Phlx states that the purpose of these requirements is to ensure that the hedging stock position represented to the crowd would be a good faith effort to provide crowd participants with the same opportunity as the member or member organization introducing the Stock Tied Up Order to compete for the option order. For example, if the member or member organization introducing the Stock Tied Up Order were to offer 1,000 XYZ option contracts to the crowd (overlying 100,000 shares of XYZ stock) and concurrently offers only 30,000 shares of the underlying stock, crowd participants might only be willing or able to participate in 300 of the option contracts offered, if the hedging stock position cannot be obtained at a price as favorable as the stock hedging position offering price, if at all. The Exchange states that the effect of this would be to place the crowd at a disadvantage relative to the introducing member firm for the remaining 700 option contracts