Proposed Rule Change by Philadelphia Stock Exchange

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

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<th>Initial</th>
<th>Amendment</th>
<th>Withdrawal</th>
<th>Section 19(b)(2)</th>
<th>Section 19(b)(3)(A)</th>
<th>Section 19(b)(3)(B)</th>
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Pilot

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<th>Extension of Time Period for Commission Action</th>
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Rule

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Description

Provide a brief description of the proposed rule change (limit 250 characters).

Proposed rule change relating to the extension of a pilot concerning synthetic option order priority.

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name Richard

Last Name Rudolph

Title Vice President and Counsel

E-mail Richard.Rudolph@phlx.com

Telephone (215) 496-5074

Fax (215) 496-6729

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 06/08/2006

By Richard S. Rudolph

Vice President and Counsel

(Name)

(Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Richard Rudolph,
The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3).

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission’s permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e., partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.
1. **Text of the Proposed Rule Change**

The Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") and Rule 19b-4 thereunder, proposes to extend, for an additional one-year period, a pilot concerning Exchange Rule 1033(e), which affords priority to synthetic option orders (as defined below) traded in open outcry over bids and offers in the trading crowd but not over bids (offers) of public customers on the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price. The rule applies to orders for 100 contracts or more, and is subject to a pilot program scheduled to expire June 30, 2006. The Exchange proposes to extend the pilot through June 30, 2007.

A notice of the proposed rule change for publication in the Federal Register is attached hereto as Exhibit 1. The text of the proposed rule change is set forth below. Brackets indicate deletions; underlining indicates new text.

**Bids And Offers --Premium**

**Rule 1033.** (a) - (d) No change.

(e) Synthetic Option Orders. When a member holding a synthetic option order, as defined in Rule 1066, and bidding or offering on the basis of a total credit or debit for the order has determined that the order may not be executed by a combination of transactions at or within the bids and offers established in the marketplace, then the order may be executed as a synthetic option order at the total credit or debit with one other member, provided that, the member executes the option leg at a better price than the established bid or offer for that option contract, in accordance with Rule 1014. Subject to a pilot expiring June 30, 2006, synthetic option orders in open outcry, in which the option component is for a size of 100 contracts or more, have priority over bids (offers) of crowd participants who are bidding (offering) only for the option component of the

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synthetic option order, but not over bids (offers) of public customers on the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price.

(f) - (i) No change.

2. Procedures of the Self-Regulatory Organization

The Exchange’s Board of Governors approved the proposal for filing with the Securities and Exchange Commission (“Commission”) on June 7, 2006.

Questions and comments on the proposed rule change may be directed to Richard S. Rudolph, Vice President and Counsel, at (215) 496-5074, or Edith Hallahan, Senior Vice President and Deputy General Counsel, at (215) 496-5179.

3. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

a. Purpose

The purpose of the proposed rule change is to extend, for a one-year period, a pilot that facilitates the execution of option orders that are represented in the crowd together with a stock component, known under the Exchange’s rules as synthetic option orders, which by virtue of the stock component may be difficult to execute without a limited exception to current Exchange priority rules. The pilot was originally adopted in

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3 Exchange Rule 1066(g) defines a synthetic option order as 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:

(1) 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.

(2) 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.

(3) 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.
July, 2005,\(^4\) and was extended for an additional six-month period, currently scheduled to expire June 30, 2006.\(^5\)

Currently, Rule 1033(e) provides that, if an Exchange member who is holding a synthetic option order and who is bidding or offering on a net debit or credit basis determines that such synthetic option order cannot be executed at the net debit or credit against the established bids and offers in the crowd, the member bidding for or offering the synthetic option on a net debit or credit basis may execute the synthetic option order with one other crowd participant, provided that the option portion of the synthetic option order is executed at a price that is better than the established bid or offer for the option. Thus, if the desired net debit or credit amount cannot be achieved by way of executing against the established bids and offers in the crowd, the member may elect to trade at the desired net debit or credit amount with one other member, provided that there is price improvement for the option component of the synthetic option order.

The pilot affords synthetic option orders priority over bids (offers) of the trading crowd but not over bids (offers) of public customers on the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price. The effect of the rule is that a crowd participant bidding or offering for the synthetic option order has priority over other crowd participants that are bidding or offering only for the option component of the order. The rule applies only to synthetic option orders of 100 contracts or more.


In addition, the rule provides that members bidding and offering for synthetic option orders of 100 contracts or more do not have priority over bids (offers) of public customers on the limit order book. Therefore, if members of the trading crowd wish to trade a synthetic option order that is marketable against public customer orders on the limit order book, public customers would have priority. Multiple public customer orders at the same price are accorded priority based on time.

The Exchange believes that the pilot, which provides a limited exception to the Exchange’s priority rules only respecting controlled accounts competing at the same price, should enable Floor Brokers representing synthetic option orders to provide best executions to customers placing such orders, and should enable the Exchange to provide liquid markets and compete for order flow in such orders.

As stated above, the rule applies only to synthetic option orders in which the option component is for a size of 100 contracts or more that are represented in the trading crowd in open outcry, and would be subject to a pilot program through June 30, 2007.

b. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act in general, and furthers the objectives of Section 6(b)(5) of the Act in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and,

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6 See Exchange Rule 1080, Commentary .02.

7 A controlled account includes any account controlled by or under common control with a broker-dealer. Customer accounts are all other accounts. Orders of controlled accounts are required to yield priority to customer orders when competing at the same price. Orders of controlled accounts generally are not required to yield priority to other controlled account orders. See Exchange Rule 1014(g)(i)(A).


in general, to protect investors and the public interest, by adopting a limited exception to
the Exchange’s priority rules concerning synthetic option orders.

4. **Self-Regulatory Organization's Statement on Burden on Competition**

   The Phlx does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

5. **Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

   No written comments were either solicited or received.

6. **Extension of Time Period for Commission Action**

   The Exchange does not consent to an extension of the time period for Commission action.

7. **Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

   The foregoing proposed rule change: (1) does not significantly affect the protection of investors or the public interest; and (2) does not impose any significant burden on competition. Therefore, it has become effective pursuant to Section 19(b)(3)(A)\(^{10}\) of the Act and Rule 19b-4(f)(6)\(^{11}\) thereunder. The Exchange requests that the Commission waive the 5-day pre-filing requirement, and that the Commission waive the 30-day period for the proposal to become operative in order to ensure the continuity of the pilot, which is scheduled to expire June 30, 2006.


8. **Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

The proposed rule change is based on Chicago Board Options Exchange, Inc. ("CBOE") Rule 6.45A(b)(iii).\(^\text{12}\)

9. **Exhibits**

1. Notice of proposed rule for publication in the Federal Register.

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Exhibit 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. ; File No. SR-Phlx-2006-38)

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to the Extension of a Pilot Concerning Priority in Trades Involving Synthetic Option Orders

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") \(^1\), and Rule 19b-4\(^2\) thereunder, notice is hereby given that on ______________________ 2006, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III, below, which Items have been prepared by the Phlx. 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, pursuant to Section 19(b)(1) of the Act\(^3\) and Rule 19b-4 thereunder,\(^4\) proposes to extend, for an additional one-year period, a pilot concerning Exchange Rule 1033(e), which affords priority to synthetic option orders (as defined below) traded in open outcry over bids and offers in the trading crowd but not over bids (offers) of public customers on the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price. The rule applies to

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orders for 100 contracts or more, and is subject to a pilot program scheduled to expire

The text of the proposed rule change is set forth below.

Brackets indicate deletions; underlining indicates new text.

Bids And Offers --Premium

Rule 1033. (a) - (d) No change.

(e) Synthetic Option Orders. When a member holding a synthetic option order, as
defined in Rule 1066, and bidding or offering on the basis of a total credit or debit for the
order has determined that the order may not be executed by a combination of transactions
at or within the bids and offers established in the marketplace, then the order may be
executed as a synthetic option order at the total credit or debit with one other member,
provided that, the member executes the option leg at a better price than the established
bid or offer for that option contract, in accordance with Rule 1014.

Subject to a pilot expiring June 30, 200[6], synthetic option orders in open outcry, in which the option
component is for a size of 100 contracts or more, have priority over bids (offers) of
crowd participants who are bidding (offering) only for the option component of the
synthetic option order, but not over bids (offers) of public customers on the limit order
book, and not over crowd participants that are willing to participate in the synthetic
option order at the net debit or credit price.

(f) - (i) No change.

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 Phlx 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 Phlx 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 purpose of the proposed rule change is to extend, for a one-year period, a pilot that facilitates the execution of option orders that are represented in the crowd together with a stock component, known under the Exchange’s rules as synthetic option orders,\(^5\) which by virtue of the stock component may be difficult to execute without a limited exception to current Exchange priority rules. The pilot was originally adopted in July, 2005,\(^6\) and was extended for an additional six-month period, currently scheduled to expire June 30, 2006.\(^7\)

Currently, Rule 1033(e) provides that, if an Exchange member who is holding a synthetic option order and who is bidding or offering on a net debit or credit basis determines that such synthetic option order cannot be executed at the net debit or credit against the established bids and offers in the crowd, the member bidding for or offering the synthetic option on a net debit or credit basis may execute the synthetic option order with one other crowd participant, provided that the option portion of the synthetic option order is executed at a price that is better than the established bid or offer for the option.

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\(^5\) Exchange Rule 1066(g) defines a synthetic option order as 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:

- (1) 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.
- (2) 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.
- (3) 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.


Thus, if the desired net debit or credit amount cannot be achieved by way of executing against the established bids and offers in the crowd, the member may elect to trade at the desired net debit or credit amount with one other member, provided that there is price improvement for the option component of the synthetic option order.

The pilot affords synthetic option orders priority over bids (offers) of the trading crowd but not over bids (offers) of public customers on the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price. The effect of the rule is that a crowd participant bidding or offering for the synthetic option order has priority over other crowd participants that are bidding or offering only for the option component of the order. The rule applies only to synthetic option orders of 100 contracts or more.

In addition, the rule provides that members bidding and offering for synthetic option orders of 100 contracts or more do not have priority over bids (offers) of public customers on the limit order book.\(^8\) Therefore, if members of the trading crowd wish to trade a synthetic option order that is marketable against public customer orders on the limit order book, public customers would have priority. Multiple public customer orders at the same price are accorded priority based on time.

The Exchange believes that the pilot, which provides a limited exception to the Exchange’s priority rules only respecting controlled accounts\(^9\) competing at the same price, should enable Floor Brokers representing synthetic option orders to provide best

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\(^8\) See Exchange Rule 1080, Commentary .02.

\(^9\) A controlled account includes any account controlled by or under common control with a broker-dealer. Customer accounts are all other accounts. Orders of controlled accounts are required to yield priority to customer orders when competing at the same price. Orders of controlled accounts generally are not required to yield priority to other controlled account orders. See Exchange Rule 1014(g)(i)(A).
executions to customers placing such orders, and should enable the Exchange to provide liquid markets and compete for order flow in such orders.

As stated above, the rule applies only to synthetic option orders in which the option component is for a size of 100 contracts or more that are represented in the trading crowd in open outcry, and would be subject to a pilot program through June 30, 2007.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act\(^{10}\) in general, and furthers the objectives of Section 6(b)(5) of the Act\(^{11}\) in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest, by adopting a limited exception to the Exchange’s priority rules concerning synthetic option orders.

B. Self-Regulatory Organization’s Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

\(^{10}\) 15 U.S.C. 78f(b).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing proposed rule change: (1) does not significantly affect the protection of investors or the public interest; and (2) does not impose any significant burden on competition. Therefore, it has become effective pursuant to Section 19(b)(3)(A)\textsuperscript{12} of the Act and Rule 19b-4(f)(6)\textsuperscript{13} thereunder. The Exchange requests that the Commission waive the 5-day pre-filing requirement, and that the Commission waive the 30-day period for the proposal to become operative in order to ensure the continuity of the pilot, which is scheduled to expire June 30, 2006.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission’s Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2006-38 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.


\textsuperscript{13}17 CFR 240.19b-4(f)(6).
All submissions should refer to File Number SR-Phlx-2006-38. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (http://www.sec.gov/rules/sro.shtml). 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 the filing also will be available for inspection and copying at the principal office of the Phlx. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Phlx-2006-38 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.\textsuperscript{14}

Nancy M. Morris
Secretary

\textsuperscript{14} 17 CFR 200.30-3(a)(12).