

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 53919 / June 1, 2006**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-12315**

**In the Matter of**  
  
**Philadelphia Stock Exchange, Inc.,**  
  
**Respondent.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND A CEASE-  
AND-DESIST ORDER PURSUANT TO  
SECTIONS 19(h) AND 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate, in the public interest, and for the protection of investors that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against Philadelphia Stock Exchange, Inc. (“Phlx”).

**II.**

In anticipation of the institution of these proceedings, Phlx has submitted an Offer of Settlement (the “Offer”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Phlx consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

### III.

On the basis of this Order and Phlx's Offer, the Commission finds that:

#### A. Summary

This matter involves Phlx's failure to adequately enforce certain rules governing options<sup>1</sup> and equities trading and order handling rules. From approximately April 1999 through at least January 2002, Phlx had several deficiencies in its surveillance procedures for assuring compliance with its rules as well as the federal securities laws. Phlx did not conduct adequate surveillance for certain types of trading and order handling violations by its specialists. Phlx's failure to adequately surveil for certain rule violations was a result of either Phlx's failure to develop any program to detect such violations, or the programs in place were not adequate to detect such violations. These deficiencies were a substantial cause of Phlx's failure to adequately enforce certain of its rules governing options and equities trading and order handling. As a result, Phlx violated Section 19(g) of the Exchange Act.

#### B. Respondent

**Phlx**, located in Philadelphia, Pennsylvania, is a national securities exchange registered with the Commission pursuant to Section 6 of the Exchange Act. Phlx trades nearly 2,000 stocks, 1,600 equity options, 18 sectors index options, and currency options.

#### C. Discussion

Section 19(g) of the Exchange Act requires registered exchanges to comply with their own rules, as well as the federal securities laws, and, absent reasonable justification or excuse, to enforce compliance with them by their members and persons associated with their members. Phlx had deficient surveillance programs related to options and equities trading and order handling rules. As a result, it did not properly enforce the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules and, therefore, violated Section 19(g) of the Exchange Act.

The regulatory failures addressed here follow others in the late 1990s, which the Commission addressed in an order issued in September 2000. In the Matter of Certain Activities of Options Exchanges, Sec. Rel. No. 43268 (September 11, 2000) ("September 2000 Order"). The September 2000 Order found that, among other things, Phlx failed to adequately enforce its order handling rules, policies, and procedures in its options market and ordered the Phlx to enhance and improve its surveillance, investigative and enforcement processes with respect to options order handling rules.<sup>2</sup> In response to the September 2000 Order, Phlx implemented

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<sup>1</sup> All references in this Order to the term "options" refers specifically and solely to equity and equity index options.

<sup>2</sup> See September 2000 Order at Paragraph IV.B.f.

numerous enhancements to its regulatory program. However, despite these enhancements, certain inadequacies continued in Phlx's surveillance programs for order handling in its options market. Phlx also had inadequate surveillance programs for trading violations in its options market and trading and order handling violations in its equities market.

From at least April 1999 through at least January 2002, Phlx had deficiencies in its surveillance programs related to options and equities trading and order handling rules. Because of this inadequate surveillance, Phlx failed to detect certain violations by specialists.

## **1. Options Market**

In Phlx's options market, Phlx did not adequately surveil for violations of rules relating to priority of options orders. Phlx rules prohibit specialists from trading for their own account or for an account in which they have an interest at prices equal to or better than open customer orders,<sup>3</sup> and generally grant customer orders priority over all other orders on the floor when competing at the same price.<sup>4</sup> Priority rule violations include trading ahead and interpositioning violations. Trading ahead occurs when a specialist executes an order for his/her own account, or an account in which he/she holds an interest, while holding unexecuted customer orders, which would be entitled to an execution at the price the specialist received.<sup>5</sup> Interpositioning occurs when a specialist fails to match two marketable orders and instead executes the orders with its proprietary account as contra-party to each order to capture the spread between the orders. Phlx surveiled for potential violations of the priority rule by reviewing certain exception reports. However, in generating these reports, Phlx employed surveillance parameters that improperly excluded certain transactions and consequently, potential priority rule violations, from review.

Phlx's failure to properly surveil for priority rule violations in its options market included two main categories of transactions. First, Phlx's surveillance reports excluded instances in which a specialist traded in advance of customer orders that were eventually executed or cancelled. During the relevant time period, Phlx was only surveiling for priority rule violations for orders that remained on the specialists' books. Second, Phlx also improperly excluded from its surveillance reports instances in which customer orders represented by a specialist failed to participate in trades occurring between other floor participants, such as Registered Options Traders<sup>6</sup> ("ROTs"). Such occurrences can be indicative of a violation of the specialist's obligation to exercise due diligence in the representation of customer orders entrusted to him.

Phlx also did not adequately surveil for violations of the firm quote rule in its options market. Exchange Act Rule 11Ac1-1, effective in April 2001,<sup>7</sup> requires "every responsible

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<sup>3</sup> See Phlx Rules 452 and 1019.

<sup>4</sup> See Phlx Rule 1014(g).

<sup>5</sup> See Phlx Rules 452, 1019, and 1014(g).

<sup>6</sup> A Registered Options Trader ("ROT") is a participant on the exchange trading for their own or their firm's account who is responsible for making two-sided markets. A ROT is also referred to as a market maker.

<sup>7</sup> See Securities Exchange Act Rel. No. 43591 (Nov. 17, 2000), 65 FR 75489 (Dec. 1, 2000). This rule is now Rule 602 of Regulation NMS.

broker or dealer” to execute options transactions with customers at prices at least as favorable as their published bids or offers at the time the orders are presented and in any amount of contracts up to their published sizes.<sup>8</sup> Phlx surveiled for potential violations of the firm quote rule by reviewing certain exception reports. However, again, Phlx employed parameters that improperly excluded certain transactions, and consequently, certain firm quote rule violations, from review.

Phlx’s failure to properly surveil for firm quote rule violations in its options market included four main categories of transactions. First, Phlx’s surveillance reports for violations of the firm quote rule improperly excluded instances in which the customer order was received when the Phlx quote was not part of the national best bid or offer (“NBBO”). Second, Phlx improperly excluded instances in which the customer order was received when the NBBO was locked or crossed. Third, Phlx excluded from its firm quote surveillance report orders received prior to 9:45 a.m., and, as a result, did not surveil for any violations of the firm quote rule that occurred between the open of the market and 9:45 a.m. Finally, Phlx excluded all or none orders from its surveillance reports.<sup>9</sup>

## **2. Equities Market**

In its equities market, Phlx’s surveillance programs had similar deficiencies during the same time period relating to rules governing equities order handling, including the firm quote rule, priority rules, and limit order display.<sup>10</sup> Specifically, Phlx had not implemented any type of surveillance of its equities market to monitor its specialists for compliance with the firm quote rule. Furthermore, as with its options surveillance, Phlx also used exception reports to surveil for potential priority violations in its equities market. However, the reports improperly omitted instances in which the specialist traded ahead of a customer order where the customer order was eventually executed.

Phlx also had deficiencies with respect to surveillance for violations of equities trading rules relating to short sales, front-running,<sup>11</sup> marking the close,<sup>12</sup> and wash trades.<sup>13</sup> Specifically, Phlx had not implemented any type of surveillance of its equities market to monitor

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<sup>8</sup> A responsible broker or dealer is excused from its obligations under the firm quote rule under specified conditions set forth in that rule. See Rule 602 of Regulation NMS; see also Phlx Rule 1082.

<sup>9</sup> All or none orders are market or limit orders that are to be executed either in their entirety or not at all. See Phlx Rule 1066(c)(4). Phlx improperly excluded from its surveillance reports all or none orders with a size less than or equal to the Phlx disseminated size and, consequently, failed to surveil for possible firm quote violations.

<sup>10</sup> The limit order display rule requires specialists to immediately display a bid or offer that reflects the price and the full size of each customer limit order held by the specialist that improves the bid or offer of such specialist, and the full size of a customer limit order held by the specialist that (1) is priced equal to the bid or offer of such specialist, (2) is priced equal to the national best bid or offer, and (3) represents more than a de minimus change in the size of the specialist’s bid or offer. See Rule 604 of Regulation NMS and Phlx Equity Floor Procedure Advice A-1.

<sup>11</sup> Front-running involves a trader taking a position in a security to profit from advance non-public knowledge of an imminent order that may affect the market price of that security. See Phlx Rules 782 and 707.

<sup>12</sup> Phlx Rules 707 and 782 prohibit marking the close which involves trading at the end of the day in order to manipulate reported closing prices.

<sup>13</sup> See Phlx Rules 707 and 782.

its specialists for short sale violations. Furthermore, the reports generated to detect front-running, marking the close, and wash trade violations did not actually reflect the violations they were meant to detect. For example, Phlx had been unable to utilize its exception report effectively to identify potential instances of front-running because it generated an excessive number of alerts, most of which were false positives. Further, Phlx had not developed or implemented an adequate exception report to detect marking the close activity. The report Phlx used to detect wash trades was also ineffective, as it listed trades that were subsequently cancelled, and trades reported either the day, or several days, after the trade. This did not necessarily detect violative behavior. These surveillance programs were inadequate to fulfill Phlx's regulatory obligations.

### **3. Written Surveillance Procedures**

In addition to having inadequate surveillance reports, Phlx also did not maintain adequate written surveillance procedures for Phlx investigators reviewing the surveillance reports for options and equities trading and order handling violations. As a result, there was no adequate written guidance available to investigators to assist them in understanding what each report contained, how to review the reports, and how to identify items on the reports that required further scrutiny. For example, the surveillance procedure manuals were not updated to reflect changes in surveillance procedures including the actual practices of Phlx investigative staff reviewing the surveillance reports or as new exception reports were developed. Further, the written surveillance procedures for interpositioning, marking the close, and pegging and capping<sup>14</sup> violations did not accurately describe the content of the respective exception reports. Finally, Phlx did not provide sufficient written guidance to its investigative staff in certain sections of the procedural manual with respect to closing an exception without further action.

### **D. Violations**

Section 19(g)(1) of the Exchange Act requires every national securities exchange and self-regulatory organization to comply with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules, and, absent reasonable justification or excuse, enforce compliance with such provisions by its members and persons associated with its members. As described above, Phlx violated Section 19(g)(1) of the Exchange Act by failing to meet these responsibilities.

### **Phlx's Remedial Efforts**

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Phlx, cooperation afforded the Commission staff, and the commitment to improve

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<sup>14</sup> The purpose of pegging or capping is to manipulate the price of a security so that an option on the security will be out of the money at the time of expiration. Pegging involves trying to increase the value of the underlying security so that it will not be put to the option writers, while capping involves trying to decrease the value of the underlying security so that it will not be called. See Phlx Rules 707 and 782.

the oversight of its regulatory function described in Section IV below. These remedial acts include but are not limited to Phlx engaging outside counsel and consultants to conduct a complete review of its regulatory programs, augmenting the ranks of regulatory staff and management, and significantly increasing its regulatory budget in an effort to enhance its regulatory programs.

#### IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Phlx's Offer.

Accordingly, pursuant to Sections 19(h) and 21C of the Exchange Act it is hereby ORDERED that:

- A. Respondent Phlx cease and desist from committing or causing any violations and any future violations of Section 19(g) of the Exchange Act.
- B. Phlx shall comply with the following undertakings:
  1. Phlx shall, within 180 days after issuance of the final order, design and implement a mandatory, annual training program for all floor members and members of Phlx's regulatory staff responsible for surveillance, investigation, examination, and discipline of floor members that addresses compliance with the federal securities laws and Phlx's rules in place to prevent and deter unlawful trading by floor members.
  2. Phlx shall:
    - a. In 2006 and 2008, retain a Third Party Auditor ("Auditor"), not unacceptable to the Commission staff, to conduct a comprehensive audit of Phlx's surveillance, examination, investigation, and disciplinary programs relating to trading applicable to all floor members in order to achieve the following audit objectives:
      - i. To determine whether Phlx's policies and procedures are reasonably designed and effective to ensure compliance with and to detect and deter violations of the federal securities laws and Phlx's rules relating to trading; and
      - ii. To determine whether Phlx is in compliance with (1) the policies and procedures identified in Paragraph (a)(i) above; (2) any outstanding commitments made by Phlx in relation to recommendations made by the Commission's Office of Compliance Inspections and Examinations ("OCIE") or the Division of Market Regulation relating to compliance with trading

rules or surveillance for trading rule violations; and (3) any undertakings contained in this order, or Paragraph IV.B.f. of the September 2000 Order.

- b. Phlx shall require the Auditor and other qualified persons hired by the Auditor (“qualified persons”) to have adequate knowledge and understanding of Phlx’s regulatory programs, policies and procedures and shall possess sufficient competence and resources necessary to assess Phlx’s surveillance, examination, investigation, and disciplinary programs.
- c. Phlx shall require the Auditor to develop a written audit plan of sufficient scope and detail to achieve the audit objectives described in paragraph (a) above, and to identify regulatory areas in need of special consideration. In performing the audit, the Auditor and the qualified persons shall exercise due professional care and independence in performing the audit.
- d. Phlx shall require the Auditor to formulate an opinion based on sufficient, competent evidential matter that is obtained through, among other things, (i) inspection of documents, including written procedures, rules, and staff files; (ii) observation of trading processes and Phlx’s regulatory systems and practices; (iii) interviews of regulatory staff, floor members and other relevant persons; and (iv) case studies and testing of various regulatory functions and trading practices.
- e. Phlx shall cooperate fully with the Auditor and qualified persons and provide the Auditor and qualified persons with access to its files, books, records, and staff as reasonably requested for the audit.
- f. Phlx shall ensure that the audit is concluded within 180 days of the start of the field work. No later than 45 days after the audit is concluded, Phlx shall require the Auditor to submit an audit opinion as to its assessment of Phlx’s surveillance, examination, investigation, and disciplinary programs to the Phlx’s Board of Directors and to the following officials at the Commission (the “Commission Officials”): (i) the Director of OCIE and (ii) the Director of the Division of Market Regulation. The audit opinion shall also be included in Phlx’s annual report.
- g. No later than 45 days after the audit is concluded, Phlx shall require the Auditor to also submit an audit report to Phlx’s Board of Directors and to the Commission Officials (i) describing the purpose, scope and nature of the audit; and (ii) identifying any significant deficiencies or weaknesses in Phlx’s policies and procedures or Phlx’s compliance with the policies and procedures, OCIE recommendations, and undertakings described in paragraphs 1 and 2(a) above.

- h. No later than 90 days after the date of the audit report, Phlx shall review all significant deficiencies or weaknesses identified in the audit report and develop a written plan of corrective actions to address each deficiency or weakness, including a date by which each corrective action shall be implemented. Phlx shall maintain a copy of such plan for the entire period of this undertaking and shall provide the plan to the Commission staff upon request.
- i. Phlx shall bear the full expense of the audits. In 2006 and 2008, Phlx shall allocate \$500,000 for the establishment, retention and payment of the Auditor. If the expenses for the audits exceed the designated funds, the Phlx shall use additional funds to pay the costs of the audits. If any funds remain after the audit period, those funds shall be used solely for regulatory matters.
- j. Phlx shall require the Auditor to provide the Commission staff with any documents or other information the Commission staff requests regarding the Auditor's work pursuant to this undertaking. Phlx shall not assert, and shall require the Auditor to agree not to assert, privilege or work product claims in response to any of the Commission staff's requests.

By the Commission.

Nancy M. Morris  
Secretary