

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50100; File No. SR-Phlx-2003-59)

July 27, 2004

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments No. 1, 2, 3, 4, and 5 and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 6 and 7 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to the Exchange's New Electronic Trading Platform, "Phlx XL"

I. Introduction

On October 3, 2003, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt new rules for the implementation of its new electronic trading platform, "Phlx XL." On December 9, 2003, December 11, 2003, January 28, 2004, and May 11, 2004, the Exchange filed Amendments No. 1, 2, 3, and 4, respectively, to the proposed rule change.³ On June 4, 2004, the Exchange filed Amendment No. 5 to the proposed rule change.⁴ The proposed rule change and Amendments No. 1, 2, 3, 4, and 5 were published for comment in the Federal Register on June 15, 2004.⁵ The Commission received no comments with respect to the proposal, as amended. On July 6, 2004 and July 15, 2004, the Phlx filed Amendments No. 6 and 7, respectively, to the proposed rule change.⁶ This order approves the proposed rule change and

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letters from Richard S. Rudolph, Director and Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated December 9, 2003 ("Amendment No. 1"); December 11, 2003 ("Amendment No. 2"); January 28, 2004 ("Amendment No. 3"); and May 10, 2004 ("Amendment No. 4").

⁴ See letter from Richard S. Rudolph, Director and Counsel, Phlx, to Deborah Lassman Flynn, Assistant Director, Division, Commission, dated June 3, 2004 ("Amendment No. 5").

⁵ See Securities Exchange Act Release No. 49832 (June 8, 2004); 69 FR 33442 ("Notice").

⁶ See letters from Richard S. Rudolph, Director and Counsel, Phlx, to Deborah Lassman Flynn, Assistant Director, Division, Commission, dated July 2, 2004 ("Amendment No. 6") and July 14, 2004

Amendments No. 1, 2, 3, 4, and 5; grants accelerated approval to Amendments No. 6 and 7 to the proposed rule change; and solicits comments from interested persons on Amendments No. 6 and 7.

II. Description of the Proposal

The Exchange proposes to adopt rules regarding the Exchange's new electronic trading platform, Phlx XL. The proposal would permit on-floor Exchange Registered Options Traders ("ROTs"), to be called Streaming Quote Traders ("SQTs"), to submit streaming electronic option quotations via an electronic interface with the Exchange's Automated Options Market ("AUTOM") System.⁷

A. Implementation and Deployment

The Exchange proposes to begin the initial rollout of Phlx XL on an issue-by-issue basis, beginning with the first of approximately 10 issues not later than 10 days following the Commission's approval of the proposed rules applicable to Phlx XL.⁸ The Exchange also proposes to expand the deployment of Phlx XL to include the Top 120 equity options within 8 months of the initial deployment, and the Exchange expects to roll out Phlx XL for all options floor wide not later than December 31, 2005.⁹

("Amendment No. 7"). In Amendment No. 6, the Exchange (i) corrected technical drafting and typographical errors and omissions contained in the proposed rule text, and (ii) provided a more detailed description of the procedures by which the opening price on Phlx XL would be established. In Amendment No. 7, the Exchange further clarified the procedures by which the opening price on Phlx XL would be established for a six month pilot period, and reiterated its Section 11(a) representations.

⁷ AUTOM is the Exchange's electronic order delivery, routing, execution 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 features, AUTO-X, Book Sweep, and Book Match. 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. See Phlx Rule 1080.

⁸ See Notice, supra note 5.

⁹ See id. In January 2004, the Exchange submitted a proposal to modify the timing of the deployment of the ROT Access feature of its AUTOM system in light of the Exchange's proposal to introduce Phlx XL. See

B. Streaming Quote Traders and Streaming Quote Options

An SQT would be defined in proposed Phlx Rule 1014(b)(ii) as a ROT, who has received permission from the Exchange to generate and submit option quotations electronically through an electronic interface with AUTOM via an Exchange approved proprietary electronic quoting device in eligible options to which such SQT is assigned. The Exchange's Options Committee may, on an issue-by-issue basis, determine the specific issues, to be known as "Streaming Quote Options," in which SQTs may generate and submit option quotations.¹⁰ Phlx XL would allow an individual SQT to submit its own firm disseminated quotes representing its trading interest.

C. Market Maker Obligations

1. Specialist and SQT Quoting Requirements

Under the proposal, an SQT would be required to quote continuous, two-sided markets in not less than 60% of the series in each Streaming Quote Option in which such SQT is assigned.¹¹ The specialist assigned in a Streaming Quote Option would be required, however, to quote continuous, two-sided markets in 100% of the series in each assigned option. ROTs, including SQTs and ROTs who are not SQTs, would continue to be responsible to fulfill all of the requirements for ROTs set forth in Phlx Rule 1014.

Securities Exchange Act Release No. 49151 (January 29, 2004), 69 FR 6010 (February 9, 2004) (SR-Phlx-2004-01). Specifically, if Phlx XL is not deployed floor-wide for all options by April 30, 2005, the Exchange has committed to ensure that, as of that date, the AUTOM system automatically executes eligible incoming orders in options that are not then Streaming Quote Options (as defined below) against Phlx Price Improving Registered Options Traders and specialist price improving orders and orders matching such price-improving orders entered via the electronic interface with AUTOM, as described in Commentary .04 to Phlx Rule 1080.

¹⁰ See proposed Phlx Rule 1080(k).

¹¹ For example, if an SQT is assigned in one Streaming Quote Option that includes five series (A, B, C, D, and E), such SQT would be required to quote continuous, two-sided markets in three of those series in order to fulfill the 60% quoting requirement. If such an SQT initially submits quotations in series A, B, and C, and the size associated with the quotation in Series A is exhausted, such SQT would be required either to refresh its quotation in Series A while continuing to submit quotations in Series B and C, or to submit new quotations in any three of the five series to fulfill the 60% quoting requirement.

Proposed Phlx Rule 1014(b)(ii)(B) would set forth the minimum quotation size for specialists and SQTs in Streaming Quote Options traded on Phlx XL. Specifically, after a six-month implementation period, the specialist and any SQT assigned in a Streaming Quote Option on Phlx XL would be required to submit electronic quotations with a size of not less than 10 contracts¹² beginning on the date on which such Streaming Quote Option begins trading on Phlx XL.¹³

An SQT would be permitted to submit electronic quotations only while physically present on the floor of the Exchange. Under Phlx XL, SQTs and the specialist would be able to quote verbally in open outcry in response to a request for a market, or to quote electronically (or submit orders electronically) by use of an Exchange-approved quoting device.

2. Non-SQT ROT Quoting Requirements

Non-SQT ROTs trading Streaming Quote Options would be required to quote verbally in response to a request for a market, and would continue to have the ability to place limit orders electronically directly onto the limit order book through electronic interface with AUTOM.¹⁴ A non-SQT ROT would not, however, have the same continuous, electronic quoting requirements

¹² The ten-contract minimum quotation size obligation would apply only to an SQT or specialist's undecremented quote.

¹³ During a six-month implementation period commencing on the date of the initial deployment of Phlx XL (the "initial six-month period"), the specialist and any SQT assigned in a Streaming Quote Option would be permitted temporarily to submit electronic quotations with a size of fewer than 10 contracts for a period of 60 days after such option begins trading as a Streaming Quote Option. Beginning on the sixty-first day after such option begins trading as a Streaming Quote Option, SQTs and the specialist assigned in such Streaming Quote Option would be required to submit electronic quotations with a size of not less than 10 contracts. Subsequently, during a six-month period commencing on the first day following the expiration of the initial six-month period, the specialist and any SQT assigned in a Streaming Quote Option would be permitted to submit electronic quotations with a size of fewer than 10 contracts for a period of 30 days after such option begins trading as a Streaming Quote Option. Beginning on the thirty-first day after such option begins trading as a Streaming Quote Option, SQTs and the specialist assigned in such Streaming Quote Option would be required to submit electronic quotations with a size of not less than 10 contracts. Thereafter, the specialist and any SQT assigned in a Streaming Quote Option that is newly listed and deployed on Phlx XL would be required to submit electronic quotations with a size of not less than 10 contracts beginning on the date on which such Streaming Quote Option begins trading on Phlx XL.

¹⁴ See Phlx Rule 1080, Commentary .04.

as an SQT trading the same Streaming Quote Option, unless it traded in excess of a specified number of contracts electronically (i.e., by way of placing limit orders on the book that are executed via Book Match or Book Sweep, as described more fully below) in a given calendar quarter.

The proposed rule would require that, after a six-month implementation period, non-SQT ROTs would be required to provide quotations with a size of not less than 10 contracts beginning on the date on which the Streaming Quote Option begins trading on Phlx XL.¹⁵ The same size requirements set forth for non-SQT ROTs in open outcry would apply to non-SQT ROTs that are required to submit electronic quotations in a Streaming Quote Option for which a non-SQT ROT transacts more than 20% of his/her contract volume in a Streaming Quote Option electronically (i.e., by way of placing limit orders on the limit order book that are executed electronically and allocated automatically in accordance with proposed Phlx Rule 1014(g)(vii)) versus in open outcry during any calendar quarter.¹⁶

Proposed Phlx Rule 1014(b)(ii)(C)(1)(d) would clarify that any volume transacted electronically by a non-SQT ROT (i.e., limit orders placed on the limit order book that are

¹⁵ During the initial six-month implementation period, for a period of sixty days commencing immediately after an option begins trading as a Streaming Quote Option, such non-SQT ROTs may provide such quotations with a size of fewer than 10 contracts. Beginning on the sixty-first day after such option begins trading as a Streaming Quote Option, such quotations would be required to be for a size of at least 10 contracts. During a six month period commencing on the first day following the expiration of the initial six-month period, such non-SQT ROTs may provide such quotations with a size of fewer than 10 contracts for a period of thirty days after such option begins trading as a Streaming Quote Option. Beginning on the thirty-first day after such option begins trading as a Streaming Quote Option, such quotations would be required to be for a size of at least 10 contracts. Thereafter, such non-SQT ROTs would be required to provide such quotations with a size of not less than 10 contracts beginning on the date on which such Streaming Quote Option begins trading on Phlx XL.

¹⁶ See proposed Phlx Rule 1014(b)(ii)(C)(2).

executed via Book Match or Book Sweep) would not count towards the ROT's in-person requirement contained in Phlx Rule 1014, Commentary .01.¹⁷

D. ROT Limit Orders

The proposed rule change would amend the Exchange's rules regarding ROT electronic access to the limit order book.¹⁸ Currently, ROTs are permitted by rule to enter electronic price improving limit orders (and orders matching such orders entered by the specialist or other ROTs in the trading crowd) onto the limit order book via electronic interface with AUTOM, and are entitled to receive a special allocation in trades stemming from such price improving limit orders. Under the instant proposal, ROTs would be permitted under Phlx Rule 1080(b)(i)(B) and Commentary .04 to place certain limit orders on the limit order book electronically. The requirement that such limit orders be price-improving orders, however, would be deleted. ROTs would be permitted to place limit orders, including Good Till Cancelled ("GTC") orders, on the limit order book whether such an order improves the then-prevailing Exchange market or not. ROTs entering limit orders on the book would be required, after the phased-in implementation discussed above,¹⁹ to submit such orders with a size of at least ten contracts in both Streaming Quote Options and non-Streaming Quote Options. "Price-Improving ROTs" that place price-improving limit orders would continue to be entitled to receive contracts under the aforementioned special allocation.

The proposed rule would provide that, with respect to Streaming Quote Options, inbound AUTOM orders or electronic quotations eligible for execution against non-SQT ROT orders

¹⁷ Phlx Rule 1014, Commentary .01 provides that, for an ROT to receive specialist margin treatment for off-floor orders in any calendar quarter, the ROT must execute the greater of 1,000 contracts or 80% of his total contracts that quarter in person and 75% of his total contracts that quarter in assigned options.

¹⁸ See proposed Phlx Rule 1080(b)(i)(B) and Commentary .04.

¹⁹ See note 15 and accompanying text.

entered into AUTOM via electronic interface would be automatically executed and would be allocated automatically pursuant to Exchange rules.²⁰

E. Assignment in Streaming Quote Options

Under the proposal, the Options Allocation, Evaluation and Securities Committee (“OAESC”)²¹ would assign SQTs in one or more eligible options in a fashion similar to the current practice of allocating trading privileges to specialists. Proposed Phlx Rule 507 would provide that an application for assignment in Streaming Quote Options would be submitted in writing to the Exchange’s designated staff and would be required to include, at a minimum, the name of the SQT applicant and written verification from the Exchange’s Membership Services Department that such SQT applicant is qualified as a ROT.

To ensure an SQT applicant’s technological readiness to submit electronic quotes, proposed Phlx Rule 507(b)(ii) would mandate that no application for assignment in Streaming Quote Options would be approved by the OAESC without written certification signed by an officer (Vice President or above) of the Exchange’s Financial Automation Department indicating that the SQT applicant has sufficient technological ability to support his/her continuous quoting requirements as set forth in Phlx Rule 1014(b)(ii), and the SQT applicant has successfully completed, or is scheduled to complete, testing of its quoting system with the Exchange.

To clarify that proposed Phlx Rule 507 is not intended to function as a barrier to entry to the Exchange’s marketplace and to account for the possibility that quote capacity could become an issue for SQT applicants, the Exchange proposes to add Phlx Rule 507(b)(iii) to provide that

²⁰ With respect to Streaming Quote Options, non-SQT ROT limit orders on the book, entered electronically or manually by the specialist, that are automatically executed would be allocated pursuant to proposed Phlx Rule 1014(g)(vii).

²¹ The Options Allocation, Evaluation and Securities Committee has jurisdiction over the allocation, retention and transfer of the privileges to deal in all options to, by and among members on the options and foreign currency options trading floors. See Exchange By-Law Article X, Section 10-7. See also, Phlx Rule 500.

(i) there is no limit on the number of qualifying ROTs that may become SQTs and (ii) any applicant that is qualified as an ROT in good standing and that satisfies the technological readiness and testing requirements described in sub-paragraph (b)(ii) must be approved as an SQT. Proposed Phlx Rule 507 also states that, based on system constraints, capacity restrictions or other factors relevant to the maintenance of a fair and orderly market, the Board would be permitted to defer, for a period to be determined in the Board's discretion, approval of qualifying applications for SQT status pending any action required to address the issue of concern to the Board. The Board would not be permitted to defer a determination of the approval of the application of any SQT applicant or place any limitation(s) on access to Phlx XL on any SQT applicant unless the basis for such limitation(s) or deferral has been objectively determined by the Board and submitted to the Commission for approval or effectiveness pursuant to a proposed rule change filed under Section 19(b) of the Act. The Committee would be required to provide written notification to any SQT applicant whose application is the subject of such limitation(s) or deferral, describing the objective basis for such limitation(s) or deferral.

The proposed rule also includes a provision that, during the first six months of the deployment of Phlx XL, an SQT applicant member or member organization that has, for at least the immediately preceding twelve months, been a member of the Exchange and maintained a continuous presence as an ROT in the trading crowd associated with the Streaming Quote Option(s) that are the subject of the application must be guaranteed an assignment in the Streaming Quote Option, provided that such member organization has received the written certification concerning technological readiness as set forth in proposed Phlx Rule 507(b)(ii).

Proposed Phlx Rule 507(g) would clarify that an appeal to the Board of Governors from a decision of the Committee may be taken by a member or member organization interested therein

by filing with the Secretary of the Exchange written notice of appeal within ten (10) days after the decision has been rendered, in accordance with Exchange By-Law Article XI, Section 11-1.

F. Trade Allocation in Streaming Quote Options

The proposed rules would codify the allocation algorithm that would apply to orders or electronic quotes in Streaming Quote Options that result in automatic executions²² via the AUTOM System.²³ In the case of trades stemming from orders that are not automatically executed and instead handled manually by the specialist or represented in the trading crowd by a Floor Broker, current Exchange rules concerning allocation of non-automatically executed trades would apply.²⁴

The proposed rules would require that automatically executed trades in Streaming Quote Options would be allocated among the specialist and crowd participants with orders or

²² Trades in Streaming Quote Options involving inbound orders and specialist and SQT quotes delivered via AUTOM would be automatically executed by the Book Match function (described below in Section II.I). Eligible orders for non-Streaming Quote Options delivered via AUTOM would be automatically executed via AUTO-X, an automatic execution feature of AUTOM (see Phlx Rule 1080(c)), or against contra-side orders resting on the limit order book by Book Match under Phlx Rule 1080(g)(ii).

²³ The proposed trade allocation rules would only apply to trades in Streaming Quote Options that are automatically executed via Book Match pursuant to Phlx Rule 1080(g)(ii) and via Book Sweep described below in Section II.J pursuant to Phlx Rule 1080(c)(iii). Currently, trades that are automatically executed via AUTO-X are allocated among the specialist and ROTs participating on the “Wheel.” The “Wheel” is a feature of AUTOM that provides an automated mechanism for assigning specialists and ROTs signed on the Wheel for a given listed option, on a rotating basis, as contra-side participants to trades executed via AUTO-X. See Phlx Rule 1080(g) and Option Floor Procedure Advice (“OFPA”) F-24. Under the instant proposal, trades in Streaming Quote Options that are automatically executed via Book Match pursuant to the proposed amendments to Phlx Rule 1080(g)(ii) would be allocated automatically according to the algorithm set forth in proposed Phlx Rule 1014(g)(vii) and proposed OFPA B-6, Section F. Trades in non-Streaming Quote Options that are automatically executed via AUTO-X would continue to be allocated on the Wheel or by Book Match.

²⁴ In April 2003, the Commission approved the Exchange’s proposal to adopt Phlx Rule 1014(g)(v) and OFPA B-6 concerning the allocation of non-automatically executed orders in options. See Securities Exchange Act Release No. 47739 (April 25, 2003), 68 FR 23354 (May 1, 2003) (SR-Phlx-2001-39).

quotations at the Exchange's disseminated price after public customer market and marketable limit orders have been executed.²⁵

Quoting alone at the Exchange's best bid/offer. The proposed rules provide that if one Phlx XL participant is quoting alone at the disseminated price and its quote is not matched by another Phlx XL participant prior to execution, such Phlx XL participant would be entitled to receive a number of contracts up to the size associated with his/her quote.

Parity. The proposed rules codify the automatic allocation algorithm that would apply to orders or electronic quotes in Streaming Quote Options that result in automatic executions when two or more Phlx XL participants have quotes or booked limit orders at the Exchange's disseminated price.²⁶

Quotations entered electronically by the specialist or an SQT that do not cause an order resting on the limit order book to become due for execution may be matched, or joined, at any time by quotations entered electronically by the specialist and/or other SQTs, and by ROT limit orders placed on the limit order book via electronic interface, and would be deemed to be on parity, subject to the requirement that orders of controlled accounts must yield priority to customer orders as set forth in Phlx Rule 1014(g)(i)(A).

Quotations entered electronically by the specialist or an SQT that cause the specialist's quote, an SQT's quote, or an order resting on the limit order book to become due for execution

²⁵ Phlx Rule 1014(g)(i)(A) requires that orders of controlled accounts must yield priority to customer orders. A "controlled account" includes any account controlled by or under common control with a broker-dealer (such as a specialist or an SQT). Customer accounts are all other accounts.

²⁶ Phlx Rules 119, 120, and 1014(g) are the general rules concerning establishment of parity and priority in the execution of orders on the options floor. The trade allocation algorithm in proposed Phlx Rule 1014(g)(vii) generally does not contemplate that price-time priority would apply to quotes and orders in Streaming Quote Options. Proposed Phlx Rule 1014(g)(vii)(B)(4) thus would state that, notwithstanding the first sentence of Phlx Rule 1014(g)(i), neither Phlx Rule 119(a)-(d) and (f), nor Phlx Rule 120 (insofar as it incorporates those provisions by reference) would apply to the allocation of automatically executed trades in Streaming Quote Options.

would be subject to execution under the proposed amended rules concerning the Exchange's Book Match or Book Sweep functions, described more fully below.

Specialist on parity. If the specialist is quoting at the Exchange's best bid/offer, after public customer market and marketable limit orders have been executed, the specialist would initially be entitled to receive the entire allocation of orders for five contracts or fewer.²⁷

With respect to orders for greater than five contracts, the specialist would be entitled to receive the greater of the proportion of the total disseminated size at the disseminated price represented by the size of the specialist's quote or a specified percentage of the contracts to be allocated, depending on how many ROTs are on parity.²⁸

After public customer limit orders have been executed and the specialist has received its entitlement, SQTs quoting at the disseminated price and non-SQT ROTs that have placed limit orders on the limit order book via the electronic interface representing the Exchange's disseminated price would be entitled to receive a number of contracts that is the proportion of the remaining aggregate size associated with SQT quotes and non-SQT ROT limit orders on the book entered via the electronic interface at the disseminated price represented by the size of the SQT's quote or, in the case of a non-SQT ROT, by the size of the limit order they have placed on the limit order book via the electronic interface. Such SQT(s) and non-SQT ROTs would not be

²⁷ Proposed Phlx Rule 1014 (g)(vii)(B)(1)(a) provides that, on a quarterly basis, the Exchange will evaluate what percentage of the volume executed on the Exchange is comprised of orders for five contracts or fewer executed by specialists, and will reduce the size of the orders included in this provision if such percentage is over 25%.

²⁸ Specifically, the specialist would receive: (i) 60% of the contracts to be allocated if the specialist is on parity with one SQT or one non-SQT ROT that has placed a limit order on the book at the Exchange's disseminated price; (ii) 40% of the contracts to be allocated if the specialist is on parity with two SQTs or non-SQT ROTs that have placed a limit order on the book at the Exchange's disseminated price; or (iii) 30% of the contracts to be allocated if the specialist is on parity with three or more SQTs or non-SQT ROTs that have placed a limit order on the book at the Exchange's disseminated price. To be entitled to receive the specified percentages, and the five contract or fewer order preference, the specialist must be quoting at the Exchange's disseminated price. The specialist would not be entitled to receive a number of contracts that is greater than the size associated with the specialist's quote.

entitled to receive a number of contracts that is greater than the size associated with their quotation or limit order.

With respect to contracts relating to off-floor broker-dealer²⁹ limit orders resting on the limit order book that are executed and allocated automatically, if any contracts remain to be allocated after the specialist, SQTs, and non-SQT ROTs with limit orders on the limit order book have received their respective allocations, off-floor broker-dealers that have placed limit orders on the limit order book which represent the Exchange's disseminated price would be entitled to receive the number of contracts that is the proportion of the aggregate size associated with off-floor broker-dealer limit orders on the limit order book at the disseminated price represented by the size of the limit order they have placed on the limit order book. Such off-floor broker-dealers would not be entitled to receive a number of contracts that is greater than the size that is associated with its order.

However, when an off-floor broker-dealer order is resting on the limit order book at the Exchange's disseminated bid or offer, an order executed manually by the specialist would be required to be allocated first to customer orders, and next to off-floor broker-dealer limit orders, before the specialist and SQTs with quotations at the same price and non-SQT ROTs that have placed limit orders via electronic interface at the same price would be entitled to receive their respective allocations under proposed Phlx Rule 1014(g)(vii).

Currently, Phlx Rule 1014(g)(i)(A) provides that orders of controlled accounts³⁰ must yield priority to customer orders, but that orders of controlled accounts are not required to yield

²⁹ Phlx Rule 1080(b)(i)(C) defines an "off-floor broker-dealer" as a broker-dealer that delivers orders from off the floor of the Exchange for the proprietary account(s) of such broker-dealer, including a market maker located on an exchange or trading floor other than the Exchange's trading floor who elects to deliver orders via AUTOM for the proprietary account(s) of such market maker.

³⁰ See supra note 23.

priority to other controlled account orders. The Exchange proposes to amend Phlx Rule 1014(g)(i)(A) to require the specialist, SQTs and non-SQT ROTs to yield priority to off-floor broker-dealer limit orders in Streaming Quote Options resting on the limit order book solely in the limited circumstance where the specialist executes such an order manually, and not in the circumstance where such an order is executed and allocated automatically under Phlx XL.

Specialist not on parity. If the specialist is not quoting at the Exchange's disseminated quote, SQTs quoting at the disseminated price and non-SQT ROTs that have placed limit orders on the limit order book via the electronic interface which represent the Exchange's disseminated price would be entitled to receive the number of contracts that is the proportion of the total remaining disseminated size at the disseminated price represented by the size of the SQT's quote or, in the case of a non-SQT ROT, by the size of the limit order they have placed on the limit order book via the electronic interface. Thereafter, off-floor broker-dealers that have placed limit orders on the limit order book which represent the Exchange's disseminated price would be entitled to receive a number of contracts that is the proportion of the aggregate size associated with off-floor broker-dealer limit orders on the limit order book at the disseminated price represented by the size of the limit order they have placed on the limit order book, not to exceed the size of their limit orders.

Split price executions. Proposed Phlx Rule 1014(g)(vii)(B)(3) provides that there would be no automatic split-price executions in Streaming Quote Options. Therefore, if a market order or an electronic quotation to be executed in a Streaming Quote Option is received for a greater number of contracts than the Exchange's disseminated size, the portion of such an order or quotation executed via Book Match at the Exchange's disseminated size would be allocated in

accordance with proposed Phlx Rule 1014(g)(vii). Contracts remaining in such an order would be represented by the specialist and handled in accordance with Exchange rules.

Participation in non-electronic orders. An SQT participating in a crowd (together with the specialist and non-SQT ROTs in the crowd) would be permitted to participate in manual trades initiated by Floor Brokers or the specialist in such a crowd. Accordingly, an SQT generally must be present in the trading crowd to participate in non-electronic trades, with one exception. Proposed Phlx Rule 1014, Commentary .05(c) would provide that, where a non-electronic trade is initiated by a Floor Broker or specialist, an SQT assigned in a Streaming Quote Option who is located in the SQT Zone (as described below) for the Streaming Quote Option, but who is not participating in the crowd trading the Streaming Quote Option, would be able to participate in such a manual trade only if the non-electronic order is executed at the price quoted by the non-crowd participant SQT at the time of execution. For purposes of trade allocation, such an SQT would be entitled to receive contracts under existing Phlx Rule 1014(g)(v), which applies to the allocation of contracts for orders handled manually by the specialist or represented in the crowd by a floor broker.

The proposed rule would also permit the specialist or SQTs participating in a crowd, in response to a verbal request for a market by a floor broker, to state a bid or offer that is different than its electronically submitted bid or offer, provided that such stated bid or offer is not inferior to such electronically submitted bid or offer, with one exception. Specifically, Commentary .05(c) would provide that the requirement that a specialist or SQT state a bid or offer that is not inferior to its electronically submitted quotation would not apply if the bid or offer is in response to a floor broker's solicitation of a single bid or offer as set forth in Phlx Rule 1033(a)(ii). In such a situation, Phlx Rule 1033(a)(ii) permits the members of a trading crowd to discuss,

negotiate and agree upon the price or prices at which an order of a size greater than the Exchange's disseminated size can be executed at that time, or the number of contracts that could be executed at a given price or prices.³¹ The Exchange also proposes to amend Phlx Rule 1033(a)(ii) and OFPA F-32 to provide that orders executed under the Rule and OFPA are subject to the provisions of the Plan for the Purpose of Creating an Options Intermarket Linkage ("Linkage Plan") and Phlx Rules 1083 – 1087.

G. Crowd Area

For purposes of Phlx Rule 1014, Commentary .05(c), an SQT or non-SQT ROT would be deemed to be participating in a crowd if such SQT or non-SQT ROT is, at the time an order is represented in the crowd, physically located in a specific "Crowd Area." A Crowd Area would consist of a physical location marked with specific, visible physical boundaries on the options floor, as determined by the Options Committee. An SQT or non-SQT ROT who is physically present in such Crowd Area may engage in options transactions in assigned issues as a crowd participant in such a Crowd Area, provided that such SQT or non-SQT ROT fulfills the requirements set forth in Phlx Rule 1014. An SQT or non-SQT ROT would be deemed to be participating in a single Crowd Area, and thus would not be permitted to be a crowd participant in more than one particular Crowd Area at any specific time.

³¹ Phlx Rule 1033(a)(ii) and OFPA F-32, Solicitation of Quotations, provide that, in response to a floor broker's solicitation of a single bid or offer, the members of a trading crowd (including the specialist and ROTs) may discuss, negotiate and agree upon the price or prices at which an order of a size greater than the AUTO-X guarantee can be executed at that time, or the number of contracts that could be executed at a given price or prices. Notwithstanding the foregoing, a single crowd participant may voice a bid or offer independently from, and differently from, the members of a trading crowd (including the specialist and ROTs). See Securities Exchange Act Release No. 45573 (March 15, 2002), 67 FR 13674 (March 25, 2003) (SR-Phlx-2001-33).

H. SQT Zones

Proposed Phlx Rule 1014, Commentary .05(b) would provide that an SQT may be assigned to, and thus submit quotes electronically in, all of the options located within, a specified physical zone on the Exchange Floor (an “SQT Zone”) provided that such SQT is physically present in such SQT Zone.³² Thus, each member organization must have at least one SQT physically present in each SQT Zone in which it submits electronic quotations. An SQT Zone could consist of multiple Crowd Areas.

I. Book Match

Book Match is a feature of AUTOM that currently provides automatic executions for inbound AUTOM-delivered customer and off-floor broker-dealer orders against customer limit orders on the book.³³ The proposed rules would amend Book Match to provide that the contra-side to automatically executed inbound eligible orders would be a limit order on the book or specialist and/or SQT electronic quotes (“electronic quotes”) at the disseminated price where the Exchange’s disseminated size includes a limit order on the book and/or electronic quotes at the disseminated price.

J. Book Sweep

Similar to Book Match, the Book Sweep function currently matches specialist quotations generated automatically against booked limit orders representing the Exchange’s disseminated

³² Initially, there would be one SQT Zone representing the entire options trading floor. This means that an SQT could submit electronic quotations in any Streaming Quote Option while such SQT is physically on the Exchange floor. The number and location of any additional SQT Zones would be determined by the Options Committee based on its review of quote and trade data during the first six months of the deployment of Phlx XL. Proposed Phlx Rule 1014, Commentary .05(b) would require the Exchange to file for, and receive, Commission approval in the event the Options Committee determines to change the number and/or location of SQT Zones.

³³ Book Match would not be engaged: (i) when the Exchange’s disseminated price represented by a limit order on the book is not the National Best Bid or Offer (“NBBO”); (ii) for pre-opening orders; and (iii) during trading rotations. In these situations, incoming orders would be subject to manual handling by the specialist.

bid or offer when such quotations lock or cross the booked limit order (provided that the disseminated bid or offer is at the NBBO). Currently, Phlx Rule 1080(c)(iii) provides that, when the bid or offer generated by the Exchange's Auto-Quote system or SQF matches (locks) or crosses the Exchange's best bid or offer in a particular series as established by an order on the limit order book, orders on the limit order book in that series will be automatically executed up to the size associated with the quote that locks or crosses the order on the limit order book and allocated among crowd participants signed onto the Wheel.

Book Sweep would be amended in Phlx XL for Streaming Quote Options to allow SQT quotations, in addition to specialist quotations, to initiate the Book Sweep function. The SQT Book Sweep feature would function in essentially the same manner as the current Auto-Quote or SQF Book Sweep feature, i.e., when an SQT submits a quotation that locks or crosses a limit order on the book that represents the Exchange's best bid or offer, such limit order would be executed automatically up to the size associated with the SQT's quotation, and would be automatically allocated to the SQT that submitted the quotation. The specialist or SQT may manually initiate the Book Sweep feature by sending a manual quote in situations where the specialist or SQT's automatic generation of electronic quotations is suspended due to, for example, a system malfunction. Eligible orders on the limit order book would be automatically executed up to the size associated with the quote that matches or crosses such limit orders. Orders on the limit order book would not be eligible for Book Sweep when the NBBO is crossed (e.g., 2.10 bid, 2 offer). The current functionality of Book Sweep would remain effective for non-Streaming Quote Options, however, proposed Phlx Rule 1080(c)(iii) would apply the enhanced Book Sweep functionality for Streaming Quote Options.

K. Firm Quotations

Definition of disseminated size. The Exchange proposes to amend Phlx Rule 1082 by establishing by rule the Exchange's firm quotation size with respect to non-Streaming Quote Options and with respect to Streaming Quote Options.³⁴

Respecting non-Streaming Quote Options, the Exchange's "disseminated size" would be defined as at least the sum of the size associated with: (i) limit orders; and (ii) specialists' quotations generated automatically as described in Phlx Rule 1080, Commentary .01 (which represents the collective quotation size of the specialist and any ROTs bidding or offering at the disseminated price unless an ROT has expressly indicated otherwise in a clear and audible manner). The proposed definition of "disseminated size" respecting non-Streaming Quote Options would provide more specificity to the current definition, which includes at least the sum of limit orders and allows, but does not require, the specialist and/or crowd to add additional size to the Exchange's disseminated size.

The Exchange proposes to adopt new Phlx Rule 1082(a)(ii)(B) to establish by rule the definition of "disseminated size" that would apply to Streaming Quote Options. Specifically, for Streaming Quote Options, "disseminated size" would mean at least the sum of the size associated with limit orders, specialists' quotations,³⁵ and SQTs' quotations. The Exchange would disseminate the aggregate size of these three components.

Proposed Phlx Rule 1082(a)(ii)(C)(1) provides that, if an SQT's quotation size in a Streaming Quote Option is exhausted, such SQT's quotation would be deleted from the

³⁴ Rule 11Ac1-1(d)(1)(i) under the Act permits an exchange to establish by rule, and periodically publish, the quotation size for listed options, for which responsible brokers or dealers are obligated to execute an order. 17 CFR 240.11Ac1-1(d)(1)(i).

³⁵ Because the specialist and SQTs in Streaming Quote Options would be quoting independently, the term "specialist's quotations" with respect to Streaming Quote Options would mean the individual specialist's quotation, including, for purposes of the definition of "disseminated size," the size associated with such a quotation.

Exchange's disseminated quotation until the time the SQT revises his/her quotation. Although such SQT's quotation size in a given series may be exhausted and thus removed from the Exchange's disseminated quotation in that series, such an SQT would nonetheless continue to be required to submit continuous two-sided quotations in not less than 60% of the series in each Streaming Quote Option to which such SQT is assigned, in accordance with proposed Phlx Rule 1014(b)(ii)(B).

Proposed Phlx Rule 1082(a)(ii)(C)(2) provides that, if the Exchange's disseminated size in a particular series in a Streaming Quote Option is exhausted, the Exchange would disseminate the next best available quotation.³⁶ If no specialist or SQT has revised its quotation immediately following the exhaustion of the Exchange's disseminated size, the Exchange would automatically disseminate the specialist's most recent disseminated price prior to the time of such exhaustion with a size of one contract.

Responsible broker or dealer. Currently, the Exchange's disseminated market is deemed to represent the quotations of all ROTs in that option unless an ROT has expressly indicated otherwise.³⁷ All ROTs in such an option who have not expressly indicated that the disseminated market does not represent their quote would collectively be bidding or offering at the disseminated price, and thus are the collective "responsible brokers or dealers" for purposes of the Exchange's "Firm Quote" requirement. Phlx Rule 1082(b) currently provides that responsible brokers or dealers bidding (or offering) at the disseminated price are collectively

³⁶ The Exchange would have available the quotations submitted by the specialist and SQTs in a particular series, and would disseminate only the aggregate size of SQT and specialist quotations at the best bid and offer on the Exchange. If the best bid or offer is exhausted and not refreshed, the Exchange would disseminate the next best bid or offer submitted by the specialist and/or SQTs quoting in the series.

³⁷ See Phlx Rule 1080, Commentary .01(c).

required to execute orders presented to them at such price up to the disseminated size. This would remain in effect for non-Streaming Quote Options.

Because SQTs and specialists would be quoting independently in Streaming Quote Options, each individual SQT and specialist would be deemed to be a “responsible broker or dealer” in Streaming Quote Options under proposed new Phlx Rule 1082(b)(ii). There thus would be individual “responsible brokers or dealers,” and no “collective” firm quotation requirement in Streaming Quote Options.

Locked and crossed markets. Two new commentaries to Phlx Rule 1082 are proposed, relating to the situation in which a specialist or SQT’s quotation locks (e.g., 1.00 bid, 1.00 offer) or crosses (e.g., 1.10 bid, 1.00 offer) another quotation.

Because the specialist and multiple SQTs would be quoting simultaneously, there may be instances where quotes may become locked. Under the proposal, the Exchange would disseminate the locked market and both quotations (bid and offer) would be deemed “firm” disseminated market quotations. Once SQT and/or specialists’ quotations become locked, a one-second “counting period” would begin during which SQTs and/or specialists whose quotations are locked may eliminate the locked market.³⁸ However, such SQT and/or specialist would be obligated to execute orders at their disseminated quotation. During the “counting period” SQTs and specialists located in the Crowd Area in which the option that is the subject of the locked market is traded would continue to be obligated to respond to floor brokers as set forth in Phlx Rule 1014, Commentary .05(c), and would continue to be obligated for one contract in open outcry to other SQTs, non-SQT ROTs, and specialists. If at the end of the counting period the

³⁸ The Options Committee may shorten the duration of the one-second “counting period.”

quotations remain locked, the locked quotations would automatically execute against each other in accordance with the allocation algorithm set forth in Phlx Rule 1014(g)(vii).

Crossed Markets. The Exchange will not disseminate an internally crossed market (e.g., \$1.10 bid, 1.00 offer). If an SQT or specialist submits a quotation in a Streaming Quote Option (“incoming quotation”) that would cross an existing quotation (“existing quotation”), the Exchange will: (i) change the incoming quotation such that it locks the existing quotation; (ii) send a notice to the SQT or specialist that submitted the existing quotation indicating that its quotation was crossed; and (iii) send a notice to the specialist or SQT that submitted the incoming quotation, indicating that its quotation crossed the existing quotation and was changed. Such a locked market would be handled in accordance with proposed Commentary .01 concerning locked markets. During the one-second counting period, if the existing quotation is cancelled subsequent to the time the incoming quotation is changed, the incoming quotation would automatically be restored to its original terms.

L. Other Rules and OFPAs

The Wheel. The Exchange proposes to amend OFPA F-24 to reflect that the Wheel will apply only to non-Streaming Quote Options.

Auto-X Disengagement. The provisions relating to orders otherwise eligible for automatic execution via AUTO-X currently included in Phlx Rule 1080(c)(iv) would continue to apply to non-Streaming Quote Options; such provisions would not apply to Streaming Quote Options because the automatic execution function for Streaming Quote Options is Book Match or Book Sweep, not AUTO-X.

Removal of Unreliable Quotes. While the Exchange is proposing to delete the provisions in Phlx Rule 1080(c)(i) relating to the NBBO Feature, certain language contained in that rule

describing the conditions and procedures under which the Exchange can exclude another market's quotes from its calculation of the NBBO would be retained. The provisions relating to the removal of unreliable quotes from another exchange from the Exchange's calculation of NBBO are intended to apply to both Streaming Quote Options and non-Streaming Quote Options.

Eligible AUTOM order types. Currently, the specialist, when alerted by AUTOM, handles the conversion of contingency orders on the limit order book into market or marketable limit orders when the respective condition applicable to such orders is manifested. The Exchange's systems do not currently perform this task electronically. The Exchange therefore proposes to amend Phlx Rule 1080(b)(i)(a) to provide that the following contingency order types would not be eligible for delivery via AUTOM: stop, stop limit market close, market on opening, limit on opening, and limit close.³⁹ Because the conversion of these contingency order types is not done electronically by AUTOM, such order types would not be eligible for electronic entry on the electronic limit order book. Previously, any limit order on the book that became due for execution against an inbound electronic order delivered via AUTOM was handled manually by the specialist. With the development and deployment of Book Match, such contingency orders may now be executed electronically, but would not be converted electronically. Thus, such orders would not be placed on the electronic limit order book. Customers wishing to submit such orders would be required to do so by way of representation by a Floor Broker.

Eligible order delivery size. To allow a greater number of orders to be delivered electronically to the Exchange via AUTOM, the Exchange proposes to amend Phlx Rules 1080(b)(i)(A), (B), and (C) to increase the maximum AUTOM order delivery size from 1,000

³⁹ For a complete description of these order types, see Phlx Rule 1066.

contracts to 5,000 contracts for all eligible order types. This increase would apply to both Streaming Quote Options and non-Streaming Quote Options.

Opening Rotations. In Amendment No. 7, the Exchange proposed additional amendments to Phlx Rule 1017, Priority and Parity at Openings in Options, and OFPAs A-12 and A-14, to adopt more specific rules relating to the manner in which the Exchange conducts openings, including openings in Streaming Quote Options. The Exchange proposes to adopt the proposed opening rules on a pilot basis, beginning on the first day of the deployment of Phlx XL, and scheduled to expire after 180 days.

The proposed rules address the opening process in three main parts: the pre-opening, the opening rotation, and the specialist's calculation of the price of the opening trade of the session in a given series. First, prior to the opening, the specialist would determine from Floor Brokers, and from orders resting on the limit order book, the size and prices of those orders which are near the previous closing prices of those options in which the specialist is assigned. In addition, the specialist would consider markets from ROTs in the crowd and, respecting Streaming Quote Options traded on Phlx XL, would consider electronic quotations submitted by SQTs in addition to establishing the specialist's own quote in the series. This would enable the specialist to ascertain orders and quotes on both sides of the market in a series to determine eventually the opening price in the series.

Because the proposed opening will not initially be automated, there would be no "broadcast" of opening limit orders and quotes on the Phlx XL system. The participants would, however, have access to market information necessary to ascertain bids and offers in the pre-opening phase. Specialists would be able to view the entire limit order book, including orders resting on the book from the previous trading session and any orders submitted before the

opening, on their on-floor screens (known as the X-Station), and would be able to view all electronically submitted quotes in Phlx XL options, while SQTs would have the same view of the limit order book and their own quotes, but not those of other SQTs. Non-SQT ROTs would be able to view the current on-floor displayed market, whether generated by a pre-opening quote or by limit orders at the then-best bid or offer. All in-crowd SQTs and the specialist, together with non-SQT ROTs in the crowd, would be able to ascertain all in-crowd verbal bids and offers.

Currently, OFPA A-12 requires the specialist to accept and include in the opening for options all market orders which are placed on the book five minutes or more prior to the opening of the underlying security, unless exempted by a Floor Official. The proposed rule change would modify this provision to require the specialist to accept and include in the opening for options all market orders that are placed on the book prior to the opening in the underlying security. Market orders that are received following the opening in the underlying security but prior to the opening in the overlying option will be accepted, but will not be included in the opening trade. If, however, such a market order could be executed against a contra-side order to fill an imbalance on the opening, the specialist would be required to match the market order and the contra-side order before the specialist could execute an order (or quotation with respect to Streaming Quote Options) for his own account.⁴⁰ The purpose of this provision is to allow the specialist to conduct an orderly opening in the particular series by establishing a “cut-off” time (the opening in the underlying security) after which the specialist would consider market orders

⁴⁰ Phlx Rule 1019 requires the specialist to give precedence to orders entrusted to him as an agent in any option in which he is registered before executing at the same price any purchase or sale in the same option for an account in which he has an interest. The Exchange represents that its Market Surveillance Department conducts surveillance for violations of this requirement. Therefore, according to the Exchange, if a specialist intends to trade for his own account on the opening, the specialist must first be sure that he does not trade ahead of any orders (as agent) even if received after the cut-off. Otherwise, he would be subject to possible disciplinary action for violation of Rule 1019, regardless of when such a market order is received (*i.e.*, in this circumstance, after the underlying security opens but prior to the opening in the underlying security). *See* Amendment No. 7, *supra* note 6.

already received in determining the opening price, without including potentially chaotic, last-minute market orders received after the opening in the underlying security but before the specialist has opened the series. Market orders would have precedence over limit orders at an opening regardless of account type (*i.e.*, customer, Firm, broker-dealer, ROT, specialist).⁴¹ Following the pre-opening phase, the specialist would conduct an opening rotation.⁴²

The proposed rule change would provide that the opening price is the price at which the specialist determines that the greatest number of contracts will trade, provided that such opening price falls within an acceptable range to be determined by the Options Committee. An acceptable range would be determined as a percentage of the highest bid as the lower boundary of the acceptable range, and as a percentage of the highest offer as the upper boundary of the acceptable range. For example, such an acceptable range may be established as 75% of the lowest bid and 125% of the highest offer. Once determined by the Options Committee, such an acceptable range would be announced to the membership via regulatory circular.⁴³ In the interest of a fair and orderly market, a Floor Official could provide a specific exemption from the established acceptable range in a particular series.

Proposed Commentary .03(b) to the rule includes further limitations on the opening price to be determined by the specialist. First, if two or more prices would satisfy the criteria for determining the opening price, the price which would leave the fewest number of contracts resting on the limit order book would be selected as the opening price. If there are still two or

⁴¹ The Exchange recently made technological changes that removed the member firm identifier from orders received via AUTOM. Therefore, the specialist can identify the account type in which an order is placed (*i.e.*, whether the order is for a customer, firm, broker-dealer or ROT account), but cannot identify the specific member organization that submitted the order.

⁴² A trading rotation is a series of very brief time periods during each of which bids, offers and transactions in only a single, specified option contract can be made. See Exchange Rule 1047, Commentary .01.

⁴³ This provision in the proposed rule is based on Chicago Board Options Exchange, Inc. Rule 6.2B(e)(ii).

more prices that would each satisfy such criteria, the price which is closest to the previous session's closing price would be selected as the opening price. Complex orders and contingency orders would not participate in opening rotations or in the determination of an opening price.

Once the specialist determines the opening price, the Exchange would disseminate the opening trade price to the Option Price Reporting Authority ("OPRA"). At this point, the series would be open for trading. Once the opening trade price in a series has been disseminated to OPRA, the specialist, ROTs and SQTs trading such series would be required to fulfill their respective quoting obligations under Rule 1014.

The proposed rule also includes circumstances in which a specialist would not open a series. Specifically, the specialist would not open a series if: it is not within an acceptable range, as described above, unless a specific exemption is given by a Floor Official in the interest of a fair and orderly market; the opening trade would leave a market order imbalance (i.e., there are more market orders to buy or to sell for the particular series than can be satisfied by the market orders, limit orders and specialist or SQT quotations on the opposite side). For purposes of this provision, "market orders" would include those orders that are treated as limit orders in accordance with Rule 1017(b) (i.e., orders at a limited price order to buy which is at a higher price than the price at which the option is to be opened and a limited price order to sell which is at a lower price than the price at which the option is to be opened) and market-on-opening orders.

In such a circumstance, the specialist would request bids and offers from ROTs in the crowd and, in the case of Streaming Quote Options, SQTs that are assigned in the option. Such ROTs and/or SQTs would be required to respond to such a request immediately. The series

could not open until responses to the specialist's request have been received and the consequent opening price is deemed by a Floor Official to be compatible with a fair and orderly market.

Finally, the proposed rule concerning openings would address the situation in which there are no orders in a particular series when the underlying security opens. In such a situation the Exchange would disseminate quotations in such series generated automatically upon the opening in the underlying security.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 6 and 7, including whether Amendments No. 6 and 7 are 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-2003-59 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-Phlx-2003-59. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such 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 Amendments No. 6 and 7 of File Number SR-Phlx-2003-59 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations promulgated thereunder applicable to a national securities exchange and, in particular, with the requirements of Section 6(b) of the Act.⁴⁴ Specifically, the Commission finds that approval of the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act⁴⁵ in that it is designed to facilitate transactions in securities; to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; 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.

⁴⁴ 15 U.S.C. 78f(b). In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁴⁵ 15 U.S.C. 78f(b)(5).

A. Market Maker Obligations

Phlx Rule 1014, as amended, would continue to govern market maker obligations. Under the proposed rule change, specialists would be required to maintain a continuous, two-sided quote in 100% of the series of Streaming Quote Options to which it is assigned, while each SQT would be required to maintain a continuous, two-sided quote in at least 60% of the Streaming Quote Options to which it is assigned. Non-SQT ROTs would be required to quote verbally in response to a request for a market, and maintain a two-sided quoting obligations in a designated percentage of series of Streaming Quote Options in the calendar quarter that followed a calendar quarter that it transacted more than 20% of its contract volume electronically in a Streaming Quote Option. However, if a non-SQT ROT transacts less than 20% of its contract volume electronically, it would not be bound by the quote spread parameters and the electronic quoting obligations set forth in Rule 1014, and electronic quotes would not count towards its in-person trading requirement.

The Commission believes that the obligations for specialists and ROTs (SQTs and non-SQTs) are consistent with the Act. As market makers, SQTs and non-SQT ROTs receive certain benefits for carrying out their duties. For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is to be used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange.⁴⁶ The Commission believes that a market maker should have an affirmative obligation to hold itself out as willing to buy and sell options for their own account on a regular or continuous basis to justify this favorable treatment. In this regard, by excluding electronic transactions from being applied towards satisfying a non-SQT

⁴⁶ See 12 CFR 221.5(c)(6).

ROTs in-person requirements where the non-SQT ROT transacts 20% or less of its contract volume electronically and is not required to continuously quote or comply with quote-width requirements, the Commission believes that the Exchange's proposal would impose such affirmative obligations on SQTs and non-SQT ROTs.

The Commission also believes that allowing an SQT and the specialist in a Streaming Quote Option to quote with a size of less than ten contracts during the initial stages of deployment of Phlx XL is not unreasonable, so that such SQTs and specialists may determine during this period of time that their quotation systems and models function properly and reliably, and may make any changes necessary to manage their risk while providing fair and orderly markets in the Streaming Quote Option.

B. Assignment in Streaming Quote Options

The Commission believes that the Exchange's SQT qualification and allocation requirements, which set forth objective criteria for the assignment of SQTs to Streaming Quote Options, are consistent with the Act. The Commission notes that the proposed requirements are similar to those adopted by other options exchanges.⁴⁷ In particular, the Commission notes that the proposed rule change, as amended, (i) places no limit on the number of qualifying ROTs that may become SQTs, and (ii) requires the OAESC to approve any applicant that is qualified as an ROT in good standing and that satisfies the technological readiness and testing requirements. The Commission also notes that the Exchange has no discretion to defer or limit the approval of qualifying applications for SQT status. In the event that the Board defers or limits the approval of qualifying applicants, such deferral or limitation must be based on system constraints and any basis for such deferral or limitation must be objectively determined by the Board and approved

⁴⁷ See, e.g., CBOE Rule 8.3(a); ISE Rule 802(a); and BOX Chapter VI, Section 4.

by the Commission pursuant to a proposed rule change filed under Section 19(b) of the Act. Moreover, the Committee must provide written notification to any SQT applicant whose application is the subject of such limitation(s) or deferral, describing the objective basis for such limitation(s) or deferral.

C. Allocation Algorithm

The Commission believes that the Phlx's proposed trade allocation algorithm that would apply to orders and electronic quotes in Streaming Quote Options that result in automatic executions via the AUTOM System is consistent with the Act. The Commission also believes that Phlx XL, including the proposed trade allocation algorithm, should substantially enhance incentives to quote competitively by providing market participants with the ability to independently submit their quotes and rewarding market participants that quote at the best price with an allocation of the resulting trade.

The proposed rules codify the automatic allocation algorithm that applies to orders or electronic quotes in Streaming Quote Options that result in automatic executions when two or more Phlx XL participants have quotes or booked limit orders at the Exchange's disseminated price. The proposed rules also codify how manual trades would be initiated and executed in Phlx XL. The Commission believes that the various types of Phlx XL executions, including automated and manual executions, should allow specialists, SQT ROTs, and non-SQT ROTs to provide more efficient and immediate executions for inbound orders and market maker quotations subject to priority and allocation principles.

The Commission notes that the proposal does not provide for split price executions. Consequently, if the size associated with a market order or an electronic quotation to be executed in a Streaming Quote Option is received for a greater number of contracts than the Exchange's

disseminated size, the portion of such an order or quotation executed automatically at the Exchange's disseminated size would be allocated automatically in accordance with Phlx Rule 1014(g)(vii), and the contracts remaining in such an order would be represented by the specialist and handled in accordance with Exchange rules. The Commission emphasizes that the contracts remaining for such orders should be handled in a manner that does not effectuate a trade-through⁴⁸ of better prices on other markets in violation of Exchange rules and the Linkage Plan.

The Commission also notes that in response to a floor broker's solicitation of a single bid or offer, the members of a trading crowd (including the specialist and ROTs) may discuss, negotiate and agree upon the price or prices at which an order of a size greater than the AUTO-X guarantee can be executed at that time, or the number of contracts that could be executed at a given price or prices, subject to the provisions of the Linkage Plan and Exchange rules.

D. Specialist Fiduciary Duties

The Exchange proposes to amend Phlx Rule 1014(g)(i)(A) to require the specialist, SQTs and non-SQT ROTs to yield priority to off-floor broker-dealer limit orders in Streaming Quote Options resting on the limit order book solely in the limited circumstance where the specialist executes such an order manually, and not in the circumstance where such an order is executed and allocated automatically under Phlx XL. The Commission believes that this provision should help ensure that the specialist complies with its fiduciary obligation when acting as agent for a limit order. In the situation where the off-floor broker-dealer limit order resting on the limit order book is executed and allocated automatically, the Commission believes that the operation of the proposed automatic trade allocation algorithm contained in proposed Phlx Rule

⁴⁸ Under the Linkage Plan and Exchange rules, a "Trade-Through" means a transaction in an options series at a price that is inferior to the NBBO. The Linkage Plan and Exchange Rules provide that, absent reasonable justification and during normal market conditions, members should not effect Trade-Throughs. See e.g., Phlx Rule 1085.

1014(g)(vii), which would allocate contracts to off-floor broker-dealer limit orders resting on the limit order book after customers, the specialist, SQTs and non-SQT ROTs have received their respective allocations is not unreasonable since the specialist is not acting as “agent” in that circumstance.

E. ROT Limit Orders

The Commission believes that the instant proposal, which would enable SQTs to stream electronic quotes, combined with the size pro rata allocation algorithm applicable to automatically executed trades resulting from such quotes, rewards market participants for quoting and providing liquidity at the best price. In addition, the Commission notes that in Streaming Quote Options, non-SQT ROTs with limit orders on the book at the Exchange’s disseminated price that are automatically executed would be allocated contracts according to proposed new Phlx Rule 1014(g)(vii), which would reward non-SQT ROTs who provide liquidity at the best price. Moreover, non-SQT ROTs that place price-improving limit orders would continue to receive a special allocation under the Exchange’s proposal. Therefore, the Commission believes that the proposal should provide incentives for market participants to quote competitively.

F. Book Match

The Commission believes that the proposed enhancements to Book Match should provide for a greater number of automatic executions by matching inbound orders against booked limit orders and SQT and specialist quotations that are included in the Exchange’s disseminated quotation, which should result in customers receiving quicker, more efficient executions for a larger number of trades.

G. Locked Markets

The Commission believes that the proposed rules relating to a one-second “counting period,” during which SQTs and/or specialists whose quotations are locked may eliminate a locked market, are consistent with the Commission’s Quote Rule. The Commission notes that, during the one-second “counting period,” market makers would continue to be required to honor their quotes and, thus, would be obligated to execute incoming orders pursuant to proposed Phlx Rule 1082. The Commission also notes that the market makers whose quotes are locked would continue to be obligated under the Quote Rule for at least one contract to each other during the counting period. At the end of the counting period, assuming neither market maker has changed its quotes, the market makers’ quotes would execute against each other in all series.

Accordingly, the Commission believes that the proposed “counting period” provides a reasonable method for SQTs or specialists that lock or cross a market to unlock or uncross the market. Importantly, during the “counting period,” the SQTs or specialists whose quotes are locked would remain obligated to execute customer and broker-dealer orders eligible for automatic execution at the locked price.

H. Firm Quotations

The Commission believes that the proposed amendments to the Exchange’s “Firm Quote” requirements are consistent with the Act. The Commission notes that the requirement that specialists’ quotations automatically generated be included in the disseminated size should result in a more accurate and transparent reflection of the size for which the Exchange is firm.

I. Opening the Market on Phlx XL

In Amendment No. 7, the Exchange proposes additional amendments to its rules relating to the manner in which the Exchange conducts openings to provide a more detailed description

of the procedures by which the opening price on Phlx XL would be established. The proposed opening rules set forth which orders and quotes the specialist in a particular option is required to accept prior to the opening in a given series. The proposed opening rules also provide that the opening price is the price at which the specialist determines that the greatest number of contracts would trade, subject to the opening price falling within an acceptable range, to be determined by the Options Committee. In addition, the proposed opening rules sets forth the circumstances in which a specialist would not open a series. The Exchange proposes to adopt the proposed opening rules on a pilot basis, beginning on the first day of the deployment of Phlx XL, and scheduled to expire after 180 days.

The Commission believes that the proposed rules governing the opening procedures on Phlx XL provide a reasonable process by which Phlx participants, including SQTs, would access and participate in the rotations. The Commission also believes that the proposed rules governing the opening procedures on Phlx XL should provide greater transparency with respect to the manner an opening price is determined on the Exchange. In addition, the Commission believes that approving the opening rules on a pilot basis should provide the Phlx and the Commission an opportunity to review the operation of the proposal and address any potential concerns that may arise.

J. Application of “Effect v. Execute” Exemption from Section 11(a) of the Act

Section 11(a) of the Exchange Act⁴⁹ prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, “covered accounts”) unless an exception applies. In addition to the exceptions set forth in the

⁴⁹ 15 U.S.C. 78k(a).

statute, Rule 11a2-2(T)⁵⁰ provides exchange members with an exemption from this prohibition. Known as the “effect versus execute” rule, Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with the Rule’s conditions, a member (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;⁵¹ (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction, except as provided in the Rule.

In a letter to the Commission,⁵² the Notice, and in Amendment No. 7, the Phlx represents that the transactions effected pursuant to the Phlx XL rules, both automatic and manual, satisfy the conditions of Rule 11a2-2(T).⁵³ The Commission notes that the staff of the Division previously provided interpretive guidance to the Phlx regarding its AUTO-X system.⁵⁴ Based on Phlx’s instant representations, the Commission believes that its previous guidance is still

⁵⁰ 17 CFR 240.11a2-2(T).

⁵¹ The member, however, may participate in clearing and settling the transactions.

⁵² See letter from Richard S. Rudolph, Counsel, Phlx, to Catherine McGuire, Chief Counsel, Division, Commission, dated April 15, 2002 (“April 2002 Letter”).

⁵³ Based on the Phlx’s representations in Amendment No. 7, the staff believes that the Exchange’s rules relating to the manual execution by specialists of off-floor broker-dealer orders that were received by the AUTO-X system comply with the requirements of Section 11(a) of the Act and Rule 11a2-2(T) thereunder. As discussed above, off-floor broker-dealers would enter these orders through AUTOM. According to the Phlx, the member firm identifier is removed from orders received through AUTOM. This, according to the Phlx, should prevent members from using affiliated persons on the exchange floor to influence or guide their orders’ execution.

⁵⁴ See letter from Paula R. Jenson, Deputy Chief Counsel, Division, Commission, to Richard S. Rudolph, Counsel, Phlx, dated April 15, 2002.

applicable to Phlx XL. Accordingly, the Commission finds that Phlx XL's electronic order submission and execution process satisfies the four conditions of Rule 11a2-2(T).⁵⁵

V. Accelerated Approval of Amendments No. 6 and 7

Pursuant to Section 19(b)(2) of the Act,⁵⁶ the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice of filing thereof, unless the Commission finds good cause for so finding. The Commission hereby finds good cause for approving Amendments No. 6 and 7 to the proposed rule change prior to the thirtieth day after publishing notice of Amendments No. 6 and 7 in the Federal Register pursuant to Section 19(b)(2) of the Act.⁵⁷ Amendment No. 6 corrects technical drafting and typographical errors and omissions contained in the proposed rule text and, in response to concerns raised by Commission staff, provides a more detailed description of the procedures by which the opening price on Phlx XL would be established. Amendment No. 7 provides additional description of the procedures by which the opening price on Phlx XL would be established. The Commission notes that the rules relating to the opening procedures on the Phlx are modeled on and substantially similar to the existing rules of the other options

⁵⁵ The Commission and its staff, on numerous occasions, have considered the application of Rule 11a2-2(T) to electronic trading and order routing systems. See, e.g., Securities Exchange Act Release Nos. 49068 (January 13, 2004) (Order approving the Boston Options Exchange as an options trading facility of the Boston Stock Exchange); 44983 (October 25, 2001) (Order approving the Archipelago Exchange as the equities trading facility of PCX Equities Inc.); 29237 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979) (regarding the Amex Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX's Communications and Execution System, and the Phlx's Automated Communications and Execution System); and 14563 (March 14, 1978) (regarding the NYSE's Designated Order Turnaround System). See also letter from Larry E. Bergmann, Senior Associate Director, Division, Commission, to Edith Hallahan, Associate General Counsel, Phlx (March 24, 1999) (regarding Phlx's VWAP Trading System); letter from Catherine McGuire, Chief Counsel, Division, Commission, to David E. Rosedahl, PCX (November 30, 1998) (regarding Optimark); and Letter from Brandon Becker, Director, Division, Commission, to George T. Simon, Foley & Lardner (November 30, 1994) (regarding Chicago Match).

⁵⁶ 15 U.S.C. 78s(b)(2).

⁵⁷ Id.

exchanges. The Commission previously approved these rules and, therefore, believes that accelerating such rules for Phlx XL on a six month pilot basis is appropriate, because the revisions do not raise new issues of regulatory concern. Therefore, the Commission finds that accelerated approval of Amendments No. 6 and 7 is consistent with Section 19(b)(2) of the Act.⁵⁸

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5) of the Act.⁵⁹

⁵⁸ Id.

⁵⁹ 15 U.S.C. 78f(b)(5).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁶⁰ that the proposed rule change and Amendments No. 1, 2, 3, 4, and 5 (SR-Phlx-2003-59) are approved, that Amendments No. 6 and 7 thereto are approved on an accelerated basis, and that the opening procedures are approved on a pilot basis until January 31, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁶¹

Jill M. Peterson
Assistant Secretary

⁶⁰ 15 U.S.C. 78s(b)(2).

⁶¹ 17 CFR 200.30-3(a)(12).