



DIVISION OF  
MARKET REGULATION

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

November 9, 2006

John Dayton  
Director and Counsel  
Philadelphia Stock Exchange, Inc.  
1900 Market Street  
Philadelphia, PA 19103

Re: Application of Rule 11a2-2(T) under Section 11(a) of the Securities Exchange Act of 1934 to the XLE System

Dear Mr. Dayton:

In your letter dated November 2, 2006, you provided the staff of the Division of Market Regulation ("Division") with your analysis regarding the application of Rule 11a2-2(T) under the Securities Exchange Act of 1934 ("Act") to transactions executed via the Philadelphia Stock Exchange, Inc.'s ("Exchange" or "Phlx") fully automated electronic facility for the display and execution of orders in NMS stocks -- XLE.

Section 11(a) of the Act<sup>1</sup> 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 investment discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T)<sup>2</sup> under the Act, known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a) prohibition. 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 floor. To comply with Rule 11a2-2(T)'s conditions, a member: (1) must transmit the order from off the exchange floor; (2) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution; (3) may not be affiliated with the executing member; and (4) with respect to an account over which the member or its associated person 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 considering other automated systems, the Commission and the staff have stated that the off-floor transmission requirement would be met if a covered account order is transmitted from off the floor directly to the exchange floor by electronic means.<sup>3</sup> However,

<sup>1</sup> 15 U.S.C. 78k(a).

<sup>2</sup> 17 CFR 240.11a2-2(T).

<sup>3</sup> See, e.g., Securities Exchange Act Release Nos. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (regarding the

in your letter you stated that Phlx proposes to allow its floor members to use automated means while on the Exchange's options floor to transmit orders for their own account into XLE. The Commission has stated that the off-floor transmission requirement may be met when an order is sent from one trading floor of an exchange to another, separate trading floor of the same exchange.<sup>4</sup> On the basis of the Exchange's representations, the Commission believes that orders sent, by electronic means, from the Exchange's options trading floor may be considered to be sent from "off-floor" for purposes of XLE. Specifically, the Commission believes that because the securities traded on XLE are only traded on XLE and not through other systems or functionalities of the Exchange, nor on any physical floor of the Exchange, XLE is essentially a different, separate "trading floor." You represent that Phlx members will not have a time / place advantage with regard to the securities traded in XLE. Specifically, orders transmitted from the Exchange's options floor, will not be processed any more quickly by XLE than those orders received from off such floor. In addition, members will see information about orders that are at the top of XLE only after that information has been sent to the securities information processor for dissemination to the public. Thus, based on these facts, the staff believes the off-floor transmission requirement is satisfied in this case.

Rule 11a2-2(T) further provides that the exchange member and its associated persons may not participate in the execution of a transaction once the order has been transmitted to

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American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the Pacific Exchange's ("PCX") Communications and Execution System, and the Phlx Automated Communications and Execution System ("1979 Release"); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (regarding New York Stock Exchange's ("NYSE") Off-Hours Trading Facility); 49066 (January 13, 2004), 69 FR 2773 (January 20, 2004) (order approving the Boston Options Exchange as an options trading facility of the Boston Stock Exchange). See also Letter from Brandon Becker, Director, Division, Commission, to George T. Simon, Foley & Lardner, dated November 30, 1994 (regarding Chicago Match ("Chicago Match Letter")); Letter from Paula R. Jensen, Deputy Chief Counsel, Division, Commission, to Kathryn L. Beck, Senior Vice President, Special Counsel and Antitrust Compliance Officer, PCX, dated October 25, 2001 (regarding Archipelago Exchange ("ArcaEx") ("ArcaEx Letter")); Letter from Paula R. Jensen, Deputy Chief Counsel, Division, Commission, to Richard S. Rudolph, Counsel, Phlx, dated April 15, 2002 (regarding Phlx's AUTOM System and its automatic execution feature AUTO-X); Letter from Paula R. Jensen, Deputy Chief Counsel, Division, Commission, to Jeffrey P. Burns, Assistant General Counsel, Amex, dated July 9, 2002 (regarding Amex's Auto-Ex system for options); Letter from Paula R. Jensen, Deputy Chief Counsel, Division, Commission, to Angelo Evangelou, Senior Attorney, Chicago Board Options Exchange ("CBOE"), dated March 31, 2003 (regarding CBOE's CBOEdirect system ("CBOEdirect Letter")).

<sup>4</sup> See Securities Exchange Act Release No. 52094 (July 21, 2005), 70 FR 43913 (July 29, 2005) (order approving Chicago Stock Exchange's Ebook).

the exchange floor.<sup>5</sup> You represent that Phlx members relinquish control of their orders once they are submitted to XLE and note that the members do not receive special or unique trading advantages. Orders submitted to XLE will enter the queue and execute against other orders based on an established matching algorithm. The execution will depend upon the other orders entered into XLE at or around the same time as the covered account order, the orders residing in XLE, and order ranking based on XLE's price-time priority ranking rules. Because users of XLE will relinquish control of their orders upon transmission to XLE, and will not be able to influence or guide the execution of their orders, the staff believes that this requirement is met with respect to orders that are executed automatically on XLE.

Although Rule 11a2-2(T) contemplates having an order executed by an exchange member who is unaffiliated with the member initiating the order, the Commission has recognized that this requirement is not applicable when automated exchange facilities are used.<sup>6</sup> You represent that the design of XLE ensures that members do not possess any special or unique trading advantages in the handling of their orders after transmission. Finally, the staff notes that members who intend to rely on Rule 11a2-2(T) in connection with transactions using XLE must comply with the requirements of Section (a)(2)(iv) of the Rule.

This interpretive position is based solely on your representations and the facts presented, and is strictly limited to the application of Rule 11a2-2(T) to the XLE transactions as described in your letter. Any different facts or circumstances may require a different response.

Sincerely,



David S. Shillman  
Associate Director

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<sup>5</sup> See 1979 Release, supra note 3, at 6086 note 25. See also CBOEdirect Letter, supra note 3; Letter from Larry E. Bergmann, Senior Associate Director, Division, Commission, to Edith Hallahan, Associate General Counsel, Phlx, dated March 24, 1999 (regarding Phlx's VWAP Trading System); Letter from Catherine McGuire, Chief Counsel, Division, Commission, to David E. Rosedahl, PCX, dated November 30, 1998 (regarding Optimark); and Chicago Match Letter, supra note 3.

<sup>6</sup> In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, supra note 3, at 6086 note 25.

**Philadelphia Stock Exchange**

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SECURITIES AND EXCHANGE COMMISSION  
November 2, 2006  
RECEIVED

NOV 06 2006

Kelly M. Riley  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

DIVISION OF MARKET REGULATION

Dear Ms. Riley:

The Philadelphia Stock Exchange, Inc. (“Phlx” or the “Exchange”) has received approval for a proposed rule change<sup>1</sup> through which the Exchange seeks to implement a fully automated electronic facility for the display and execution of orders in NMS Stocks – XLE. In connection with this filing, the Exchange respectfully requests that the Division of Market Regulation of the Securities and Exchange Commission (“Commission”) provide interpretive guidance regarding the application of Rule 11a2-2(T)<sup>2</sup> to Phlx’s proposal. The Exchange believes that XLE meets the parameters of Rule 11a2-2(T) and that its proposal does not raise any of the policy concerns that Congress sought to address in Section 11(a) of the Securities Exchange Act of 1934<sup>3</sup> – including, specifically, the time and place advantages that members on exchange floors might have over non-members off the floor and the general public.

**A. Proposed Operation of XLE**

As noted above, XLE is designed as fully automated facility for the display and execution of orders in NMS Stocks. Under the proposal, orders could be sent to XLE through order entry technology provided by the Exchange for two-sided orders or through other order entry systems for one or two-sided orders obtained by XLE Participants<sup>4</sup> for use with XLE. The Exchange anticipates that all XLE Participants – whether they are located on the Exchange’s trading floor (either the current equity floor space immediately after the transition to XLE or on the Exchange’s options floor) or off the floor – would be able to receive access to XLE on an equal basis. In addition, information relating to the

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<sup>1</sup> See Securities Exchange Act Release No. 54538 (September 28, 2006), 71 FR 59184 (October 6, 2006) (Approval order for SR-Phlx-2006-43).

<sup>2</sup> 17 CFR 240.11a2-2(T).

<sup>3</sup> 15 U.S.C. 78k(a).

<sup>4</sup> XLE Participants are those persons authorized to use XLE. XLE Participants can include Phlx members, member organizations and their associated persons. In addition, XLE Participants can include the Sponsored Participants of member organizations as well.

best bid and offer on XLE would be disseminated through the securities information processor and the Exchange's depth of book feed,<sup>5</sup> so that all XLE Participants and the public would be able to view that information at the same time.

XLE would accept, rank, display, route and execute orders automatically without human intervention. Except for certain two-sided orders<sup>6</sup>, all orders received by XLE would be ranked according to their price and time of receipt or time of update and would be displayed to the public when they constitute the best bid or offer on XLE for a security. On XLE, one-sided orders would automatically match against each other, in price/time priority. Specifically, an incoming order would be matched against one or more orders on XLE, in the order of their ranking, at the price of each order, for the full amount of shares available at that price, or for the size of the incoming order, if smaller. If an incoming order could not be matched when it is received and it is not designated as an order that should be immediately cancelled, the order would be displayed on XLE.

The securities traded on XLE would only be traded on XLE – there would be no trading of these securities through other systems or functionalities of the Exchange and there would be no trading of these securities through use of open outcry on the Exchange's floor.

## **B. Background – Section 11(a) and Rule 11a2-2(T)**

Section 11(a) of the Exchange Act prohibits a member of a national securities exchange from effecting transactions on that exchange for his own account, the account of an associated person, or an account over which he or his associated person exercises investment discretion (collectively, the “covered accounts”), unless an exception applies. Congress intended Section 11(a) to address concerns about special time and place advantages that floor-based members of an exchange might have over persons who were not on the floor – such as the ability to “execute decisions faster than public investors.”<sup>7</sup>

Rule 11a2-2(T) provides exchange members with an exception to the trading prohibition. Known as the “effect versus execute” rule, Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect a transaction for a covered account by arranging for an unaffiliated member to execute the transactions on the exchange floor. To comply with the rule's conditions, a member must (1) transmit the order from off the exchange floor, (2) may not participate in the execution of the

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<sup>5</sup> The Exchange's depth of book feed is a data stream that will contain orders at all price levels on XLE. It will be available to any person on a non-discriminatory basis.

<sup>6</sup> See Phlx Rule 185(c). These include certain two-sided orders from Approved Dealers, two-sided orders marked as non-regular way, and certain Mid-Point Cross and IOC Cross Orders of at least 5,000 shares.

<sup>7</sup> See Securities Act Release Nos. 14563 (March 14, 1978), 43 FR 11542, 11543 (March 17, 1978) (“1978 Release I”); 14713 (April 27, 1978), 43 FR 18557, 18588 (May 1, 1978) (“1978 Release II”); 15533 (January 29, 1979), 44 FR 6084, 6092 (January 31, 1979) (“1979 Release”). The 1978 and 1979 Releases cite the House Report at 54-57.

transaction once it has been transmitted to the member performing the execution,<sup>8</sup> (3) may not be affiliated with the executing member and (4) with respect to an account over which the member has investment discretion, neither the member nor his associated person may retain any compensation in connection with effecting the transaction without express written consent from the person authorized to transact business for the account in accordance with the rule. The requirements of Rule 11a2-2(T) are “designed to put members and non-members on the same footing, to the extent practicable, in light of the purpose of Section 11(a).”<sup>9</sup>

### C. Discussion

XLE is a fully automated system for the display and execution of orders. Under the proposal, orders would be sent to XLE through any communications lines approved by the Exchange for the delivery of orders.<sup>10</sup> Orders could be sent by XLE Participants who are either from off-floor or from the Exchange’s floors.<sup>11</sup>

The orders sent to XLE by XLE Participants could comport with Section 11(a) in a variety of ways. For example, any orders sent to XLE by a XLE Market Maker in securities in which the XLE Market Maker was registered as such would comply with the exception set out in Section 11(a)(1)(A). In addition, orders sent to XLE by a XLE Participant could be for the account of a non-member and thus not subject to Section 11(a)(1) at all. Finally, as described below, Rule 11a2-2(T) is likely to apply, in that the Exchange believes that the operation of XLE places all XLE Participants – whether or not they are on the floor of the Exchange – on the same footing, as intended by Rule 11a2-2(T), and is consistent with the Rule’s requirements.

1. *Off-floor transmissions.* Under Rule 11a2-2(T), a member must transmit an order in a covered account from off the Exchange floor. The Commission has considered this requirement in connection with a number of automated systems and has consistently found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange’s floor by electronic means.<sup>12</sup>

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<sup>8</sup> The member may, however, participate in the clearing and settling of the transaction.

<sup>9</sup> See 1978 Release II at 18560.

<sup>10</sup> Exchange members could also use order entry technology provided by the Exchange for the entry of two-sided orders. Use of this technology is optional and orders received over this technology are treated no differently than order received otherwise.

<sup>11</sup> XLE Participants could send either proprietary orders or agency orders to XLE.

<sup>12</sup> See Letters from Paula R. Jenson, Deputy Chief Counsel, Division of Market Regulation, SEC, to Kathryn L. Beck, Senior Vice President, Special Counsel and Antitrust Compliance Officer, Pacific Exchange, dated October 25, 2001 (regarding ArcaEx (the “ArcaEx Letter”)); from Paula R. Jenson, Deputy Chief Counsel, Division of Market Regulation, SEC, to Angelo Evangelou, Senior Attorney, Chicago Board Options Exchange, dated March 31, 2003 (regarding CBOEdirect (the “CBOEdirect Letter”)); from Brandon Becker, Director, Division of Market Regulation, SEC, to George T. Simon, Foley

Phlx urges the Commission to find that the requirements for off-floor transmission are met when an order from the Exchange's trading floors is sent, by electronic means, to the physically separate trading platform of XLE. There would not be a physical trading crowd associated with the trading of any security on XLE (NMS Stocks); there would be no specialist's post and no order interaction would occur on any Phlx trading floor in NMS Stocks. Moreover, the systems used for processing XLE orders would not even be located on the Exchange's floor – in essence, XLE would be located elsewhere in the Exchange's facility.<sup>13</sup>

Importantly, orders transmitted from the Exchange's trading floors would not be processed any more quickly by XLE than those received from another location. All orders – whether submitted from the floor or from another location – would be routed through the same electronic “front door” at the Exchange and into a single stream of orders that would be displayed only after that information has been sent to the securities information processor for dissemination to the public. As a result, the Exchange believes that a XLE Participant who is on the Exchange's physical trading floors would not receive any time or place advantage over an off-floor participant who sends an order to XLE. For all of these reasons, the Exchange urges the Commission to find that Rule 11a2-2(T)'s requirement for off-floor transmission is met where an order from the Exchange's trading floors is sent, by electronic means, to the physically separate trading platform of XLE.

2. *Non-participation in execution of order.* Rule 11a2-2(T) requires that the exchange member (and its associated persons) cannot participate in the execution of the transaction in a covered account, once it has been transmitted to the exchange floor. This requirement was originally designated to prevent members from using their own on-floor brokers to influence or guide the execution of these orders. The Commission has consistently determined that this requirement is met when a member transmits an order into an automated system and the member relinquishes its ability to influence or guide the execution of the order within that system.<sup>14</sup>

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& Lardner (on behalf of Chicago Stock Exchange), dated November 30, 1994 (regarding Chicago Match (the “Chicago Match Letter”)); from Paula R. Jenson, Deputy Chief Counsel, Division of Market Regulation, SEC to Jeffrey P. Burns, Assistant General Counsel, American Stock Exchange, dated July 9, 2002 (regarding Amex's Auto-Ex system for options); from Paula R. Jenson, Deputy Chief Counsel, Division of Market Regulation, SEC to Richard S. Rudolph, Counsel, Phlx (regarding Phlx's AUTOM System and its automatic execution feature AUTO-X).

<sup>13</sup> In a substantially similar situation, the Commission has previously found that the off-floor transmission requirement is met where a member on the options trading floor of an exchange sends an order to a physically separate equity trading floor of the same exchange. See Letter from Richard A. Steinwurtzel, Attorney, Office of Chief Counsel, SEC, to Mr. Philip J. Lo Bue, Senior Vice President, Pacific Stock Exchange, dated December 29, 1978.

<sup>14</sup> See the ArcaEx Letter, the CBOEdirect Letter and the Chicago Match Letter.

XLE is specifically designed to operate in accordance with these principles. Orders sent to XLE would be ranked according to their price and time of receipt or update and would be displayed to the public when they constitute the best bid or offer on XLE for a security. Orders would automatically match against each other, in price/time priority.<sup>15</sup> No participant would have any special or unique trading advantage over another – all orders within XLE would be automatically ranked and matched, without any manual involvement. As a result, no XLE Participant would have the ability, after submitting an order, to control its execution or to derive any unique trading advantage from his or her presence on the floor.<sup>16</sup> The Exchange, therefore, believes that XLE satisfies the non-participation requirement.

3. *Execution through unaffiliated member.* Rule 11a2-2(T) also requires that an order in a covered account be executed by a member that is not affiliated with the member initiating the order. The Commission, however, has recognized that this requirement may be satisfied where an order is executed in an automated exchange system.<sup>17</sup> Because XLE is a fully automated system of the Exchange, which will not provide any XLE Participant with special or unique trading advantages over another XLE Participant, the Exchange believes that this requirement is satisfied.

4. *Non-retention of compensation for discretionary accounts.* As a final matter, Rule 11a2-2(T) places restrictions on a member's ability to retain compensation for effecting a transaction in an account for which the initiating member exercises investment discretion. Specially, the Rule requires that, with respect to an account over which the member has investment discretion, neither the member nor his associated person may retain any compensation in connection with effecting the transaction without express written consent from the person authorized to transact business for the account in accordance with the rule. As a prerequisite for use of XLE, if a XLE Participant is to rely on Rule 11a2-2(T) for a managed account transaction, the XLE Participant must comply with the limitations set forth in the Rule.

#### **D. Conclusion**

The Exchange believes that XLE – a fully automated facility of the Exchange for the trading of NMS Stocks – is designed to operate in accordance with the requirements of Rule 11a2-2(T) and the policy objectives of Section 11(a) of the Exchange Act. Accordingly, we request interpretive guidance that XLE would comply with the requirements of Rule 11a2-2(T) of the Act.

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<sup>15</sup> As noted in the text at and in footnote 6, the only exceptions to this price/time priority matching would occur when certain two-sided orders are executed.

<sup>16</sup> A XLE Participant would have the ability to send an electronic message to cancel an order; this cancellation message, like all other transmissions to the electronic book, would be sent into the same electronic “front door” at the Exchange and placed into a single stream of instructions that would be processed in order of receipt. Any on-floor cancellation instructions, like the orders themselves, would not be given any special advantage over any off-floor instructions.

<sup>17</sup> See ArcaEx Letter and Chicago Match Letter.

If you have any questions, please do not hesitate to call me at (215) 496-5162.

Sincerely,

A handwritten signature in black ink that reads "John Dayton". The signature is written in a cursive style with a large, looped "J" and "D".

John Dayton  
Director and Counsel

cc: Richard Holley III, Division of Market Regulation, Securities and Exchange  
Commission