SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55153; File No. SR-Phlx-2006-74)

January 23, 2007

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change as Modified by Amendment Nos. 1 and 2 Thereto, Relating to a Pilot Program to Quote Options in Penny Increments

I. Introduction

On November 13, 2006, 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 ("Act"),[1] and Rule 19b-4 thereunder,[2] a proposed rule change to amend various Exchange rules to permit certain option classes to be quoted in pennies on a pilot basis. On November 22, 2006, the Exchange filed Amendment No. 1 to the proposed rule change. The Exchange filed Amendment No. 2 to the proposed rule change on December 5, 2006. The proposed rule change, as modified by Amendment Nos. 1 and 2, was published for comment in the Federal Register on December 13, 2006.[3] The Commission received no comment letters on the proposed rule change. This order approves the proposed rule change as modified by Amendment Nos. 1 and 2.

II. Description of the Proposal

A. Scope of the Penny Pilot Program

Phlx proposes to amend its rules to permit certain option classes to be quoted in pennies during a six-month pilot ("Penny Pilot Program"), which would commence on January 26, 2007.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 54886 (December 6, 2006), 71 FR 74979.

Specifically, proposed Phlx Rule 1034(a)(i)(B) would set forth the parameters of the Penny Pilot Program.

Currently, all six options exchanges, including Phlx, quote options in nickel and dime increments. The minimum price variation for quotations in options series that are quoted at less than $3 per contract is $0.05 and the minimum price variation for quotations in options series that are quoted at $3 per contract or greater is $0.10. Under the Penny Pilot Program, beginning on January 26, 2007, market participants would be able to begin quoting in penny increments in certain series of option classes.

The Penny Pilot Program would include the following thirteen options classes: Ishares Russell 2000 (IWM); NASDAQ-100 Index Tracking Stock (QQQQ); SemiConductor Holders Trust (SMH); General Electric Company (GE); Advanced Micro Devices, Inc. (AMD), (Microsoft Corporation (MSFT); Intel Corporation (INTC); Caterpillar, Inc. (CAT); Whole Foods Market, Inc. (WFMI); Texas Instruments, Inc. (TXN); Flextronics International Ltd. (FLEX); Sun Microsystems, Inc. (SUNW); and Agilent Technologies, Inc. (A). The Exchange would communicate the list of options to be included in the Penny Pilot Program to its membership via Exchange circular.

The minimum price variation for all classes included in the Penny Pilot Program, except for the QQQQs, would be $0.01 for all quotations in option series that are quoted at less than $3 per contract and $0.05 for all quotations in option series that are quoted at $3 per contract or greater. The QQQQs would be quoted in $0.01 increments for all options series.

Proposed Phlx Rule 1034(a)(i)(C) would require the Exchange to prepare and submit a report to the Commission during the fourth month of the pilot, which would be composed of data from the first three months of trading. The report would analyze the impact of penny quoting on market quality and options systems capacity.

B. Automatic Executions During Crossed Markets

The Exchange anticipates that the instance of crossed markets (where the bid price is greater than the offer price) will increase in options traded in penny increments. Accordingly, the Exchange proposes to amend its rules concerning automatic executions during crossed markets, and its rule[4] providing exceptions from Trade-Through liability when a Trade-Through occurs due to an automatic execution when the Exchange's disseminated market is crossed, or crosses the disseminated market of another options exchange, and the Exchange's disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the NBBO.

Currently, orders on the Exchange that are otherwise eligible for automatic execution are handled manually by the specialist when the Exchange's disseminated market is crossed by more than one minimum quoting increment (as defined in Phlx Rule 1034) (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange by more than one minimum quoting increment.[5] The Exchange currently provides automatic executions during crossed markets when the Exchange's disseminated market is crossed by not more than one minimum quoting increment, or crosses the disseminated market of another options exchange by not more than one minimum quoting increment, and the Exchange's disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the NBBO.[6] The Exchange

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4 See Phlx Rule 1085(b)(10).

5 See Phlx Rule 1080(c)(iv)(A).

6 See Phlx Rule 1085(b)(10). See also Securities Exchange Act Release No. 53449 (March 8, 2006), 71 FR 13441 (March 15, 2006) (SR-Phlx-2005-45).

proposes to delete Phlx Rule 1080(c)(iv)(A), which would mean that the Exchange would provide automatic executions in options where the Exchange's disseminated market is the NBBO[7] and is crossed, or crosses the disseminated market of another options exchange, regardless of the amount by which such market is crossed.[8]

C. Trade-Throughs

Currently, Phlx Rule 1085(b) affords Exchange members several exemptions from Trade-Through liability and the requirements under Phlx's rules and the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage ("Linkage Plan") concerning satisfaction of Trade-Throughs. Among the exemptions from such liability and satisfaction responsibility is current Phlx Rule 1085(b)(10), which provides an exemption when the Trade-Through was the result of an automatic execution when the Exchange's disseminated market is the NBBO and is crossed by not more than one minimum quoting increment (as defined in Phlx Rule 1034), or crosses the disseminated market of another options exchange by not more than one minimum quoting increment.[9]

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7 The Exchange provides automatic executions only when its disseminated market is the NBBO. See Phlx Rule 1080(c)(iv)(E).

8 The Exchange notes that another options exchange currently provides automatic executions during crossed markets regardless of the amount by which the market is crossed. See Securities Exchange Act Release No. 54229 (July 27, 2006), 71 FR 44058 (August 3, 2006) (SR-CBOE-2005-90).

9 The Commission exempted the Exchange from the requirement under Rule 608(c) of Regulation NMS that Phlx comply, and enforce compliance by its members, with Section 8(c) of Linkage Plan. Section 8(c) of the Linkage Plan provides, in part, that, "absent reasonable justification and during normal market conditions, members in [Participants'] markets should not effect Trade-Throughs" in the limited situation when transactions are the result of an automatic execution when the Exchange's disseminated market is the NBBO and is crossed by not more than one minimum trading increment (as defined in Phlx Rule 1034), or crosses the disseminated market of another options exchange by not more than one minimum trading increment. See letter from Robert L.D. Colby to Meyer S. Frucher, Chairman and Chief Executive Officer, Phlx, dated March 8, 2006.

To be consistent with the proposed rule change (described above) to provide automatic executions when the Exchange's disseminated market is the NBBO regardless of the amount by which the market is crossed, the Exchange proposes to amend Phlx Rule 1085(b)(10) to exempt from such liability and satisfaction responsibility when the Trade-Through was the result of an automatic execution when the Exchange's disseminated market is the NBBO and is crossed, or crosses the disseminated market of another options exchange. The proposed rule change would delete the current language contained in Phlx Rule 1085(b)(10) that limits the exemption from Trade-Through and satisfaction liability to automatic executions at the NBBO during markets that are crossed by one minimum trading increment.

D. Zero-Bid Option Series

Currently, Phlx Rule 1080(i) states that the Exchange's AUTOM System will convert market orders to sell a particular option series to limit orders to sell with a limit price of $0.05 that are received when the bid price for such series is zero. The proposal would amend Phlx Rule 1080(i) to state that the system will convert such orders to limit orders to sell with a limit price of the minimum quoting increment applicable to such series. The effect of this with respect to options quoted and traded in minimum increments of $0.01 would be that such conversion would be to a limit order to sell at $0.01, rather than $0.05.

E. Quote Mitigation

To mitigate quote traffic, the Exchange proposes to amend Phlx Rule 1082, Firm Quotations, by adopting new Phlx Rule 1082(a)(ii)(C), which would modify the Exchange's definition of "disseminated size" such that the Exchange will disseminate fewer updated quotations.

Specifically, proposed Phlx Rule 1082(a)(ii)(C) would set forth the conditions under which the Exchange would disseminate updated quotations based on changes in the Exchange's disseminated price and/or size. The proposed rule would require the Exchange to disseminate an updated bid and offer price, together with the size associated with such bid and offer, when: (1) the Exchange's disseminated bid or offer price increases or decreases; (2) the size associated with the Exchange's disseminated bid or offer decreases; or (3) the size associated with the Exchange's bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with the previously disseminated bid (offer). Such percentage, which would never exceed 20%, would be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular. The percentage size increase necessary to give rise to a refreshed quote may vary from issue to issue, depending, without limitation, on the liquidity, average volume, and average number of quotations submitted in the issue. Proposed Phlx Rule 1082(b)(ii)(C) would not be limited to options included in the pilot, and would apply to all options traded on the Exchange.

The Exchange represents that participants on its system would not be notified of any incremental increase in the size of the Exchange's quote under proposed Phlx Rule 1082(a)(ii)(C)(3) until such quote is disseminated to OPRA. Therefore, no participant on the Exchange's system would have information that is unavailable to another participant.

III. Discussion

After careful review of the proposal, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[10] In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[11] which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission believes that the implementation of a limited six-month Penny Pilot Program by Phlx and the five other options exchanges will provide valuable information to the exchanges, the Commission and others about the impact of penny quoting in the options market. In particular, the Penny Pilot Program will allow analysis of the impact of penny quoting on: (1) spreads; (2) transaction costs; (3) payment for order flow; and (4) quote message traffic.

The Commission believes that the thirteen options classes to be included in the penny pilot program represent a diverse group of options classes with varied trading characteristics. This diversity should facilitate analyses by the Commission, the options exchanges and others. The Commission also believes that the Penny Pilot Program is sufficiently limited that it is unlikely to increase quote message traffic beyond the capacity of market participants' systems and disrupt the timely receipt of quote information.

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10 In approving this proposed rule change the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

11 15 U.S.C. 78f(b)(5).

Nevertheless, because the Commission expects that the Penny Pilot Program will increase quote message traffic, the Commission is simultaneously approving the Exchange's proposals to reduce the number of quotations it disseminates.[12]

In addition, the Commission believes that Phlx's proposed deletion of Phlx Rule 1080(c)(iv)(A) and proposed conforming changes to Phlx Rule 1085(b)(10) is consistent with the Act and will facilitate the prompt resolution of crossed markets by permitting automatic executions when the Exchange's disseminated market is the NBBO and is crossed, or crosses the disseminated market of another options exchange, regardless of the amount by which the market is crossed.[13]

Finally, the Commission believes that it is consistent with the Act for Phlx to update its rule governing Zero-Bid Options Series to provide that the system will convert such orders to limit orders to sell with a limit price of the minimum quoting increment applicable to such series,

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12 In addition to the quote mitigation proposal discussed herein, Phlx also proposed other quote mitigation strategies. See e.g., Securities Exchange Act Release No. 54648 (October 24, 2006), 71 FR 63375 (October 30, 2006) (SR-Phlx-2006-52); No. 54807 (November 21, 2006), 71 FR 69173 (November 29, 2006) (SR-Phlx-2006-53); 54859 (December 1, 2006), 71 FR 71605 (December 11, 2006) (SR-Phlx-2006-51); 54914 (December 11, 2006), 71 FR 75798 (December 18, 2006) (SR- Phlx-2006-81).

13 The exemption Phlx received from the requirement under Rule 608(c) of Regulation NMS that Phlx comply, and enforce compliance by its members, with Section 8(c) of Linkage Plan regarding trade-throughs on March 8, 2006 (see note 9, supra) was limited to transactions when the market was crossed by one minimum trading increment. Therefore, Phlx submitted an exemption request to expand the scope of the exemption to include trade-throughs resulting from automatic executions while the Exchange's disseminated market is crossed, or crosses the disseminated market of another options exchange, and the Exchange's disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the NBBO, regardless of the amount by which the market is crossed. See letter from Richard S. Rudolph, Vice President and Counsel, Chairman and Chief Executive Officer, Phlx, to Nancy M. Morris, Secretary, Commission, dated January 19, 2006. The Commission granted this exemption request on January 23, 2007. See letter from Elizabeth K. King, Associate Director, Commission, to Richard S. Rudolph, Vice President and Counsel, Phlx, dated January 23, 2006.

in order that options quoted and traded in minimum increments of $0.01 pursuant to the Penny Pilot Program would convert to a limit order to sell at $0.01, rather than $0.05.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[14] that the proposed rule change (SR-Phlx-2006-74), as modified by Amendment Nos. 1 and 2, be, and hereby is, approved on a six month pilot basis, which will commence on January 26, 2007.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[15]

Florence E. Harmon
Deputy Secretary

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14 15 U.S.C. 78s(b)(2).

15 17 CFR 200.30-3(a)(12).