

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59995; File No. SR-Phlx-2009-32)

May 28, 2009

Self-Regulatory Organizations; NASDAQ OMX PHLX, Inc; Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3 Thereto, Relating to the Exchange's Enhanced Electronic Trading Platform for Options, Phlx XL II

I. Introduction

On April 3, 2009, NASDAQ OMX PHLX, 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 implement several enhancements to its electronic options trading system, Phlx XL, the enhanced system being called Phlx XL II. The proposed rule change was published for comment in the Federal Register on April 14, 2009.³ On April 15, 2009, Phlx filed with the Commission, pursuant to Section 19(b)(1) of the Act⁴ and Rule 19b-4 thereunder,⁵ Amendment No. 1 to the proposed rule change. Amendment No. 1 to the proposed rule change was published for comment in the Federal Register on April 23, 2009.⁶ The Commission received two comment letters on the proposed rule change and one comment response letter from Phlx.⁷ On May 20,

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 59721 (April 7, 2009), 74 FR 17245 (April 14, 2009) ("Notice").

⁴ 15 U.S.C. 78s(b)(1).

⁵ 17 CFR 240.19b-4.

⁶ See Securities Exchange Act Release No. 59779 (April 16, 2009), 74 FR 18600 (April 23, 2009) ("Amendment Notice").

⁷ See Letters from Janet M. Kissane, Senior Vice President – Legal and Corporate Secretary, Office of the General Counsel, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Commission, dated May 14, 2009 ("NYSE Euronext Letter"); Angelo

2009, the Exchange submitted Amendment No. 2 to the proposed rule change.⁸ On May 28, 2009, the Exchange submitted Amendment No. 3 to the proposed rule change.⁹ This order grants accelerated approval to the proposed rule change, as modified by Amendment Nos. 1, 2, and 3.

II. Description of the Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3 to the Proposed Rule Change

The Exchange proposes to implement several enhancements to its electronic options trading system, Phlx XL.¹⁰ The enhanced system would be known as Phlx XL II and would reflect enhancements to the opening, linkage and routing, quoting, and order management processes.¹¹ These enhancements are intended to improve execution quality for Phlx users by improving a number of processes, including those related to the opening, order handling and order execution.

Evangelou, Assistant General Counsel, Chicago Board Options Exchange, Incorporated (“CBOE”), to Elizabeth M. Murphy, Secretary, Commission, dated May 20, 2009 (“CBOE Letter”); and Richard S. Rudolph, Assistant General Counsel, Phlx, to Elizabeth M. Murphy, Secretary, Commission, dated May 28, 2009 (“Response Letter”).

⁸ In Amendment No. 2, the Exchange updated the proposed rule text contained in Exhibit 5 to reflect changes that were approved as part of SR-Phlx-2009-23. See Securities Exchange Act Release No. 59924 (May 14, 2009), 74 FR 23759 (May 20, 2009). Because Amendment No. 2 is technical in nature, the Commission is not publishing it for comment.

⁹ The text of Amendment No. 3 is available on the Exchange’s Web site at <http://nasdaqomxphlx.cchwallstreet.com/NASDAQOMXPHLX/Filings/>, at the principal office of the Exchange, and at the Commission’s Public Reference Room.

¹⁰ The following description incorporates changes proposed by Phlx in Amendment Nos. 1, 2, and 3. See text accompanying notes 90-96, *infra*, for a discussion of the changes proposed in Amendment No. 3.

¹¹ The Exchange acknowledges that the proposed Options Order Protection and Locked/Crossed Market Plan may necessitate modifications to its proposed rules. See Securities Exchange Act Release No. 59647 (March 30, 2009), 74 FR 15010 (April 2, 2009).

According to Phlx, the changes to the opening process are intended to provide better executions to users, more consistent prices on executions and a smoother transition from the opening to the regular trading day. The changes to the order handling process are intended improve routing to liquidity available at other exchanges while preventing non-exempt trade-throughs of other markets, and provide users with increased flexibility and control in how their orders are handled. The Exchange expects that order processing should be more consistent, with greater continuity in prices as a result of these changes, because several of the changes are intended to introduce a price check to limit executions at far away prices. The Exchange believes that these changes should benefit investors and users through better and more consistent system behavior and resulting prices. A brief summary of these modifications and enhancements is outlined below.¹²

New Opening Process¹³

Phlx proposes to introduce opening process enhancements under Phlx XL II that would, in general, operate as described below.

If there are no opening quotes or orders that lock or cross each other, the system would open by disseminating the Exchange's best bid and offer among quotes and orders that exist in the Phlx XL II system at that time. If there are opening quotes or orders that lock or cross each other, the Phlx XL II system would take the lowest bid and the highest offer among quotations received to determine the lowest quote bid and highest quote offer and would then determine the

¹² For a more detailed description of the proposed rule change, see Notice and Amendment No. 3, supra, notes 3 and 9.

¹³ For a more detailed description of the proposed opening process, see Notice at 17245-49 and Amendment No. 3.

price at which the maximum number of contracts can trade. If that price is within the lowest quote bid and highest quote offer and leaves no imbalance, Phlx would open at that price.¹⁴

If such opening price includes interest other than solely Phlx interest, the system would initiate a “Route Timer,”¹⁵ not to exceed one second. If no new interest is received during the Route Timer, the Phlx XL II system would route to other markets disseminating prices better than Phlx’s opening price, execute marketable interest at the opening price on Phlx, and route to other markets disseminating prices equal to the Phlx opening price if necessary. Orders would be routed as Immediate or Cancel (“IOC”) orders with a limit price equal to the Exchange’s opening price. If interest is received during the Route Timer, the Phlx XL II system would recalculate the opening price taking such new interest into account. Then, if there is no imbalance, the system would execute marketable interest at the opening price on the Phlx and route the remainder to other markets.

Where there is an imbalance at the price at which the maximum number of contracts can trade that is also at or within the lowest quote bid and highest quote offer, the Phlx XL II system would calculate an Opening Quote Range (“OQR”) for a particular series.¹⁶ If there is sufficient size on the Exchange and on away markets on the opposite side of the market from the imbalance to execute all opening marketable interest at a price that is at or within the established OQR and the Away Best Bid/Offer (“ABBO”) without leaving an imbalance, the Phlx XL II system would open the affected series for trading at that price by executing opening marketable

¹⁴ See proposed Rule 1017(l)(ii).

¹⁵ See proposed Rule 1017(l)(ii)(C)-(D). All references to a “Route Timer” in the Phlx XL II system and in the proposed rules mean a system pause for a brief period. Phlx XL II participants would not receive any notification that a Route Timer has been initiated.

¹⁶ See proposed Rule 1017(l)(iii).

interest on the Phlx XL II system, as long as the system does not trade through the ABBO.¹⁷ If it would trade through the ABBO, the Phlx XL II system would initiate a Route Timer, not to exceed one second. If no new interest is received during the Route Timer, the Phlx XL II system would then route to other markets disseminating prices better than Phlx's opening price, execute marketable interest at the opening price on Phlx and, route to other markets disseminating prices equal to the Phlx opening price if necessary. If all opening marketable size cannot be completely executed at or within the OQR without trading through the ABBO, the Phlx XL II system would automatically institute an imbalance process.¹⁸ During the imbalance process Phlx XL II may submit additional opening quotes, opening sweeps and orders. Phlx XL II would then determine if the imbalance amount can then trade on the Exchange at or within the OQR. If it cannot, the Exchange would seek to route remaining interest away after initiating a Route Timer.

If the imbalance process does not satisfy the number of marketable contracts on the Exchange, the Phlx XL II system would repeat the Imbalance Process up to three times (as established by the Exchange). If after that number of times, the Phlx XL II system still cannot route and/or trade the entire imbalance amount, the Phlx XL II system would conduct a Provisional Opening by routing to other markets at prices better than the Exchange opening price for their disseminated size, trading available contracts on the Exchange at the Exchange opening price, and routing contracts to other markets at prices equal to the Phlx opening price at their disseminated size.¹⁹

¹⁷ If the ABBO is crossed, it would not be taken into consideration by the system and the system would immediately execute.

¹⁸ See proposed Rule 1017(l)(iv).

¹⁹ See proposed Rule 1017(l)(iv)(C)(7).

The opening process would then be complete. Unexecuted Opening Sweeps²⁰ would be cancelled. Any unexecuted contracts from the imbalance not traded or routed would be displayed in the Exchange quote at the opening price for the remaining size for a period not to exceed ten seconds and subsequently cancelled back to the entering participant if they remain unexecuted and priced through the opening price. During this display time period, the Phlx XL II system would disseminate, if the imbalance is a buy imbalance, an offer that is \$200,000, with a size of one or, if the imbalance is a sell imbalance, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts.

Amendments to the Exchange's Firm Quote Rule

The Exchange also proposes to amend its Rule 1082, Firm Quotations, to enhance the ability for Phlx XL II participants to refresh, and potentially improve, their quotations when their option quotation size is exhausted at a particular price level, and that would reflect the Exchange's ability to refresh its disseminated market following the exhaustion of the Exchange's disseminated size.²¹ The Exchange has proposed two functionalities to accomplish this goal:

Quote Exhaust and Market Exhaust.

²⁰ "Opening Sweeps" are one-sided electronic quotations submitted for execution against opening trading interest in the Phlx XL II system. See proposed Rule 1017(l)(v). Opening Sweeps may be entered at any price with a minimum price variation applicable to the affected series, on either side of the market, at single or multiple price level(s), and may be cancelled and re-entered. See proposed Rule 1017(l)(v)(B). In addition to the Opening Sweep, the Phlx would also introduce other new sweep capabilities. For a more detailed discussion of the proposed sweeps, see Notice at 17257 and Amendment No. 3.

²¹ See proposed Rule 1066(c)(8), which clarifies the definition of an Immediate-or-Cancel ("IOC") order as a limit order that is to be executed in whole or in part upon receipt. Any portion not so executed shall be cancelled. IOC orders are not routable and would not be subject to any routing process or timer described in the Exchange's rules. If not executed immediately, an IOC order would be cancelled by the Phlx XL II system. Contracts remaining in an IOC order following a partial execution would be cancelled. The Exchange represents that IOC orders would not be subject to any Route Timer and would not be included in the Quote Exhaust and Market Exhaust processes.

Quote Exhaust²²

Quote Exhaust occurs when the Exchange's disseminated market at a particular price level includes a quote, and such market is exhausted by an inbound contra-side quote or order ("initiating quote or order"), and following such exhaustion, contracts remain to be executed from the initiating quote or order.²³ Rather than immediately executing at the next available price, the Phlx XL II would employ a timer not to exceed one second in order to allow market participants to refresh their quotes. During the Quote Exhaust Timer, the Exchange would disseminate the reference price for the remaining size, provided that such price does not lock an away market, in which case, the Exchange would disseminate a bid and offer that is one Minimum Price Variation ("MPV") from the away market price, and if the remaining size is a buyer, an offer that is \$200,000, with a size of one or, if the remaining size is a seller, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts. If the remaining contracts in the initiating quote or order are either traded or cancelled during the Quote Exhaust Timer, the Quote Exhaust Timer would terminate and normal trading would resume.

If the Exchange receives an order, quote or sweep on the opposite side of the market from the initiating quote or order during the Quote Exhaust Timer that locks or crosses the reference price at any time during the Quote Exhaust Timer, it would execute immediately against the initiating quote or order at the reference price.²⁴ If the initiating quote or order that caused the Quote Exhaust is exhausted, the Quote Exhaust Timer would be terminated. With respect to any

²² For a more detailed description of the proposed Quote Exhaust feature, see Notice at 17249-52 and Amendment No. 3.

²³ See proposed Rule 1082(a)(ii)(B)(3). The initial execution price is known as the "reference price."

²⁴ See proposed Rule 1082(a)(ii)(B)(3)(c).

order, quote or sweep received on the opposite side of the market from the initiating quote or order during the Quote Exhaust Timer that is inferior to the reference price, the system would place any non-IOC order onto the book. Such new interest would be included in the first PBBO calculation and available to be traded immediately following the end of the Quote Exhaust Timer. All non-marketable sweeps and IOC orders would be cancelled immediately if not executed and would not participate in the Quote Exhaust process.

If the Exchange receives an order, quote or sweep on the same side of the market as the initiating quote or order during the Quote Exhaust Timer, the Phlx XL II system would cancel any sweep or IOC order.²⁵ If such new quote or order, other than an IOC order, is a market or marketable limit order or marketable quote (i.e., priced at or through the reference price) the Phlx XL II system would display it at the reference price, with a disseminated size that is the sum of such order and/or quote plus the remaining contracts in the initiating order or quote. According to Phlx, the purpose of this provision is to enhance liquidity on the Exchange by adding all available liquidity received during the Quote Exhaust Timer to the PBBO at the reference price.

If there are still unexecuted contracts remaining in the initiating quote or order or any new interest on the same side of the market, the Phlx XL II system would calculate a new PBBO.²⁶ The Phlx XL II system would conduct an Acceptable Range price “test” to determine whether there is a valid next available price at which the Phlx XL II system may execute the remaining unexecuted contracts.²⁷

²⁵ See proposed Rule 1082(a)(ii)(B)(3)(d).

²⁶ See proposed Rule 1082(a)(ii)(B)(3)(e).

²⁷ See proposed Rule 1082(a)(ii)(B)(3)(f). The Acceptable Range for the next available price would be calculated by the Phlx XL II system by taking the reference price, plus or minus a value to be determined by the Exchange (i.e., the reference price – (x) for sell orders and the reference price + (x) for buy orders).

The Phlx XL II system then conducts a Quote Exhaust Resolution,²⁸ determining whether to trade at the next available Phlx price by comparing it to the Acceptable Range price and the ABBO price to establish a Best Price. The Phlx XL II system then considers whether the price of the initiating quote or order locks or crosses the Best Price, which, in turn, determines whether the initiating quote or order trades, is routed or is posted.²⁹

Initiating Quote or Order Locks the Best Price

If the initiating quote or order locks the Best Price, the system would execute, route if a routable order, and/or post the initiating quote or order as follows:

If the Best Price is the next Phlx price, the system would execute a trade up to its disseminated size. If this Best Price (next Phlx price) is equal to the ABBO price, any remaining unexecuted routable order volume from the execution on the Phlx would be routed away. After such routing, any remaining unexecuted contracts would be posted on the Exchange at the ABBO price. If this Best Price (next Phlx price) is equal to the Acceptable Range price, any remaining unexecuted routable order volume from the execution on the Phlx would be posted on the Exchange at the Acceptable Range price. Lastly, if this Best Price (next Phlx price) is equivalent to both the ABBO and the Acceptable Range price, any remainder order volume from the execution on the Phlx would be routed away, and if after routing there still remains open contracts, the remainder would be posted on the Phlx at the Acceptable Range price.

If the Best Price is the ABBO, where the ABBO is not equal to the next Phlx price, the initiating order would be routed away up to the size of the ABBO and, after routing, any remaining unexecuted contracts from the initiating order would be posted on the Exchange at the

²⁸ See proposed Rule 1082(a)(ii)(B)(3)(g).

²⁹ For further details regarding the Quote Exhaust Resolution, including how the Phlx XL II system would determine whether to route, trade and/or post interest, see Notice at 17250 and Amendment No. 3.

ABBO price. If the Best Price (ABBO is not equal to the next Phlx price) equals the Acceptable Range price, the initiating order would be routed away and after such routing, any remaining unexecuted contracts would be posted on the Exchange at the ABBO price.

If the Best Price is the Acceptable Range Price, where the Acceptable Range Price is not equal to either the next Phlx price or the ABBO, the initiating order or quote would be posted at the Acceptable Range Price.

Initial Quote or Order Crosses Best Price

If the initiating quote or order crosses the Best Price, the Phlx XL II system would execute, route, and/or post the initiating quote or order as described below:

If the Best Price is the next Phlx price, the Phlx XL II system would execute a trade at the Exchange's next available price up to the Exchange's disseminated size. If this Best Price (next Phlx price) is equal to the ABBO price, any remaining order volume from the execution on the Exchange would be routed away and, after such routing, any remainder volume would be posted on the Exchange at the ABBO price. If this Best Price (next Phlx price) is equal to the Acceptable Range price, any remaining volume from the execution on the Phlx would be posted at the Acceptable Range Price or if locking or crossing the away market price, one minimum variation from the away market price for the remaining size for a period not to exceed ten seconds and cancelled after this time has elapsed. During this period, the Phlx XL system would disseminate if the remaining size is a buyer, an offer that is \$200,000, with a size of one or, if the remaining size is a seller, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts.

Lastly, if this Best Price (next Phlx price) is equal to both the ABBO and the Acceptable Range price, any remainder order volume from the execution on the Phlx would be routed away,

and if after routing there still remain unexecuted contracts, the remainder would be posted on the Phlx at the Acceptable Range price for a period not to exceed ten seconds, and cancelled after this time has elapsed. During this period, the Phlx XL system would disseminate if the remaining size is a buyer, an offer that is \$200,000, with a size of one or, if the remaining size is a seller, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts.

If the Best Price is the ABBO, where the ABBO is not equal to the next Phlx price, the initiating order would be routed away and if after routing there remain unexecuted contracts, the remainder of the initiating order would be posted on the Phlx at the ABBO price. If this Best Price (ABBO is not equal to the next Phlx price) equals the Acceptable Range price, the initiating order would be routed away and if after routing there remain unexecuted contracts, the remainder of the order would be posted on the Phlx at the ABBO price for a period not to exceed ten seconds, and cancelled after this time has elapsed. During this period, the Phlx XL II system would disseminate if the remaining size is a buyer, an offer that is \$200,000, with a size of one or, if the remaining size is a seller, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts.

If the Best Price is the Acceptable Range price, where the Acceptable Range price is not equal to either the next Phlx price or the ABBO, the initiating quote or order would be posted on the Exchange at the Acceptable Range price for a period not to exceed ten seconds, and cancelled after this time has elapsed. During this period, the Phlx XL II system would disseminate if the remaining size is a buyer, an offer that is \$200,000, with a size of one or, if the remaining size is a seller, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts.

If the initiating order is non-routable, when the order would otherwise route according to the process described above, the order would be posted on the Phlx at a price one minimum trading increment inferior to the Best Price so as not to lock an away market.³⁰

Exchange Generate Quote

If the Exchange's disseminated size in a particular series is exhausted at that particular price level, and no specialist, SQT or RSQT has revised their quotation immediately following the exhaustion of the Exchange's disseminated size at such price level, in Phlx XL II, the Exchange would disseminate a bid of \$0.00 and an offer of \$200,000, each for a size of one contract.³¹

Market Exhaust³²

Market Exhaust occurs when there are no Phlx XL II participant quotations in the Exchange's disseminated market for a particular series and an initiating order in the series is received. In such a circumstance, the Phlx XL II system, using Market Exhaust, would initiate a Market Exhaust Auction for the initiating order.³³ When an initiating order is received when there are no quotations in the Exchange market, the Phlx XL II system would determine if the PBBO on the opposite side of the market from the initiating order is represented by an order on the Phlx order book which is priced equal to or better than the ABBO on that same side of the market.

³⁰ See proposed Rule 1082(a)(ii)(B)(3)(g)(v).

³¹ See proposed Rule 1082(a)(ii)(B)(4)(a). The Exchange represents that it would, as it does today, surveil for compliance on the part of specialists (and SQTs and RSQTs) with the Exchange's continuous quoting requirements. See Exchange Rule 1014(b)(ii)(D).

³² For a more detailed discussion of the terms of the proposed Market Exhaust, see the Notice at 17252-55 and Amendment No. 3.

³³ See proposed Rule 1082(a)(ii)(B)(4).

If that Phlx market represented by an order on the Phlx order book is the NBBO, then the initiating order would immediately trade with the order at the PBBO price. If there are still unexecuted contracts remaining in the initiating order, the XL II system would initiate a Quote Exhaust Timer. The price at which the initiating order traded becomes the reference price. During the Quote Exhaust Timer, the Exchange would disseminate the reference price for the remaining size, provided that such price does not lock an away market, in which case, the Exchange would disseminate a bid and offer that is one Minimum Price Variation (“MPV”) from the away market price, and if the remaining size is a buyer, an offer that is \$200,000, with a size of one or, if the remaining size is a seller, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts.

If that Phlx market is not at the NBBO, then the Phlx XL II system would immediately broadcast a notification (an “Auction Notification”) to Phlx XL II participants; the purpose of the auction is to seek participation and determine the best price at which the contracts in the initiating order may be executed (the “Auction Price”). The Auction Notification would include the series, size and side of the market of the initiating order. The Auction Notification would not include a price. The Auction would be for a period of time not to exceed three seconds (the “Auction Period”).

During the Auction Period, Phlx XL II participants may submit bids and offers in response to the Auction Notification into the system until the end of the Auction Period.³⁴ Such responsive bids and offers may be submitted to the system via (1) a two-sided quote; (2) a single-sided, single-priced quotation for the auction to be known as “Auction Sweep” that would be

³⁴ See proposed Rule 1082(a)(ii)(B)(4)(c).

effective only for the Auction Period and cancelled at the end of that period if not executed,³⁵ and (3) limit orders. IOC Orders would be cancelled immediately if not executed and would not participate in the Market Exhaust process. In addition, incoming orders from non-Phlx XL II participants and existing orders on the book would be eligible to participate at the end of the Auction Period, together with responses to the Auction Notification.

If at the end of the Auction Period, there are no valid-width auction quotes³⁶ in the Exchange market, the initiating order, plus all other Auction Sweeps and orders received during the Auction Period would be cancelled.³⁷ Quotes that are not valid-width auction quotes would remain and a new PBBO would be calculated and disseminated. If at the end of the Auction Period there are valid-width auction quotes, the Phlx XL II system would determine the allowable executable price range from the lowest valid-width auction quote bid and the highest valid-width auction quote ask; this is the Auction Quote Range (“AQR”).

If the initiating order can be completely executed at or within the AQR and the ABBO, using contracts available from all available quotes, Auction Sweeps or orders priced at or within the AQR, a trade would be executed at the Exchange at the Auction Price.

³⁵ See proposed Rule 1082(a)(ii)(B)(4)(c)(i). The Auction Sweep may be entered only during the auction process and would remain in effect only until the auction is completed. A single Phlx XL II participant may enter multiple Auction Sweeps, with each Auction Sweep at a different price level. If a Phlx XL II participant submits multiple Auction Sweeps, the Phlx XL II system would consider only the most recent Auction Sweep at each price level submitted by such Phlx XL II participant in determining the Auction Price. The Phlx XL II system would aggregate the size of all Auction Sweeps (*i.e.*, for all Phlx XL II participants) at a particular price level for trade allocation purposes.

³⁶ A valid-width auction quote is a quote that has a bid/ask differential that complies with the parameters set forth in a table developed by the Exchange which would be published in an Options Trader Alert and posted on the Exchange’s website.

³⁷ See proposed Rule 1082(a)(ii)(B)(4)(d).

If quotes, Auction Sweeps and orders submitted during the Auction Period would not allow the entire initiating order to trade at a price within the AQR without trading through the ABBO, the Phlx XL II system would determine if the total number of contracts displayed at the ABBO price on away markets would satisfy the number of marketable contracts available on the Exchange. If it does, the Phlx XL II system would route a number of contracts that would satisfy interest at other markets at the ABBO price, and determine a PBBO that reflects the remaining Phlx interest without locking the away market. In this situation, the Phlx XL II system would price any contracts routed to other markets at the ABBO price.

If the total number of contracts priced at the ABBO would not satisfy the number of marketable contracts the Exchange has, the Phlx XL II system would determine how many contracts it has available on the Exchange at a price equal to the ABBO. If the total number of ABBO contracts plus the number of contracts available on the Exchange at the ABBO price would satisfy the number of marketable contracts the Exchange has, the ABBO price becomes the Exchange Auction Price and the Phlx XL II system would trade available contracts on the Exchange at the Exchange Auction Price and contemporaneously route a number of contracts that would satisfy interest at other markets at prices better than the Exchange Auction Price. In this situation, the Phlx XL II system would price any contracts routed to other markets at the away market price. The Exchange Auction Price would always be at or within the AQR.

If the total number of ABBO contracts plus the number of contracts available on the Exchange at the ABBO price would not satisfy the number of marketable contracts the Exchange has, the Phlx XL II system would determine how many contracts are available on the Exchange at a price that is one MPV through the ABBO price. If the total number of ABBO contracts plus the number of contracts available on the Exchange at the ABBO price plus the number of

contracts available on the Exchange at a price that is one MPV through the ABBO price would satisfy the number of marketable contracts the Exchange has, the price that is one MPV through the ABBO becomes the Exchange Auction Price. The system would contemporaneously route a number of contracts that would satisfy interest at the ABBO and trade a number of contracts that would satisfy interest on the Exchange at the Exchange Auction Price.³⁸ In this situation, the Phlx XL II system would price any contracts routed to other markets at the Exchange Auction Price.

If the total number of ABBO contracts plus the number of contracts available on the Exchange at the ABBO price plus the number of contracts available on the Exchange at a price that is one MPV through the ABBO price would not satisfy the number of marketable contracts the Exchange has, the system may repeat the auction process up to three times.

If after that number of times, the Phlx XL II system still cannot either route and/or trade the entire initiating order, the Phlx XL II system would conduct a Provisional Auction by routing to markets at the ABBO for their disseminated size, and trading as many contracts as possible on the Exchange at the ABBO price and at a price that is one MPV through the ABBO price. In this situation, the Phlx XL II system would price any contracts routed to other markets at the ABBO price.

The Auction would then be complete. Any unexecuted contracts from the initiating order would be displayed in the Exchange quote at the Auction Price for the remaining size for a brief period not to exceed ten seconds and subsequently cancelled back to the entering participant if they remain unexecuted and priced through the Auction Price. During the brief period, the Phlx XL II system would disseminate if the remaining size is a buyer, an offer that is \$200,000, with a

³⁸ The Phlx XL II system would route contracts to the ABBO when the next Phlx price is greater than one MPV through the ABBO.

size of one or, if the remaining size is a seller, a bid that is \$0.00, with a size of one, on the opposite side of the market from remaining unexecuted contracts.

In sum, the Exchange states that the automated auction process logic seeks to first route away all contracts executable at a better price than the Exchange's Auction Price, then executes all contracts available on the Exchange at the Auction Price or one MPV through the NBBO and, lastly, routes away all contracts available at other exchanges at the Exchange's Auction Price.

The foregoing processes occur contemporaneously.

Expanded Order Types³⁹

The Exchange has proposed three new order types: Do-Not-Route ("DNR") order, a FIND order, and a SRCH order.

DNR orders

A DNR order may execute on the Exchange at a price equal to or better than, but not inferior to, the best away market price but, if that best away market remains, the DNR order would remain in the Phlx book and be displayed at a price one minimum price variation inferior to that away best bid/offer.⁴⁰ A DNR order would never be routed outside of Phlx regardless of the prices displayed by away markets. Any incoming order interacting with such a resting DNR order would receive the best away market price. Should the best away market change its price, or move to an inferior price level, the DNR order would automatically re-price from its one minimum price variation inferior to the original away best bid/offer price to one minimum trading increment away from the new away best bid/offer price or its original limit price. Once priced at its original limit price, it would remain at that price until executed or cancelled. Should

³⁹ For a more detailed discussion of the proposed new order types, see Notice at 17255-57 and Amendment No. 3.

⁴⁰ See proposed Rule 1080(m)(iv)(A).

the best away market improve its price such that it locks or crosses the DNR order limit price, the Exchange would execute the resulting incoming order that is routed from the away market that locked or crossed the DNR order limit price.

FIND orders

A FIND order is an order that would be routable upon receipt, or any time the option goes through an opening process.⁴¹ A FIND order on the Phlx XL II book during an opening would be routed as part of the Opening Process. Once the Opening Process is complete, the FIND order would either be eligible to trade at the Phlx price or placed on the Phlx book either at its limit price or at a price that is one MPV from the ABBO price if it would otherwise lock or cross the ABBO. A FIND order would not be eligible for routing until the next time the option series is subject to a new Opening Process. A FIND order received during open trading that is not marketable against the PBBO or the ABBO would be entered into the Phlx XL II book at its limit price. The FIND order would not be eligible for routing until the next time the option series is subject to a new Opening Process.

A FIND order received during open trading that would be marketable against the PBBO when the ABBO is inferior to the PBBO would be traded at the Exchange at the PBBO price. If the FIND order has size remaining after exhausting the PBBO, it may (1) trade at the next PBBO price (or prices) if the order price is locking or crossing that price (or prices) up to and including the ABBO price, or (2) be entered into the Phlx XL II book at its limit price, or entered into the Phlx XL II book at one MPV away from the ABBO if locking or crossing the ABBO. The FIND order would not be eligible for routing until the next time the option series is subject to a new Opening Process.

⁴¹ See proposed Rule 1080(m)(iv)(B).

A FIND order received during open trading that is marketable against the PBBO when the ABBO is equal to the PBBO would be traded at the Exchange at the PBBO. If the FIND order has size remaining after exhausting the PBBO, it would initiate a Route Timer not to exceed one second in order to allow Phlx XL II participants and other market participants an opportunity to interact with the remainder of the FIND order. During the Route Timer, the FIND order would be included in the PBBO at a price one MPV away from the ABBO. If, during the Route Timer, any new interest arrives opposite the FIND order that is equal to or better than the ABBO price, the FIND order would trade against such new interest at the ABBO price. What happens to a FIND order after the Route Timer expires depends on the ABBO price at that time.⁴²

A FIND order received during open trading that is marketable against the ABBO when the ABBO is better than the PBBO would initiate a Route Timer not to exceed one second in order to allow Phlx XL II participants and other market participants an opportunity to interact with the FIND order. During the Route Timer, the FIND order would be included in the PBBO at a price one MPV away from the ABBO. If, during the Route Timer, any new interest arrives opposite the FIND order that is equal to or better than the ABBO price, the FIND order would trade against such new interest at the ABBO price. What happens to a FIND order after the Route Timer expires depends on the ABBO price at that time.⁴³

SRCH orders

⁴² See *id.* For further details regarding FIND orders, including what happens to a FIND order after the Route Timer expires in the situation described above, see Notice at 17256 and Amendment No. 3.

⁴³ See *id.* For further details regarding FIND orders, including what happens to a FIND order after the Route Time expires in the situation described above, see Notice at 17256 and Amendment No. 3.

A SRCH order is an order that would be routable at any time.⁴⁴ A SRCH order on the Phlx XL II book during an opening, whether it is received prior to the opening or it is a GTC SRCH order from a prior day, would be routed as part of the Opening Process. Once the Opening Process is complete, a SRCH order would be eligible either to: (1) trade at the Phlx price, if that price is equal to or better than the ABBO or, if the ABBO is better than the Phlx price, orders have been routed to the ABBO markets for their full size; or (2) be routed to the ABBO if the ABBO price is the best price, and/or (3) be placed on the Phlx XL II book at its limit price if not participating in the Phlx opening at the opening price and not locking or crossing the ABBO. Once on the book, the SRCH order would be eligible for routing if it is locked or crossed by an away market.

A SRCH order received during open trading that is not marketable against the PBBO or the ABBO would be entered into the Phlx XL II book. Once on the book, the SRCH order is eligible for routing if it is locked or crossed by an away market. A SRCH order received during open trading that is marketable against the PBBO when the ABBO is inferior to the PBBO would be traded at the Exchange at the PBBO price. If the SRCH order has size remaining after exhausting the PBBO, it may (1) trade at the next PBBO price (or prices) if the order price is locking or crossing that price (or prices) up to and including the price equal to the ABBO price, and/or (2) be routed, subject to a Route Timer not to exceed one second, to the ABBO markets if all Phlx interest at better or equal prices has been exhausted, and/or (3) be entered into the Phlx XL II book at its limit price if not locking or crossing the Phlx price or the ABBO. Once on the book, the SRCH order would be eligible for routing if it is locked or crossed by an away market.

⁴⁴ See proposed Rule 1080(m)(v)(C).

A SRCH order received during open trading that is marketable against the PBBO when the ABBO is equal to the PBBO would be traded at the Exchange at the PBBO. If the SRCH order has size remaining after exhausting the PBBO, it would initiate a Route Timer not to exceed one second in order to allow Phlx XL II participants and other market participants an opportunity to interact with the SRCH order. During the Route Timer, the SRCH order would be included in the PBBO at a price one MPV away from the ABBO. If, during the Route Timer, any new interest arrives opposite the SRCH order that is equal to or better than the ABBO price, the SRCH order would trade against such new interest at the ABBO price. What happens to a SRCH order after the Route Timer expires depends on the ABBO price at that time.⁴⁵

A SRCH order received during open trading that is marketable against the ABBO when the ABBO is better than the PBBO would initiate a Route Timer not to exceed one second in order to allow Phlx XL II participants and other market participants an opportunity to interact with the remainder of the SRCH order. During the Route Timer, the SRCH order would be included in the PBBO at a price one MPV inferior to the ABBO. If, during the Route Timer, any new interest arrives opposite the SRCH order that is equal to or better than the ABBO price, the SRCH order would trade against such new interest at the ABBO price. What happens to a SRCH order after the Route Timer expires depends on the ABBO price at that time.⁴⁶

A SRCH order on the Phlx XL II book may be routed to an away market if it is locked or crossed by an away market. If an ABBO locks or crosses the PBBO which includes a SRCH order, the Phlx XL II system would initiate a Route Timer not to exceed one second in order to

⁴⁵ See *id.* For further details regarding SRCH orders, including what happens to a SRCH order after the Route Timer expires in the situation described above, see Notice at 17257 and Amendment No. 3.

⁴⁶ See *id.* For further details regarding SRCH orders, including what happens to a SRCH order after the Route Timer expires in the situation described above, see Notice at 17257 and Amendment No. 3.

allow Phlx users an opportunity to interact with the SRCH order. During the Route Timer, the SRCH order would remain in the PBBO at its posted price. If, during the Route Timer, any new interest arrives opposite the SRCH order that is equal to or better than the ABBO price, the SRCH order would trade against such new interest at the ABBO price. What happens to a SRCH order after the Route Timer expires depends on the ABBO price at that time.⁴⁷

Order Routing⁴⁸

The Phlx XL II system would route only customer FIND and SRCH orders with no other contingencies. Customer FIND and SRCH orders would first be checked by the Phlx XL II system for available contracts for potential execution, then orders are sent to other available market centers for potential execution. When checking the book, the Phlx XL II system would seek to execute at the price at which it would send the order to a destination market center. In situations where the Exchange's disseminated bid or offer is one MPV inferior to the NBBO price, the Phlx XL II system would contemporaneously route to the away market(s) disseminating the NBBO at such away market's size, and execute remaining contracts at the Exchange's disseminated bid or offer up to its disseminated size. If contracts remain unexecuted after routing, they are posted on the book. Once on the book, should the order subsequently be locked or crossed by another market center, the Phlx XL II system would not route the order to the locking or crossing market center, except as specified.

Orders sent to other markets do not retain time priority with respect to other orders in the Phlx XL II system and the Phlx XL II system would continue to execute other orders while

⁴⁷ See id. For further details regarding SRCH orders, including what happens to a SRCH order after the Route Timer expires in the situation described above, see Notice at 17257 and Amendment No. 3.

⁴⁸ For a more detailed discussion of the terms of the proposed routing functions, see Notice at 17255 and Amendment No. 3.

routed orders are away at another market center. Once routed by the Phlx XL II system, an order becomes subject to the rules and procedures of the destination market including, but not limited to, order cancellation. If a routed order is subsequently returned, in whole or in part, that order, or its remainder, would receive a new time stamp reflecting the time of its return to the Phlx XL II system.⁴⁹ Entering member organizations whose orders are routed to away markets would be obligated to honor such trades that are executed on away markets to the same extent they would be obligated to honor a trade executed on the Exchange.⁵⁰

In addition, the Exchange proposes to establish Nasdaq Options Services LLC (“NOS”) as the Exchange’s exclusive order router.⁵¹ NOS will serve as the routing facility of the Exchange (“Routing Facility”), and the sole use of NOS by the Exchange⁵² will be to route orders in options listed and open for trading on the Phlx XL II system to away market centers pursuant to Exchange rules.⁵³ Also, NOS will be a member of an SRO unaffiliated with Phlx that is its designated examining authority.⁵⁴

The use of NOS to route orders to other market centers would be optional. Parties that do not desire to use NOS must designate orders as not available for routing.⁵⁵ The Exchange would

⁴⁹ See proposed Rule 1080(m)(i).

⁵⁰ See proposed Rule 1080(m)(ii).

⁵¹ See proposed Rule 1080(m)(iii)(A).

⁵² The Commission notes that if NOS were to perform any other functions for Phlx, Phlx would have to file a proposed rule change with the Commission pursuant to Section 19 of the Act and the rules and regulations thereunder.

⁵³ See Rule 1080(m)(iii)(A). The Commission notes that because the routing services provided by NOS will be pursuant to Exchange rules, they will be available only to Exchange members. Further, the Commission notes that the two order types that would be available for routing – FIND and SRCH – would both first check the Phlx XL II system for available liquidity before routing to other market centers.

⁵⁴ See id.

⁵⁵ See proposed Rule 1080(m)(iii)(B).

establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange and the Routing Facility, and any other entity, including any affiliate of the Routing Facility, and, if the Routing Facility or any of its affiliates engages in any other business activities other than providing routing services to the Exchange, between the segment of the Routing Facility or affiliate that provides the other business activities and the routing services.⁵⁶ In addition, the books, records, premises, officers, directors, agents, and employees of the Routing Facility, as a facility of the Exchange, would be deemed to be the books, records, premises, officers, directors, agents, and employees of the Exchange, for purposes of and subject to oversight pursuant to the Act, and such books and records of the Routing Facility would be subject at all times to inspection and copying by the Exchange and the Commission.⁵⁷

Exchange Rule 985(b) generally prohibits the Phlx or an entity with which it is affiliated from acquiring or maintaining an ownership interest in, or engaging in a business venture with a Phlx member or an affiliate of a Phlx member in the absence of an effective filing with the Commission under Section 19(b) of the Act. NOS is a member of Phlx, and also an indirect, wholly owned subsidiary of Phlx's parent company, and therefore an affiliate of Phlx. In July 2008, the Commission approved NOS as an affiliate of Phlx for the limited purpose of providing routing services for NASDAQ Exchange for orders that first attempt to access liquidity on NASDAQ Exchange's systems before routing to Phlx, and subject to certain conditions.⁵⁸ The Exchange now requests that the Commission provide a further exemption from the restrictions

⁵⁶ See proposed Rule 1080(m)(iii)(C).

⁵⁷ See 1080(m)(iii)(D).

⁵⁸ See Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (SR-Phlx-2008-31).

on affiliation by allowing Phlx to use NOS to provide routing services for orders that first attempt to access liquidity on the Phlx's systems before routing to other exchanges.

Miscellaneous Rule Changes

The Exchange proposes to make various additional changes and updates to delete obsolete provisions and generally update the relevant rules.⁵⁹

Pilot

In the situations described above where the Exchange proposes to disseminate quotations on one side of the market with a price of \$0.00 or \$200,000 and a size of one contract, the relevant rule provisions would be subject to a pilot period scheduled to end on November 30, 2009.

Rollout and Deployment

The Exchange expects to roll out the Phlx XL II system over a period of 12 weeks following Commission approval of this proposal (the "rollout period"), beginning with one single option traded on the Phlx XL II system, while other options traded on the Exchange would continue to trade on the original Phlx XL system (the "legacy system") during the rollout period. By the end of the rollout period, all options traded on the Exchange would be traded on the Phlx XL II system, and no options would be traded on the legacy system. Accordingly, the Exchange proposes to distinguish the proposed rules applicable to options traded on the Phlx XL II system from existing Exchange rules applicable to options traded on the legacy system.

Within 90 days following the completion of the rollout of the Phlx XL II system, the Exchange has represented that it will offer a data feed to all market participants, which would include disseminated Exchange top-of-market data (including orders, quotes and trades). The

⁵⁹ For a more detailed discussion of these additional changes, see Notice at 17257-58 and Amendment No. 3.

new data feed would also include all information that is included in the Exchange's Specialized Order Feed ("SOF"), which provides information concerning simple orders, complex orders and complex strategies to Exchange quoting members. The Exchange has also represented that, with respect to the speed with which users would receive this information, SOF users would receive this information no sooner than users of the new data feed.

III. Summary of Comments Received and Phlx's Response

The Commission received two comment letters objecting to certain aspects of Phlx's proposed rule change.⁶⁰ Both commenters object to Phlx's original proposal with regard to its proposed changes to Phlx's Firm Quote Rule, with NYSE Euronext believing that Phlx would not be displaying its best priced quotation, in violation of Rule 602 under the Act.⁶¹ NYSE Euronext argues that this aspect of Phlx's proposal erodes investor confidence and adds unnecessary confusion to the marketplace.⁶²

In its initial filing, in certain situations in the Opening, Quote Exhaust and Market Exhaust Processes, Phlx proposed to disseminate the reference price at a zero-size quotation on one side of the market. NYSE Euronext argues that Phlx's proposed zero-size quotation would mask its true best available price and also fall short of Rule 602's minimum size requirements. NYSE Euronext argues that disseminating zero-size quotes in this manner would also raise issues for "smart routers" which are generally programmed to route to the NBBO, which NYSE Euronext believes would result in increased order processing latency and might prevent customers an opportunity for execution because routers might be delayed in sending orders to

⁶⁰ See NYSE Euronext Letter and CBOE Letter, *supra* at footnote 7.

⁶¹ See 17 CFR 242.602 (Dissemination of Quotations in NMS Securities).

⁶² See NYSE Euronext Letter at 2.

other market centers that actually had liquidity at their displayed best bid or offer.⁶³ The commenters state that market participants, including options exchanges, market makers and routers, would encounter operational difficulties with the zero-size quotation, in that it would require systems to be reprogrammed or otherwise adjusted to work around the Phlx-generated quote.⁶⁴

Both commenters also point to conflicts of the Phlx zero-size proposal with The Plan For The Purpose Of Creating And Operating An Intermarket Option Linkage (“Current Linkage Plan”),⁶⁵ with NYSE Euronext noting that markets may not be able to avail themselves of certain provisions of the plan that require a Linkage Order to be sent to the exchange at the NBBO. CBOE states that the proposed quotation would undermine the objectives of the Current Linkage Plan and impact the willingness of CBOE members and traders across the industry to post bids or offers when Phlx was displaying the zero-sized quotation, if they might create or contribute to a locked market.

Finally, NYSE Euronext also argues that disseminating prices with no associated size to the Options Price Reporting Authority (“OPRA”) for dissemination to vendor is inconsistent with the provisions of the OPRA plan as it would not “reflect the current state of the market.”⁶⁶

In its comment letter, CBOE also raises concerns regarding execution at the end of the Market Exhaust Auction.⁶⁷ Specifically, CBOE notes that, at the end of the auction if Phlx has an order that could be filled within the AQR, it would trade at the best price in which the entire

⁶³ See NYSE Euronext Letter at 1-2.

⁶⁴ See NYSE Euronext Letter at 2 and CBOE Letter at 2.

⁶⁵ See NYSE Euronext Letter at 2-3 and CBOE Letter at 1-2.

⁶⁶ See Plan For Reporting Of Consolidated Options Last Sale Reports And Quotation Information, Section V(b).

⁶⁷ See CBOE Letter at 2-3.

order can be executed. CBOE questions why, under this framework, “better priced auction responses are ignored just because they are not large enough to fill the entire order, when the order, by its terms, is eligible for a partial fill” and how customer orders benefit from this process.⁶⁸

CBOE also expresses concern that the proposed rule change may contemplate certain entitlements (e.g., directed order, preferred, and specialist entitlements) extending to the final execution in a Market Exhaust Auction⁶⁹ and is specifically concerned about how Phlx’s matching rules regarding order allocation would apply to a situation where the aggregate contra-interest at the final auction price is greater in size than the initiating order. CBOE requested clarification on whether such entitlements would be applied when the potential recipient of the entitlement (i.e., the specialist or directed Market Maker) was not quoting the series at the time the initiating order was received.

Finally, CBOE notes that the auction appears to take place even if there are orders on the Phlx book.⁷⁰ CBOE questions whether those existing orders are allowed to participate in the auction, as CBOE interprets the proposed rule change as providing the auction notification only to Phlx market makers.

In its Response Letter, Phlx noted that, in Amendment No. 3, it responded many of the concerns raised by CBOE, as well as all of NYSE Euronext’s comments.⁷¹

In responding to CBOE’s comment relating to the end of the Market Exhaust Auction, when the XL II system would trade at the at the best price (within an established AQR) that the

⁶⁸ See CBOE Letter at 3.

⁶⁹ See id.

⁷⁰ See id.

⁷¹ See Response Letter at 1.

entire order can be executed., Phlx explains that its Market Exhaust Auction would function in the same manner as its proposed opening process, in that it would result in a single price where the entire incoming order can be filled with normal NBBO protection.⁷² Phlx disputes CBOE’s contention that contra-side bids or offers received during the auction at a better price than the execution price would be “ignored,” and notes that such bids or offers would have price priority and would be executed at the single execution price.⁷³

Phlx further explains that, if the PBBO includes marketable limit orders on the Phlx limit order book at the time the incoming order is received that are priced at or within the NBBO, such orders would be executed immediately by its XL II system before the auction begins, while limit orders that are not at the PBBO and are at or within the NBBO would participate in the auction.⁷⁴ Finally, Phlx states that its XL II system would not execute any trade at a price through the NBBO unless it had routed contracts to the NBBO markets contemporaneously (consistent with the “trade and ship” concept).⁷⁵

Finally, in response to CBOE’s request for clarification regarding participation entitlements under the proposed exhaust auctions, Phlx explains that for specialists that receive Directed Orders in trade allocations stemming from trade executions following an exhaust auction, the trade allocation algorithm set forth in Phlx Rule 1014(g)(vii) would apply.⁷⁶ Phlx further notes that to receive its entitlement, a specialist must have submitted a quote at the execution price and is not entitled to receive a number of contracts that is greater than his or her

⁷² See id.

⁷³ See id.

⁷⁴ See id.

⁷⁵ See id at 1-2.

⁷⁶ See id at 2.

disseminated size.⁷⁷ Phlx states that, for Directed Orders, the trade allocation algorithm set forth in Phlx Rule 1014(g)(viii) would apply and clarifies that, in order for a Directed Specialist, Directed SQT or Directed RSQT participant to receive their entitlement, they must be quoting at the Phlx disseminated price (which must be at the NBBO) at the time of receipt of the Directed Order. Therefore, if a Directed Specialist, Directed SQT or Directed RSQT does not submit a quotation at the NBBO execution price until the auction is initiated, they would not receive the entitlement described in Phlx Rule 1014(g)(viii).⁷⁸

IV. Discussion

After carefully reviewing the proposed rule change, as amended, the Commission finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁷⁹ In particular, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act,⁸⁰ which, among other things, requires that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating 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. The Commission also finds that the proposed rule change, as amended, is consistent with the provisions of Section 6(b)(8) of the Act,⁸¹ which requires that the

⁷⁷ See id.

⁷⁸ See id.

⁷⁹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁸⁰ 15 U.S.C. 78f(b)(5).

⁸¹ 15 U.S.C. 78f(b)(8).

rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

The Commission notes that while it believes the proposed rule change, as amended, is consistent with the Current Linkage Plan, the Exchange acknowledges that, should the Commission approve the proposed Options Order Protection and Locked/Crossed Market Plan,⁸² modifications to certain proposed rules may be necessary to ensure compliance with that plan.

Opening Process

The Exchange has proposed a new opening process that is designed, in general, to: (1) ensure that an option would open within a reasonable period of time after the underlying security is open and do so within an appropriate Phlx opening price range; (2) allow Phlx to route,⁸³ if necessary, to other same or better-priced markets contemporaneously with its opening of an option series so as to maximize the number of contracts executing at the open; and (3) allow quoting market participants to enter trading interest at multiple price levels.

The Commission believes that the proposed rules governing the opening procedures on Phlx XL II provide for a reasonable process for the Exchange to conduct its opening. The Commission believes that the proposed opening process may provide better executions to users, as well as more consistent prices on executions and a smoother transition from the opening to the regular trading day. Accordingly, the Commission believes that the proposed opening process is consistent with the Act.

Amendments to the Firm Quote Rule

⁸² See Securities Exchange Act Release No. 59647 (March 30, 2009), 74 FR 15010 (April 2, 2009) (File No. 4-546).

⁸³ Similar to the Exchange's current routing methodology under the Current Linkage Plan the Exchange would only route customer, non-contingency orders.

Changes to Rule 1082 include the addition of two new functionalities that are intended to enhance the ability for Phlx XL II participants to refresh, and potentially improve, their quotations when their option quotation size is exhausted at a particular price level, and that would reflect the Exchange's ability to refresh its disseminated market following the exhaustion of the Exchange's disseminated size.

The purpose of Quote Exhaust is to enhance the process for refreshing a participant's quote that has been fully exhausted by an incoming quote or order that has, after exhausting the Phlx quote at a particular price level, remaining size to be executed at a price through the reference price. The Quote Exhaust functionality provides an opportunity for remaining portions of incoming quotes or orders to be executed on the Exchange at prices that are equal to or better than away markets by allowing Phlx XL II participants to refresh their quotes before routing away, thus potentially providing better prices at which to execute such remaining portions. In addition, Quote Exhaust is intended to provide an opportunity for such quote or order to receive a price for that order better than the next price that would otherwise be available on Phlx whether by executing on the Phlx or by routing to applicable away markets. In addition, the Commission notes that market participants may utilize IOC orders if they do not wish their order to be included in the Quote Exhaust process.

The Market Exhaust is intended to provide Phlx XL II participants an opportunity to participate in the Market Exhaust Auction when an initiating order is received by the Phlx XL II system when no Phlx XL II participant is quoting in a given series. The Commission notes that, as with the Quote Exhaust process, market participants may utilize IOC orders if they do not wish their order included in the Market Exhaust process.

The Commission believes that these changes to the order handling process should assist with routing to liquidity available at other exchanges while preventing non-exempt trade-throughs of other markets in compliance with the Current Linkage Plan. The Commission further believes that the Quote Exhaust and Market Exhaust functionalities should result in greater continuity in prices as they introduce a price check to limit executions at far away prices. The Commission finds that the proposed amendments to Phlx's firm quote rule, including its proposed Quote Exhaust and Market Exhaust procedures, are consistent with the Act.

Expanded Order Types

The Exchange has proposed FIND and SRCH orders, as outlined above, which are designed to utilize route timers prior to routing to applicable away markets in order to provide Phlx XL II participants an opportunity to interact with such orders prior to routing away as needed. In addition, Phlx XL II provides for a DNR order type for those users that only want executions on Phlx. Phlx has represented that IOC orders would never go through the exposure period outlined for the FIND and SRCH order types in the proposed rules.

The Commission believes that these new order types may improve routing to liquidity available at other exchanges while preventing non-exempt trade-throughs of other markets in compliance with the Current Linkage Plan, and provide users with increased flexibility and control in how their orders are handled. The Commission believes that the proposed order types are consistent with the Act.

Routing

With respect to order routing, the Phlx XL II system would route only customer FIND and SRCH orders with no other contingencies. Customer FIND and SRCH orders would first be checked by the Phlx XL II system for available contracts for potential execution, then orders

would be sent to other available market centers for potential execution. When checking the book, the Phlx XL II system would seek to execute at the price at which it would send the order to a destination market center. In situations where the Exchange's disseminated bid or offer is one MPV inferior to the NBBO price, the Phlx XL II system would contemporaneously route to the away market(s) disseminating the NBBO at such away market's size, and execute remaining contracts at the Exchange's disseminated bid or offer up to its disseminated size. If contracts remain unexecuted after routing, they are posted on the book. Once on the book, should the order subsequently be locked or crossed by another market center, the Phlx XL II system would not route the order to the locking or crossing market center, except as specified below. Orders sent to other markets do not retain time priority with respect to other orders in the Phlx XL II system and the Phlx XL II system would continue to execute other orders while routed orders are away at another market center. Once routed by the Phlx XL II system, an order becomes subject to the rules and procedures of the destination market including, but not limited to, order cancellation. If a routed order is subsequently returned, in whole or in part, that order, or its remainder, shall receive a new time stamp reflecting the time of its return to the Phlx XL II system. Entering member organizations whose orders are routed to away markets shall be obligated to honor such trades that are executed on away markets to the same extent they would be obligated to honor a trade executed on the Exchange.

Additionally, Phlx has proposed that NOS serve as the Routing Facility of the Exchange. The sole use of NOS by the Exchange will be to route orders in options listed and trading on the Phlx XL II system to away markets pursuant to Exchange rules and on behalf of the Exchange. If NOS were to perform any other functions for Phlx, Phlx would have to file a proposed rule

change with the Commission pursuant to Section 19 of the Act and the rules and regulations thereunder.

As a facility, NOS will be subject to Exchange oversight, as well as Commission oversight.⁸⁴ NOS will also be a member of an SRO unaffiliated with Phlx that is its designated examining authority, and Phlx will establish and maintain procedures and internal controls reasonably designed to restrict the flow of confidential and proprietary information between Phlx and its facilities, including NOS, and any other entity, including any affiliate of NOS, and, if NOS or any of its affiliates engages in any other business activities other than providing routing services to the Exchange, between the segment of NOS or its affiliate that provides the other business activity and the routing services.⁸⁵ In addition, the books, records, premises, officers, directors, agents, and employees of NOS, as a facility of Phlx, will be deemed to be those of the Exchange for purposes of and subject to oversight pursuant to the Act.⁸⁶ The Commission notes that NOS's routing services are optional, and therefore not the exclusive means for accessing better priced orders in other market centers.

A participant in the PHLX XL II system would be free to route its orders to other market centers through alternative means. In light of the protections discussed above, including the regulation of NOS as a facility of the Exchange with the respect to routing of orders, the

⁸⁴ Further, the Commission notes that the Exchange will be responsible for filing with the Commission proposed rule changes and fees relating to NOS's outbound routing function and NOS's outbound routing function will be subject to exchange non-discrimination requirements.

⁸⁵ See Phlx Rule 1080(m)(iii)(C).

⁸⁶ See Phlx Rule 1080(m)(iii)(D).

Commission believes that Phlx's proposed rules and procedures regarding the use of NOS to route orders to away markets are consistent with the Act.⁸⁷

Phlx has requested that the Commission approve its affiliation with NOS for the purpose of NOS providing routing services to the Exchange for orders that first attempt to access liquidity on Phlx's system. Previously, the Commission approved Phlx's affiliation with NOS for the limited purpose of receipt of orders from NASDAQ Exchange that first attempt to access liquidity on NASDAQ Exchange's systems before routing to Phlx.⁸⁸ In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest, and the potential for unfair competitive advantage.⁸⁹ Although the Commission continues to be concerned about potential unfair competition and conflict of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, the Commission believes that it is appropriate and consistent with the Act to allow NOS to be an affiliate of Phlx to provide routing services for orders that first attempt to access liquidity on Phlx's systems before routing to other exchanges in light of the protections afforded by the conditions described above.

Miscellaneous Changes

The Exchange also proposed several changes to its rules to delete obsolete provisions and generally update other relevant rules. The Commission believes that these clarifications and

⁸⁷ In addition, the Commission notes that the Phlx rules and procedures applicable to NOS are similar to the rules and procedures adopted by other exchange to govern their routing of orders to other market centers. See, e.g., NYSE Rule 17, NYSE Amex Rule 17, and Nasdaq Rules 4758.

⁸⁸ See Securities Exchange Act Release No. 58179, supra note 58.

⁸⁹ See Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77); Securities Exchange Act Release No. 54170 (July 18, 2006), 71 FR 42149 (July 25, 2006) (SR-NASDAQ-2006-006).

deletions should assist Phlx members in better understanding Phlx's rules, thus promoting greater compliance with such rules. The Commission believes that these proposed rule changes are consistent with the Act.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether Amendment No. 3 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2009-32 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-Phlx-2009-32. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street,

NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-Phlx-2009-32 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Accelerated Approval of Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3

The Commission finds good cause to approve the proposed rule change, as modified by Amendment Nos. 1, 2, and 3, prior to the thirtieth day after publication for comment in the Federal Register.

In Amendment No. 3, the Exchange responded to comments submitted by NYSE Arca and CBOE⁹⁰ with regard to its use of a zero size bid or offer during certain situations in the opening process, the Quote Exhaust and the Market Exhaust.⁹¹ These commenters argued that dissemination of a zero size quotation violated the Quote Rule,⁹² was inconsistent with Linkage Plan and OPRA Plan, and would pose operational problems for market participants.

In Amendment No. 3, the Exchange proposed several changes to its proposed rules governing the opening process, Quote Exhaust and Market Exhaust to address these concerns.⁹³

⁹⁰ See supra notes 60-70 and accompanying text.

⁹¹ See supra notes 13-38 and accompanying text.

⁹² 17 CFR 242.602.

⁹³ See proposed Rules 1017(l)(iv)(C)(7), 1082(a)(1)(B)(3)(b), 1082(a)(ii)(B)(3)(g)(iv)(A)(3), 1082(a)(ii)(B)(3)(g)(iv)(A)(4), 1082(a)(ii)(B)(3)(g)(iv)(B)(2), 1082(a)(ii)(B)(3)(g)(iv)(B)(3), 1082(a)(ii)(B)(4)(b), and 1082(a)(ii)(B)(4)(d)(iv)(D). See also Response Letter at 1.

Specifically, in those situations where Phlx initially proposed to disseminate a quote that would contain the balance of an inbound order and an exchange generated quote for a size of zero on the other side of the market, the XL II system would instead disseminate, on the opposite side of the market from any remaining unexecuted contracts: (i) a bid price of \$0.00, with a size of one contract if the remaining size is a seller; or (ii) an offer price of \$200,000, with a size of one contract if the remaining size is a buyer. In Amendment No. 3, Phlx states that the fact that there is no quote from any XL II participant is an unusual market condition which Phlx believes requires it to disseminate via OPRA such a quote to indicate that there is a non-firm condition on the side of the market that is exhausted.

The Commission believes that this change would allow Phlx to effectively post a non-firm quote on one side of the market, while attempting to attract interest to fill an order on the other side of the market. The Commission believes that this proposal is consistent with the Quote Rule's provisions regarding non-firm quotations.⁹⁴ Specifically, Rule 602(a)(3)(i) provides that if, at any time a national securities exchange is open for trading, the exchange determines, pursuant to rules approved by the Commission, that the level of trading activities or the existence of unusual market conditions is such that the exchange is incapable of collecting, processing, and making available to vendors the data for a subject security required to be made available in a manner that accurately reflects the current state of the market on such exchange, such exchange shall immediately notify all specified persons of that determination and, upon such notification, the exchange is relieved of its obligations under paragraphs (a)(1) and (2) of Rule 602 relating to collecting and disseminating quotations, subject to certain other provisions of Rule 602(a)(3).

⁹⁴ See 17 CFR 242.602(a)(3)(i) and (ii).

By proposing to disseminate a bid of \$0.00 for one contract or an offer of \$200,000 for one contract in certain situations delineated in its rules, the Commission believes that Phlx is adequately communicating that it is non-firm on that side of the market in compliance with the Quote Rule. Further, the Commission believes that these changes proposed by Phlx in Amendment No. 3 would be consistent with the Current Linkage Plan in that they would not result in a locked market situation. Finally, these changes should address the commenter's concerns relating to the operational issues associated with Phlx's originally proposed zero-size quotation.

The Commission notes that this aspect of the proposal is being approved on a pilot basis with the pilot period to end on November 30, 2009. The Commission understands that, currently, there is no mechanism for OPRA to identify only one side of a quote as non-firm. During this pilot period, the Commission expects that the Exchange will work with OPRA to develop the capability to identify such a mechanism. Once that capability is developed, there should no longer be a need to use a \$0.00 bid or \$200,000 offer to reflect a non-firm status on one-side of the market.

In addition, in response to CBOE's comment letter, Phlx amended proposed Rule 1082(a)(ii)(B)(4), Market Exhaust, to clarify that, if an order is received when there are no quotations available in the Phlx market, but Phlx has an order on its book at the NBBO, Phlx would immediately execute the incoming order against the order on its book at the NBBO.

The Commission believes that Phlx's proposal to disseminate a non-firm quote on one side of the market with size for a limited period of time, and to execute orders during a Market Exhaust situation if there is a limit order resting on Phlx at the NBBO, responds to the concerns raised by commenters and, as discussed above, is consistent with the Act. Therefore, the

Commission finds good cause, consistent with Section 19(b)(2) of the Act,⁹⁵ to approve the proposed rule change, as modified by Amendment Nos. 1, 2, and 3, on an accelerated basis.

The Commission believes that, with regard to the additional comments made by CBOE relating to the proposed rules for order handling following the Market Exhaust Auction and the circumstances under which specialists and other Phlx XL II participants would receive entitlements,⁹⁶ Phlx has sufficiently responded to and clarified these aspects of its proposal.

VII. 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.⁹⁷

⁹⁵ 15 U.S.C. 78s(b)(2).

⁹⁶ See supra note 7.

⁹⁷ 15 U.S.C. 78f(b)(5).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁹⁸ that the proposed rule change (SR-Phlx-2009-32), as amended, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁹⁹

Florence E. Harmon
Deputy Secretary

⁹⁸ 15 U.S.C. 78s(b)(2).

⁹⁹ 17 CFR 200.30-3(a)(12).