

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-63627; File No. SR-Phlx-2010-153)

December 30, 2010

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Approving a Proposed Rule Change to Update and Streamline the Process for Specialist Evaluations and Clarify the Time Within Which SQTs and RSQTs Must Begin to Electronically Quote After Assignment

I. Introduction

On November 5, 2010, the NASDAQ OMX PHLX LLC (“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 update and streamline the process for specialist evaluations and clarify the time within which Streaming Quote Traders (“SQTs”) and Remote Streaming Quote Traders (“RSQTs”) must begin to electronically quote after assignment. The proposed rule change was published for comment in the Federal Register on November 17, 2010.³ The Commission received no comment letters regarding the proposal. This order approves the proposed rule change.

II. Description of the Proposal

The purpose of the proposed rule change is to amend Phlx By-Law Article XI Section 11-1; Rules 507, 508, 510, 511, and 515; and OFPA C-8 to revise the process the Exchange will use to assess specialist performance, as well as to ensure timely electronic quotations by SQTs and RSQTs and the ability of the Exchange to control allocation transfers.

Rules 500 through 599 (the “Allocation and Assignment Rules”) generally describe the process for: application for becoming and appointment of specialists; allocation of classes of

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 63305 (November 10, 2010), 75 FR 70331 (“Notice”).

options to specialist units and individual specialists;⁴ application for becoming and approval of SQTs⁵ and RSQT⁶ (collectively, the “Streaming Quote Traders”)⁷ and assignment of options to them; and performance evaluations for specialist units and SQTs. The Allocation and Assignment Rules also indicate, among other things, under what circumstances new specialist allocations and Streaming Quote Trader assignments may not be made.

Rules 511 and 515 deal with specialist evaluations and certain allocation procedures. Currently, Rule 511 indicates, among other things, that specialist performance evaluations may be used to inform Exchange decisions regarding allocating new options classes, reallocating options classes for substandard performance, determining whether a specialist that has been transferred an options class is performing adequately, and determining whether a staff reorganization or material change with respect to a specialist unit has affected the ability of the unit to continue to perform adequately in order to retain allocated securities. Rule 511 also discusses the process and timing for doing routine and special (cause) evaluations and reviews.

Currently, Rule 515 discusses specialist performance evaluations for options specialists and indicates, among other things, the timing and frequency of evaluations. The criterion to evaluate

⁴ A specialist unit may have one or more individual specialists. See proposed Supplementary Material .05 to Rule 511.

⁵ An SQT is a Registered Options Trader (“ROT”) who has received permission from the Exchange to generate and submit option quotations electronically in options to which such SQT is assigned. An SQT may only submit such quotations while such SQT is physically present on the floor of the Exchange. See Rule 1014(b)(ii)(A).

⁶ An RSQT is an ROT that is a member or member organization with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically in options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. See Rule 1014(b)(ii)(B).

⁷ SQTs also include Directed SQTs (“DSQTs”) and Directed RSQTs (“DRSQTs”), which are SQTs and RSQTs that receive a Directed Order. Exchange Rule 1080(l)(i)(A) defines Directed Order.

specialists may include, but is not limited to, quality of markets, observance of ethical standards, administrative responsibilities, and trade correction and exemptive relief data. Rule 515, as well as OFPA C-8, also discusses the use of floor broker questionnaires in the specialist evaluation process, which asks floor brokers their opinions of specialist performance.⁸

The Exchange now proposes to consolidate Rules 511 and 515 into a combined Rule 511 and to adopt for specialist units⁹ an objective review process that is similar to the process currently in use for Streaming Quote Traders per current Rule 510. The Exchange also proposes to relocate portions of the existing evaluation process from Rule 515 into Rule 511. As such, there would be two types of specialist evaluations or reviews per revised Rule 511: (i) Routine Specialist Performance Evaluations, which would be conducted on at least an annual basis, and would take into account any Minimum Performance Reviews conducted by the Exchange; and (ii) Special Circumstance Evaluations, which may be conducted on an ad hoc basis.

Further, the Exchange proposes changes to Rule 511 so that specialist suspension, termination, or restriction of allocations in one or more options may occur after two or more consecutive sub-standard Minimum Performance Reviews or after Special Circumstance Evaluations and after written notice. As discussed below, following substandard minimum performance, a specialist unit may have an opportunity for an informal meeting with Exchange staff. Moreover, the proposed rules provide the circumstances under which a specialist or

⁸ The Exchange currently presumes that a specialist unit performed below minimum standards if the specialist unit was rated in the bottom 10% of all units in the aggregate results for all questionnaires.

⁹ Proposed Supplementary Material .05 to Rule 511 states that reference to specialist unit within Rule 511 means the unit as a whole or any subpart of its operation that is acting in a specialist capacity on the Exchange and is subject to evaluation; and that a specialist unit may have one or more individual specialists. As such, individual specialist actions may be attributable to relevant specialist units in respect of matters discussed in this proposal such as evaluations. The proposed language in Rule 511 was moved from Rule 515 and updated to reflect current usage.

specialist unit¹⁰ may appeal, after filing a written notice of appeal with the Exchange, from a decision of the Exchange following a Minimum Performance Review or a Special Circumstance Evaluation in accordance with Exchange By-Law Article XI, Section 11-1.¹¹

Routine Specialist Performance Evaluations

Routine Specialist Performance Evaluations pursuant to proposed Rule 511(c) would be conducted at annual (or more frequent) intervals to determine whether specialists have fulfilled performance standards that may include, but are not limited to, trade correction data, exemptive relief data, quality of markets data, proper execution of duties as a specialist unit, competition among market makers and in representing the Exchange as specialist unit, observance of ethical standards, and administrative factors. The Exchange also may consider, when doing routine evaluations, any other relevant information including, but not limited to, trading data, regulatory history, the number of requests for quote spread parameter relief, how a specialist unit optimizes the submission of quotes through the Specialized Quote Feed as defined in Rule 1080 by

¹⁰ In proposed Rule 511(d) and Rule 511(e), a specialist has the right to request an appeal on behalf of his specialist unit.

¹¹ By-Law Article XI Section 11-1(c) states that an appeal shall be heard by a special committee of the Board of Governors composed of three (3) Governors, of whom at least one (1) shall be an Independent Governor. The person requesting review may appeal by filing a written notice thereof with the Secretary of the Exchange within ten (10) days after a decision. The person requesting review shall be permitted to submit a written statement to and/or appear before this special committee. The Secretary of the Exchange shall certify the record of the proceeding, if any and the written decision and shall submit these documents to the special committee. The special committee's review of the action shall be based solely on the record, the written decision and any statement submitted by the person requesting the review. The special committee shall prepare and deliver to such person a written decision and reasons therefor. If the special committee affirms the action, the action shall become effective ten (10) days from the date of the special committee's decision. There shall be no appeal to the Board of Governors from any decision of the special committee.

The Exchange is correcting a reference in By-Law Article XI Section 11-1(c) from Rule 511(e) to Rule 511(d) or (e), in light of the internal numbering changes proposed in Rule 511; and cross-referencing Rule 507, which notes the availability of the appeal process.

evaluating the number of individual quotes per quote block received by the Exchange, and such other factors and data as may be pertinent in the circumstances.

The Exchange also proposes to establish new minimum performance standards for specialist units.¹² Specifically, new Rule 511(d) proposes minimum acceptable performance standards for specialist units using the following criteria: (i) the percentage of time that the specialist unit represents or exceeds the Phlx Best Bid or Offer (“PBBO”) in the options allocated to the unit¹³ and (ii) quoting requirements of specialist units pursuant to Rule 1014.¹⁴ If the percentage of the total time that the options allocated to a specialist unit represent or exceed the PBBO is in the lowest quartile of all specialist units for two or more consecutive months, this may be considered sub-standard performance, that is, performance that does not attain minimum performance standards. If a specialist unit fails to meet the quoting requirements as prescribed by Rule 1014, this may be considered sub-standard performance.

The Exchange proposes a process that would allow a specialist to meet with Exchange staff regarding alleged sub-standard performance. Specifically, the Exchange proposes in new Rule 511(d)(ii) that if the Exchange finds that a specialist unit failed to meet Minimum Performance Standards, it would provide written notice to the unit. Pursuant to new Rule 511(d)(iii), the specialist unit may request and the Exchange may hold an informal meeting with the head

¹² For consistency, the Exchange proposes appeal language in Rules 510 and 511 that is similar, in relevant part, to that of Rule 507: An appeal to the Board of Governors from a decision of the Exchange...may be requested...by filing with the Secretary of the Exchange written notice of appeal within ten (10) days after the decision has been rendered, in accordance with Exchange By-Law Article XI, Section 11-1.

¹³ In that the Exchange would specifically establish a measure of specialist performance on Phlx, the Exchange would change the requirement to PBBO from NBBO (National Best Bid or Offer). A reference in Commentary .01 of Rule 510 would similarly be changed to PBBO for the sake of conformity.

¹⁴ This rule change proposal would make no changes to current quoting requirements for specialists delineated in Rule 1014.

specialist and any other appropriate specialist of the specialist unit to discuss the failure to meet minimum standards and to explore possible remedies. The Exchange would give notice of the meeting and no verbatim record would be kept. If, after receiving such notice from the Exchange, the specialist unit refuses or otherwise fails without reasonable justification to meet with the Exchange, the Exchange may refer the matter to the Exchange's Business Conduct Committee for the commencement of formal disciplinary proceedings. If the Exchange believes there are no mitigating circumstances that would demonstrate substantial improvement of or reasonable justification for the failure to meet minimum standards, the Exchange could take remedial action pursuant to Rule 511(d)(ii).

The Exchange proposes in Rule 511(d)(ii) that if it finds sub-standard minimum performance by a specialist unit, the Exchange may take the following remedial actions: (i) restriction of allocations in additional options (subsection (d)(ii)(A)); (ii) suspension, termination, or restriction of allocations in one or more options (subsection (d)(ii)(B)); or (iii) suspension, termination, or restriction of the specialist or specialist unit's registration in general (subsection (d)(ii)(C)). Specialist units or specialists therein may appeal to the Board of Governors from a decision of the Exchange pursuant to subsection (d)(ii)(B) or subsection (d)(ii)(C) by filing the requisite notice of appeal. Under the proposal, Minimum Performance Reviews would be conducted at least annually but may be conducted more frequently, including at monthly intervals.

The Exchange also proposes to eliminate the floor broker questionnaire. The Exchange believes that the questionnaire, which is subjective in nature and not based on data, provides limited value in the Exchange's current specialist review process. Instead, the Exchange believes that the proposed revised specialist performance evaluations it now proposes will better

inform the evaluation process and make it increasingly data-based, thereby rendering the floor broker questionnaires unnecessary.

Special Circumstance Evaluations

Under the proposal, the Exchange may also, but is not required to, conduct Special Circumstance Evaluations pursuant to proposed Rule 511(e) whenever the Exchange believes that circumstances warrant such reviews. For example, a Special Circumstance Evaluation may be conducted if a specialist unit's performance appeared to be so deficient as to call into question the Exchange's integrity or impair the Exchange's reputation for maintaining efficient, fair and orderly markets. Special Circumstance Evaluations also may be conducted within six months of new allocations¹⁵ and within four months of transfers of allocations to specialist units.¹⁶ Special Circumstance Evaluations may incorporate the same review methodology and procedures as established for routine Specialist Performance Evaluations or Minimum Performance Reviews. However, Special Circumstance Evaluations may instead (or in addition) examine such other matters related to a specialist unit's performance as the Exchange deems necessary and appropriate.

The Exchange may determine, pursuant to a Rule 511 Special Circumstance Evaluation, that a specialist unit that received a new allocation has not complied with the commitments that it made when applying for the options class, including, but not limited to, commitments regarding capital, personnel and order flow (subsection (e)(i)(A)) or that the performance of a specialist unit was inadequate after the transfer of one or more options classes or when there has been a material change in the specialist unit (subsection (e)(i)(B)). After the Exchange indicates to the applicable

¹⁵ For purposes of conformity with the proposed six month period, 90 days would be changed to 180 days (six months) in Rule 511(b).

¹⁶ While Special Circumstance Evaluations are optional during the noted four month and six month periods, the Exchange also may conduct separate Minimum Performance Reviews during that period.

specialist unit why its performance is inadequate, the specialist unit would be afforded thirty days in which to improve its performance. If the specialist unit does not improve its performance, the Exchange may, after written notice, remove and reallocate one or more securities that were allocated to such unit. Specialists units and specialists therein may appeal to the Board of Governors from a decision of the Exchange pursuant to proposed subsection (e)(ii) by filing the requisite notice of appeal.¹⁷

Additionally, the proposed rules establish limits on the allocation of new options to specialist units that fail to perform adequately. Under proposed Rule 511(e)(iii), if a specialist allocation in an option is terminated as a result of a Special Circumstance Evaluation, the specialist unit may not receive an allocation (or re-allocation) in the terminated option or options for a period not to exceed six months. Similarly, under proposed Rule 511(d)(v), if an allocation is terminated because a specialist exhibits sub-standard performance in terms of best bid and offer or in terms of quoting requirements, such specialist may not receive an allocation (or re-allocation) in the terminated option or options for a period not to exceed six months; and if an allocation is terminated because a specialist unit exhibits sub-standard performance in terms of minimum quoting requirements per Rule 1014, such specialist unit may not receive an allocation (or re-allocation) in the terminated option or options for a period not to exceed twelve months.

As discussed, all specialists and specialist units would have the right to appeal from an Exchange decision that was taken pursuant to a Specialist Evaluation or a Special Circumstance Evaluation. Moreover, the Exchange would provide written notice regarding the lack of adequate performance and give specialist units an opportunity to discuss performance before the Exchange would take remedial action.

¹⁷ See supra note 11.

In Rule 510 (regarding SQTs and RSQTs) and Rule 511 (regarding specialists), the Exchange proposes to eliminate the right to appeal from an Exchange's determination to restrict additional options allocations based on failure to meet minimum performance requirements. The Exchange believes that a formal appeal process for restriction of allocations or assignments in additional (not currently allocated or assigned) options, which would require a 10 day notice period followed by a potentially lengthy appeals proceeding, is not necessary and may be counterproductive in light of the Exchange's desire to efficiently allocate or assign additional options on a timely basis.

Assignment in Options

Rule 507 deals with the process of applying for approval as an SQT or RSQT on the Exchange and assignment of options to SQTs and RSQTs.¹⁸ The Exchange proposes to add new Commentary .01 to Rule 507 to state that within not more than thirty business days after assignment of an option pursuant to this rule, an assigned SQTs or RSQTs shall begin to generate and submit electronic quotations for such option through the Exchange's electronic quotation, execution, and trading system. Should an assigned SQT or RSQT not generate electronic quotes within the requisite time frame, the Exchange would have the ability to terminate the assignment in question after providing written notice to the assigned SQT or RSQT, and make a re-assignment, unless there are exigent circumstances that the Exchange believes may not have allowed timely generation and submission of electronic quotes.

¹⁸ Rule 507 also defines the Maximum Number of Quoters ("MNQ") in equity options, which establishes the greatest number of SQT and RSQT assignments that the Exchange may make in a particular class of option. MNQ in equity options is currently set in Commentary .02 to Rule 507 at no more than: (i) twenty-four market participants (SQTs and RSQTs) for equity options in the top 5% most actively traded options; (ii) nineteen market participants for the next 10% most actively traded options; (iii) and seventeen market participants for all other options.

Transfer of Allocated Option Classes

Rule 508 deals with agreements between specialist units to transfer one or more options classes that are already allocated by the Exchange to one of such units. Currently, Rule 508 states that failure to provide the Exchange with prior notice of an arranged (agreed-upon) transfer of one or more already allocated options classes in accordance with this rule permits the Exchange to reallocate such options classes. Pursuant to the proposed change, Rule 508 would state that failure to provide the Exchange prior notice of a transfer in accordance with this Rule, or failure to obtain Exchange approval of a transfer, would permit the Exchange to recover the allocated securities and reallocate them. The Exchange believes that this is appropriate given that the Exchange initially makes the allocation of the option class after evaluating the relevant factors, and should continue to have a similar ability to evaluate the propriety of subsequent transfer of the same option class.

The Exchange proposes to delete Commentary .01 to Rule 508 that currently indicates that no member may effect a change in the floor trading location of any equity option or index option class until forty-five calendar days after final approval of the change by the Exchange has been disseminated to the option floor. The Exchange believes that the 45-day period is unnecessarily long in light of the current fast-paced trading environment. In addition, the Exchange proposes technical rule changes to ensure conformity of rule language and delete references that are obsolete or no longer in use. The reference to Registrant would be changed to specialist or specialist unit in Rules 508 and 511, and the reference to “grant” would be changed to “allocate” in Rule 511 for purposes of conformity.¹⁹ The Exchange further proposes to remove the reference to initial implementation of the existing rule in Commentary .02 of Rule 510. The Exchange also proposes to make conforming changes in Rule 511 in light of the changes to Rule 515.

¹⁹ The Exchange notes that this change in terminology conforms it to current usage.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange²⁰ and, in particular, the requirements of Section 6(b) of the Act²¹ and the rules and regulations thereunder. Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,²² which requires, among other things, that the rules of a national securities 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 Exchange's proposal updates its specialist evaluation process to make it more objective and more consistent with the process used for other Streaming Quote Traders. While the Exchange is changing its process for evaluating specialists, it is not proposing any changes to existing specialist obligations, including the quoting requirements for specialists delineated in Rule 1014. Further, though the Exchange would replace the current formal appeal and hearing process with a more informal hearing process in the context of alleged failure of performance, it would retain an opportunity for the specialist or specialist unit to be heard on the matter before the Exchange takes remedial action. In addition, the Exchange would preserve the requirement to provide advance written notice to a specialist or a specialist unit to inform it of its right to appeal an Exchange's decision regarding a specialist's failure to meet the minimum performance standards. Accordingly, the Commission believes the streamlined

²⁰ 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).

²¹ 15 U.S.C. 78f(b).

²² 15 U.S.C. 78f(b)(5).

specialist evaluation procedures are reasonable and will allow the Exchange to monitor and review specialist performance in the interests of ensuring compliance with all applicable requirements.

Further, the Commission believes that the proposed time requirement for a SQT or a RSQT to electronically quote, i.e., within thirty business days after assignment, is reasonable. This provision will allow the Exchange to ensure that new appointments are utilized promptly and would enable the Exchange to, in the absence of exigent circumstances, reassign those options after a written notice is provided to the previously-assigned SQT or RSQT.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²³ that the proposed rule change (SR-Phlx-2010-153) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁴

Florence E. Harmon
Deputy Secretary

²³ 15 U.S.C. 78s(b)(2).

²⁴ 17 CFR 200.30-3(a)(12).