

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54886; File No. SR-Phlx-2006-74)

December 6, 2006

Self-Regulatory Organizations; Philadelphia Stock Exchange Inc.; Notice of Filing of Proposed Rule Change, and Amendment Nos. 1 and 2 Thereto, Relating to a Pilot Program to Quote and Trade Options in Penny Increments

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 13, 2006, the Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the Phlx. On November 22, 2006, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Exchange filed Amendment No. 2 to the proposed rule change on December 5, 2006.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Phlx, pursuant to Section 19(b)(1) of the Act<sup>5</sup> and Rule 19b-4 thereunder,<sup>6</sup> proposes to amend various Exchange rules in order to establish a six-month pilot period, beginning on January 26, 2007 (the “pilot”), during which certain options would be quoted and traded on the Exchange in minimum increments of \$0.01 for all series in such

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 replaced the original filing in its entirety.

<sup>4</sup> Amendment No. 2 replaced the previous filing in its entirety.

<sup>5</sup> 15 U.S.C. 78s(b)(1).

<sup>6</sup> 17 CFR 240.19b-4.

options with a price of less than \$3.00, and in minimum increments of \$0.05 for all series in such options with a price of \$3.00 or higher, except that options overlying the Nasdaq-100 Index Tracking Stock (“QQQQ”)<sup>7</sup> would be quoted and traded in minimum increments of \$0.01 for all series regardless of the price. A list of all such options would be communicated to Phlx’s membership via Exchange circular.

The text of the proposed rule change, including Exhibit 2 (a draft Exchange circular which includes a list of all options to be included in the pilot), is available on the Phlx’s Web site at <http://www.phlx.com>, at the Phlx’s Office of the Secretary, and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Phlx included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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<sup>7</sup> The Nasdaq-100®, Nasdaq-100 Index®, Nasdaq®, The Nasdaq Stock Market®, Nasdaq-100 Shares<sup>SM</sup>, Nasdaq-100 Trust<sup>SM</sup>, Nasdaq-100 Index Tracking Stock<sup>SM</sup>, and QQQ<sup>SM</sup> are trademarks or service marks of The Nasdaq Stock Market, Inc. (Nasdaq) and have been licensed for use for certain purposes by the Philadelphia Stock Exchange pursuant to a License Agreement with Nasdaq. The Nasdaq-100 Index® (the Index) is determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 Trust<sup>SM</sup>, or the beneficial owners of Nasdaq-100 Shares<sup>SM</sup>. Nasdaq has complete control and sole discretion in determining, comprising, or calculating the Index or in modifying in any way its method for determining, comprising, or calculating the Index in the future.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to establish a six-month pilot program during which certain options would be quoted and traded in increments of \$0.01.

Scope of the Pilot

Proposed Phlx Rule 1034(a)(i)(B) states that the pilot would begin on January 26, 2007, and would extend for a six-month period. There will be 13 options included in the pilot as determined by the Commission, subject to a rollout schedule to be determined.

The rollout would begin on January 26, 2007. The options included in the pilot are:

<u>Symbol</u>	<u>Underlying Security</u>
IWM	Ishares Russell 2000
QQQQ	QQQQ
SMH	SemiConductor Holders
GE	General Electric
AMD	Advanced Micro Devices
MSFT	Microsoft
INTC	Intel
CAT	Caterpillar
WFMI	Whole Foods
TXN	Texas Instruments
A	Agilent Tech Inc.
FLEX	Flextronics International
SUNW	Sun Micro

### Changes to Minimum Increments

The Exchange proposes to adopt Phlx Rule 1034(a)(i)(B), which would provide that the options included in the pilot would be quoted in minimum increments of \$0.01 for all series in such options with a price of less than \$3.00, and in minimum increments of \$0.05 for all series in such options with a price of \$3.00 or higher, except that options overlying the QQQQ would be quoted and traded in minimum increments of \$0.01 for all series regardless of the price. A list of all such options would be communicated to Phlx's membership via Exchange circular.

### Automatic Executions During Crossed Markets

The Exchange anticipates that the instance of crossed markets (where the bid price is greater than the offer price) will increase in options traded in penny increments. Accordingly, the Exchange proposes to amend its rules concerning automatic executions during crossed markets, and its exemption from Trade-Through<sup>8</sup> liability when a Trade-Through occurs due to an automatic execution when the Exchange's disseminated market is crossed, or crosses the disseminated market of another options exchange, and the Exchange's disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the NBBO.

Currently, orders on the Exchange that are otherwise eligible for automatic execution are handled manually by the specialist when the Exchange's disseminated market is crossed by more than one minimum trading increment (as defined in Phlx Rule

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<sup>8</sup> "Trade-Through" means a transaction in an options series at a price that is inferior to the National Best Bid or Offer ("NBBO"), but shall not include a transaction that occurs at a price that is one minimum quoting increment inferior to the NBBO provided a Linkage Order is contemporaneously sent to each Participant Exchange disseminating the NBBO for the full size of the Participant Exchange's bid (offer) that represents the NBBO. See Phlx Rule 1083(t).

1034) (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange by more than one minimum trading increment.<sup>9</sup> The effect of this is that the Exchange currently provides automatic executions during crossed markets when the Exchange's disseminated market is crossed by not more than one minimum trading increment, or crosses the disseminated market of another options exchange by not more than one minimum trading increment, and the Exchange's disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the NBBO.<sup>10</sup> The Exchange proposes to delete Phlx Rule 1080(c)(iv)(A), which would thereby mean that the Exchange will provide automatic executions in options where the Exchange's disseminated market is the NBBO<sup>11</sup> and is crossed, or crosses the disseminated market of another options exchange, regardless of the amount by which such market is crossed.<sup>12</sup>

#### Trade-Throughs

Currently, Phlx Rule 1085(b) affords Exchange members several exemptions from Trade-Through liability and the requirements under Phlx's rules and the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage concerning satisfaction of Trade-Throughs. Among the exemptions from such liability and satisfaction responsibility is current Phlx Rule 1085(b)(10), which provides an exemption

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<sup>9</sup> See Phlx Rule 1080(c)(iv)(A).

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

<sup>11</sup> The Exchange provides automatic executions only when its disseminated market is the NBBO. See Phlx Rule 1080(c)(iv)(E).

<sup>12</sup> The Exchange notes that another options exchange currently provides automatic executions during crossed markets regardless of the amount by which the market is crossed. See Securities Exchange Act Release No. 54229 (July 27, 2006), 71 FR 44058 (August 3, 2006) (SR-CBOE-2005-90).

when the Trade-Through was the result of an automatic execution when the Exchange's disseminated market is the NBBO and is crossed by not more than one minimum trading increment (as defined in Phlx Rule 1034), or crosses the disseminated market of another options exchange by not more than one minimum trading increment.

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

#### Report to the Commission

Proposed Phlx Rule 1034(a)(i)(C) would require the Exchange to prepare and submit an analytical report to the Commission that addresses the impact of the first three months of the pilot on the quality of the Exchange's markets and options quote traffic and capacity on or before the last day of the fourth month of the pilot. The purpose of this

provision is to comply with the Commission's mandate that the Exchange submit such a report within the time frame specified in the rule.

#### Zero-Bid Option Series

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

#### Quote Mitigation

The Exchange recognizes that quoting and trading in \$0.01 increments will most assuredly result in a greater number of quotations submitted in options that are included in the pilot. Therefore, in order to mitigate quote traffic, the Exchange proposes to amend Phlx Rule 1082, Firm Quotations, by adopting new Phlx Rule 1082(a)(ii)(C), which would modify the Exchange's definition of "disseminated size" such that the Exchange will disseminate fewer updated quotations.

Specifically, proposed Phlx Rule 1082(a)(ii)(C) would set forth the conditions under which the Exchange would disseminate updated quotations based on changes in the Exchange's disseminated price and/or size. The proposed rule would require the Exchange to disseminate an updated bid and offer price, together with the size associated with such bid and offer, when: (1) the Exchange's disseminated bid or offer price

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

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

The Exchange believes that the limitation on dissemination of quotations that increase in size by a nominal amount should significantly mitigate the amount of options quote traffic on the Exchange, and addresses issues of options quote capacity on the Exchange and in the National Market System.

In addition to the measures proposed above concerning mitigation of quote traffic on the Exchange, the Exchange has filed other proposed rule changes that the Exchange believes should reduce the number of quotations generated on the Exchange.

Specifically, the Commission recently approved a proposed rule change stating



that, on a six-month pilot basis, Streaming Quote Traders (“SQTs”),<sup>13</sup> Remote Streaming Quote Traders (“RSQTs”),<sup>14</sup> and SQTs and RSQTs that receive Directed Orders<sup>15</sup> (“DSQTs” and “DRSQTs” respectively) are deemed not to be assigned in any option series until the time to expiration for such series is less than nine months.<sup>16</sup> Accordingly, the market making obligations described in Phlx Rule 1014(b)(ii)(D) do not apply to SQTs, RSQTs, DSQTs and DRSQTs respecting series with an expiration of nine months or greater, and thus they will be required to submit fewer quotes.

Additionally, the Exchange filed a proposed rule change authorizing the Exchange’s Options Allocation, Evaluation and Securities Committee (“OAESC”)<sup>17</sup> to

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<sup>13</sup> An SQT is an Exchange Registered Options Trader (“ROT”) who has received permission from the Exchange to generate and submit option quotations electronically through AUTOM in eligible 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 Phlx Rule 1014(b)(ii)(A).

<sup>14</sup> 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 through AUTOM in eligible options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. See Phlx Rule 1014(b)(ii)(B).

<sup>15</sup> The term “Directed Order” means any customer order (other than a stop or stop-limit order as defined in Phlx Rule 1066) to buy or sell which has been directed to a particular specialist, RSQT, or SQT by an Order Flow Provider. See Phlx Rule 1080(l)(i)(A).

<sup>16</sup> See Securities Exchange Act Release No. 54648 (October 24, 2006), 71 FR 63375 (October 30, 2006) (SR-Phlx-2006-52).

<sup>17</sup> The OAESC is a standing committee of the Exchange that has jurisdiction over the allocation, retention and transfer of the privileges to deal in all options to, by and among members on the options and foreign currency options trading floors. It is responsible for appointing specialists, alternate or assistant specialists or odd-lot dealers on the options and foreign currency options trading floors. It also establishes standards for the periodic review and evaluation of their performance and is empowered to suspend or revoke their appointments upon showing of reasonable cause therefore. See Phlx By-Law Article X, Section 10-7(a); see also Phlx Rule 500.

assign trading privileges in options to SQTs and RSQTs by “root symbol,” as applied by the Options Clearing Corporation such that an SQT or RSQT, on request, may be assigned in only certain series of an option.<sup>18</sup> The market making obligations applicable to SQTs and RSQTs thus would not apply to series in which an SQT or RSQT is not assigned, which should reduce the number of quotations required to be submitted.

The Exchange has also submitted a separate proposal to establish a maximum number of quoting participants that may be assigned to a particular equity option at any one time.<sup>19</sup> This would limit the number of participants quoting in a particular equity option and thus should limit the number of quotations submitted in such equity options.

In another separate submission, the Exchange has proposed to establish monthly Performance Evaluations by the Exchange of its member organizations that have SQTs and RSQTs, to determine whether they have fulfilled performance standards relating to, among other things, quality of markets, efficient quote submission to the Exchange (including quotes submitted through a third party vendor), competition, observance of ethical standards, and administrative factors.<sup>20</sup> Under that proposal, failure to meet established minimum performance requirements could result in restriction by the OAESC of additional options assignments; suspension, termination, or restriction of an existing assignment on one or more options; or suspension, termination, or restriction of an SQT’s or RSQT’s status as such. The Exchange believes that such evaluations and possible consequences for failure to meet specific minimum standards should encourage efficient

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<sup>18</sup> See Securities Exchange Act Release No. 54807 (November 21, 2006), 71 FR 69173 (November 29, 2006) (SR-Phlx-2006-53).

<sup>19</sup> See SR-Phlx-2006-81.

<sup>20</sup> See Securities Exchange Act Release No. 54859 (December 1, 2006) (SR-Phlx-2006-51).

quoting and use of the Exchange's capacity and bandwidth by providing a disincentive for SQTs and RSQTs to submit quotations that do not improve the Exchange's disseminated price or materially increase the Exchange's disseminated size.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>21</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>22</sup> in particular, in that the proposed rule change is 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, by establishing rules concerning the pilot, while simultaneously mitigating quote traffic.

### B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments on the proposed rule change were neither solicited nor received.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which

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<sup>21</sup> 15 U.S.C. 78f(b).

<sup>22</sup> 15 U.S.C. 78f(b)(5).

the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change 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](mailto:rule-comments@sec.gov). Please include File No. SR-Phlx-2006-74 on the subject line.

##### Paper Comments:

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

All submissions should refer to File No. SR-Phlx-2006-74. 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 at <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. Copies of such 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 No. SR-Phlx-2006-74 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>23</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>23</sup> 17 CFR 200.30-3(a)(12).