

SECURITIES AND EXCHANGE COMMISSION  
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December 17, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Remote Streaming Quote Traders

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup>, and Rule 19b-4<sup>2</sup> thereunder, notice is hereby given that on December 9, 2004, 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 prepared by Phlx. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

Phlx proposes to amend the Exchange’s rules to establish a new category of option market-making participant on the Exchange, a Remote Streaming Quote Trader (“RSQT”). An RSQT would be defined as a Registered Options Trader (“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. The Exchange is also proposing to amend various Exchange rules to apply to and govern RSQTs.

The text of the proposed rule change is set forth below. Brackets indicate deletions; italics indicates new text.

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

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

## **Obligations and Restrictions Applicable to Specialists and Registered Options Traders**

**Rule 1014.** (a) General. Transactions of a Specialist and a Registered Options Trader (ROT) should constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market, and those members should not enter into transactions or make bids or offers that are inconsistent with such a course of dealings.

(b) ROT. (i) An ROT is a regular member or a foreign currency options participant of the Exchange located on the trading floor who has received permission from the Exchange to trade in options for his own account. For purposes of this Rule 1014, the term “ROT” shall include a Streaming Quote Trader, and a Remote Streaming Quote Trader, as defined below.

Each ROT electing to engage in Exchange options transactions shall be assigned by the Exchange one or more classes of options, and Exchange options transactions initiated by such ROT on the Floor for any account in which he had an interest shall to the extent prescribed by the Exchange be in such assigned classes.

(ii) (A) Streaming Quote Trader ("SQT"). An SQT is an ROT who has received permission from the Exchange to generate and submit option quotations electronically through [an electronic interface with] AUTOM [via an Exchange approved proprietary electronic quoting device] 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.

(B) Remote Streaming Quote Trader (“RSQT”). 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.

Notwithstanding the provisions of sub-paragraph (b)(i) above, an RSQT may only submit such quotations electronically from off the floor of the Exchange. No person who is either directly or indirectly affiliated with an RSQT shall submit quotations as a specialist, SQT, RSQT or non-SQT ROT in options in which such affiliated RSQT is assigned. An RSQT may only trade in a market making capacity in classes of options in which he is assigned.

(C) Non-SQT ROT. A non-SQT ROT is an ROT who is neither an SQT nor an RSQT.

([B]D) Market Making Obligations Applicable in Streaming Quote Options. In addition to the other requirements for ROTs set forth in this Rule 1014, an SQT and an RSQT shall be responsible to quote continuous, two-sided markets in not less than 60% of the series in each Streaming Quote Option (as defined in Rule 1080(k)) in which such SQT or RSQT is assigned, provided that a Directed SQT or RSQT (as defined in Rule 1080(l)(i)(C)) shall be responsible to quote continuous, two-sided markets in not less than 100% of the series in each Streaming Quote Option in which they receive Directed Orders (as defined in Rule 1080(l)(i)(A)). The specialist shall be responsible to quote continuous, two-sided markets in not less than 100% of the series in each Streaming Quote Option in which such specialist is assigned.

(1) During a six month period commencing on the date of the initial deployment of Phlx XL (the “initial six-month period”), any SQT or RSQT assigned in a Streaming Quote Option (and the specialist assigned in such Streaming Quote Option) may submit electronic quotations with a size of fewer than 10 contracts for a period of sixty days after such option begins trading as a Streaming Quote Option. Beginning on the sixty-first day after such option begins trading as a

Streaming Quote Option, SQTs, RSQTs and the specialist assigned in such Streaming Quote Option shall submit electronic quotations with a size of not less than 10 contracts.

(2) During a six month period commencing on the first day following the expiration of the initial six-month period, any SQT or RSQT assigned in a Streaming Quote Option (and the specialist assigned in such Streaming Quote Option) may submit electronic quotations with a size of fewer than 10 contracts for a period of thirty days after such option begins trading as a Streaming Quote Option. Beginning on the thirty-first day after such option begins trading as a Streaming Quote Option, SQTs, RSQTs and the specialist assigned in such Streaming Quote Option shall submit electronic quotations with a size of not less than 10 contracts.

(3) Thereafter, any SQT or RSQT assigned in a Streaming Quote Option that is newly deployed on Phlx XL (and the specialist assigned in such Streaming Quote Option) shall submit electronic quotations with a size of not less than 10 contracts beginning on the date on which such Streaming Quote Option begins trading on Phlx XL.

[An SQT may only submit such quotations while such SQT is physically present on the floor of the Exchange.]

([C]E) Non-SQT ROTs Trading Streaming Quote Options. These requirements are applicable on a per option basis depending upon the percentage of volume a non-SQT ROT transacts electronically (i.e., by way of placing limit orders on the limit order book that are executed electronically and allocated automatically in accordance with Rule

1014(g)(vii)) versus in open outcry. With respect to making this determination, the Exchange will monitor the non-SQT ROT's trading activity every calendar quarter to determine whether they exceed the thresholds established in this sub-paragraph (C). If a non-SQT ROT exceeds the threshold established below, the obligations contained in sub-paragraph (C)(2) will be effective the next calendar quarter.

For a period of 90 days commencing immediately after an option begins trading as a Streaming Quote Option, the provisions of sub-paragraph (C)(1) below shall govern trading in that Streaming Quote Option.

(1) No change.

(2)(a) and (b) No change.

(c) Continuous Open Outcry Quoting Obligation: In response to any request for quote by a Floor Broker, specialist, Floor Official, [or other ROT (including an SQT or other non-SQT ROT)], non-SQT ROTs must provide a two-sided market complying with the quote spread parameter requirements contained in Rule 1014(c)(i). During a six month period commencing on the date of the initial deployment of Phlx XL (the "initial six-month period"), for a period of sixty days commencing immediately after an option begins trading as a Streaming Quote Option, such non-SQT ROTs may provide such quotations with a size of fewer than 10 contracts. Beginning on the sixty-first day after such option begins trading as a Streaming Quote Option, such quotations shall be for a size of at least 10 contracts. During a six month period commencing on the first day following the expiration of the initial six-month period, such non-SQT ROT may provide such quotations with a size of fewer than 10 contracts for a period of thirty days after

such option begins trading as a Streaming Quote Option. Beginning on the thirty-first day after such option begins trading as a Streaming Quote Option, such quotations shall be for a size of at least 10 contracts. Thereafter, such non-SQT ROTs shall provide such quotations with a size of not less than 10 contracts beginning on the date on which such Streaming Quote Option begins trading on Phlx XL.

(c) In Classes of Option Contracts to Which Assigned --Affirmative Obligations. With respect to classes of option contracts to which his assignment extends, a Specialist and an ROT, whenever the ROT (except an RSQT) enters the trading crowd in other than a floor brokerage capacity or is called upon by a Floor Official or a Floor Broker, to make a market, are expected to engage, to a reasonable degree under the existing circumstances, in dealing for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between option contracts of the same class. Without limiting the foregoing, a Specialist and an ROT is expected to perform the following activities in the course of maintaining a fair and orderly market:

(i) - (ii) No change.

(d) In Classes of Option Contracts Other Than Those Which Appointed. With respect to classes of option contracts other than those to which his appointment extends, an ROT (other than an RSQT), whenever he enters the trading crowd in other than a floor brokerage capacity or is called upon by a floor official or a floor broker to make a market, shall undertake the obligations specified in paragraph (c) of this rule. Furthermore, an ROT should not:

(i) Individually or as a group, intentionally or unintentionally, dominate the market in option contracts of a particular class; or

(ii) Effect purchases or sales on the floor of the Exchange except in a reasonable and orderly manner.

(iii) Be conspicuous in the general market or in the market in a particular option.

(e)- (f) No change.

(g) Equity Option and Index Option Priority and Parity

(i) - (iv) No change.

(v) Allocation of the Remainder of the Order Among Specialist and ROTs on Parity.

After the application of Rule1014(g)(i) to an Initiating Order, the Remainder of the Order shall be allocated by the Allocating Participant (as defined in Rule1014(g)(vi)) as follows:

(A) Entitlement. ROTs and specialists on parity are entitled to their Defined Participation (as described below), subject to: (1) any Waiver, as described below; and (2) rounding, as described below.

(B) Size. The term “stated size” [in relation to a crowd participant and] in respect of an order or electronic quotation shall mean:

(1) in the case of orders handled manually by the specialist:

(a)(i) if a crowd participant (including the specialist) has actually stated a size (“Actual Size”), such crowd participant’s stated size shall be his or her Actual Size;

(ii) if the specialist, an SQT or RSQT is disseminating an electronic

quotation at the Exchange's disseminated price in a particular series at the time of the execution of an Initiating Order in such series, such specialist, SQT or RSQT's disseminated size at the Exchange's disseminated price shall be his or her Actual Size, and such specialist, SQT and/or RSQT shall be deemed a "crowd participant" for purposes of this Rule 1014(g)(v);

(b) - (c) No change.

(2) No change.

(C) No change.

(D) Waiver. (1) An[y] ROT (other than an RSQT) or specialist may, in his or her sole discretion, offer to waive, in whole or in part, any part of a trade to which they were entitled to be allocated (an "Offer to Waive").

(a) - (c) No change.

(E) - (G) No change.

(vi) In order to facilitate timely tape reporting of executed trades, it is the duty of the persons identified below to allocate, match and time stamp manually executed trades as well as to submit the matched trade to the appropriate person at the respective specialist post immediately upon execution:

(i)a in a trade involving a floor broker, the floor broker shall so do, provided that a floor broker may delegate this responsibility to the specialist (or an assistant to the specialist under the specialist's direct supervision) if the specialist agrees to accept such

responsibility, and, in the event of such delegation, the specialist (or an assistant to the specialist under the specialist's direct supervision) shall do so:

([ii]b) in all other cases where the specialist is a participant (i.e., where there is no floor broker), the specialist (or an assistant to the specialist under the specialist's direct supervision) shall do so;

([iii]c) in any other case (i.e., where there is no floor broker and no specialist is involved), the largest on-floor participant shall do so (for example, where several Registered Options Traders are involved)[:]; and

([iv]d) if there is only one seller and one buyer (no floor broker and no specialist is involved), the seller shall do so (for example, where only two Registered Options Traders are involved), unless either the seller or the buyer is an RSQT, in which case the on-floor participant in the transaction shall do so.

The person responsible for trade allocation (the “Allocating Participant”) shall, for each trade allocated by such Allocating Participant, circle his or her badge identification number on the trade tickets, identifying himself or herself as the Allocating Participant in the particular trade. If the Allocating Participant is not a participant in the trade to be allocated, he/she shall identify himself/herself by initiating the trade tickets. In the case of a trade in which a Floor Broker is the Allocating Participant, such Floor Broker shall allocate the trade using the Options Floor Broker Management System.

(vii) Allocation of Automatically Executed Trades in Streaming Quote Options. Solely with respect to Streaming Quote Options approved by the Exchange to be traded on Phlx XL [by Streaming Quote Traders (“SQTs”)] pursuant to Exchange Rule 1080(k), after public customer

market and marketable limit orders have been executed, trades automatically executed in such options shall be allocated automatically in the following manner:

(A) If the specialist, an SQT, RSQT or a non-SQT ROT that has placed a limit order on the limit order book (“Phlx XL Participant”) is quoting alone at the disseminated price and their quote is not matched by another Phlx XL participant prior to execution, such Phlx XL Participant shall be entitled to receive a number of contracts up to the size associated with his/her quotation.

(B) Parity. Quotations entered electronically by the specialist, an RSQT or an SQT that do not cause an order resting on the limit order book to become due for execution may be matched at any time by quotations entered electronically by the specialist and/or other SQTs and RSQTs, and by ROT limit orders entered via electronic interface and shall be deemed to be on parity, subject to the requirement that orders of controlled accounts must yield priority to customer orders as set forth in Rule 1014(g)(i)(A).

(1) (a) - (e) No change.

(2) - (4) No change.

(h) No change.

**Commentary:**

.01 An ROT electing to engage in Exchange Options transactions is designated as a specialist on the Exchange for all purposes under the Securities Exchange Act of 1934 and the rules and regulations thereunder with respect to options transactions initiated and effected by him on the floor in his capacity as an ROT. For purposes of this commentary, the term “transactions

initiated and effected on the floor” shall not include transactions initiated by an ROT off the floor, but which are considered “on-floor” pursuant to Commentaries .07 and .08 of Rule 1014. Similarly, an RSQT electing to engage in Exchange Options transactions is designated as a specialist on the Exchange for all purposes under the Securities Exchange Act of 1934 and the rules and regulations thereunder with respect to options transactions initiated and effected by him in his capacity as an ROT.

However, in order for an ROT (other than an RSQT) to receive specialist margin treatment for off-floor orders in any calendar quarter, the ROT must execute the greater of 1,000 contracts or 80% of his total contracts that quarter in person (not through the use of orders) and 75% of his total contracts that quarter in assigned options. The off-floor orders for which an ROT receives specialist margin treatment shall be subject to the obligations of Rule 1014(a) and, in general, be effected for the purpose of hedging, reducing risk of, or rebalancing positions of the ROT. An ROT is responsible for evidencing compliance with these provisions. The Options Committee may exempt one or more classes of options from this calculation.

.02 No change.

.03 The Exchange has determined for purposes of paragraph (c) of this Rule that, except for unusual circumstances, at least 50% of the trading activity in any quarter (measured in terms of contract volume) of an ROT (other than an RSQT) shall ordinarily be in classes of options to which he is assigned. Temporarily undertaking the obligations of paragraph (c) at the request of a member of the Committee on Options in non assigned classes of options shall not be deemed trading in non assigned option contracts.

The Exchange may, in computing the percentage specified herein, assign a weighting factor based upon relative inactivity to one or more classes or series of option contracts.

.04 No change.

.05 (a) Assignment in non-Streaming Quote Options. With respect to options that are not eligible to be traded by SQTs and RSQTs (“non-Streaming Quote Options”), the Exchange will assign an ROT to act in one or more classes of option contracts. In making such assignments, the Exchange shall give attention to (i) the preference of applicants; (ii) assuring that financial resources available to an ROT enable him to satisfy the obligations set forth in Rule 1014 with respect to each class of option contracts to which he is assigned; (iii) the applicant's expertise in options trading; and (iv) the applicant's prior market performance. The Exchange may suspend or terminate any assignment of an ROT under this Rule and may make additional assignments whenever, in the Exchange's judgment, the interests of a fair and orderly market are best served by such action.

(b) Assignment in Streaming Quote Options. The Options Allocation, Evaluation and Securities Committee (“OAESC”) or its designee shall assign SQTs and RSQTs in one or more Streaming Quote Options in accordance with Rule 507. An SQT or RSQT may be assigned to (and thus submit quotes electronically in) any option traded on Phlx XL for which they are approved by the OAESC.

[up to all of the options located within a specified physical zone on the Exchange Options Floor (an “SQT Zone”) provided that such SQT is physically present in such SQT Zone. Each member organization must have at least one SQT physically present in each SQT Zone in which such member organization submits electronic quotations. The number and location of SQT Zones will be determined by the Options Committee. Initially, there will be one single SQT Zone encompassing the entire options floor. In the event the Options Committee determines to change the number and/or location of SQT Zones, the effectiveness of any such change shall be

conditioned upon its having been approved by the Securities and Exchange Commission pursuant to Section 19(b) of the Securities Exchange Act of 1934, as amended, and the rules and regulations thereunder.]

(c) Non-Electronic Orders. In the event that a Floor Broker or specialist presents a non-electronic order in a[n option] Streaming Quote Option in which an RSQT is assigned, and/or in which an SQT assigned in such Streaming Quote Option is not a crowd participant, [but which is traded in the SQT Zone where such SQT is located,] such SQT and/or RSQT may not participate in trades stemming from such a non-electronic order unless such non-electronic order is executed at the price quoted by the non-crowd participant SQT and/or RSQT at the time of execution. The specialist and/or SQTs participating in a trading crowd may, in response to a verbal request for a market by a floor broker, state a bid or offer that is different than their electronically submitted bid or offer, provided that such stated bid or offer is not inferior to such electronically submitted bid or offer, except when such stated bid or offer is made in response to a floor broker's solicitation of a single bid or offer as set forth in Rule 1033(a)(ii). For purposes of this Rule, an SQT or non-SQT ROT shall be deemed to be participating in a crowd if such SQT is, at the time an order is represented in the crowd, physically located in a specific "Crowd Area." A Crowd Area shall consist of a specific physical location marked with specific, visible physical boundaries on the options floor, as determined by the Options Committee. An SQT or non-SQT ROT who is physically present in such Crowd Area may engage in options transactions in assigned issues as a crowd participant in such a Crowd Area, provided that such SQT or non-SQT ROT fulfills the requirements set forth in this Rule 1014. An SQT or non-SQT ROT shall be deemed to be participating in a single Crowd Area.

.06 An RSQT shall be required to maintain information barriers that are reasonably designed to

prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in options assigned to the RSQT or act as a specialist or market maker in any security underlying options assigned to the RSQT, and otherwise comply with the requirements of Rule 1020 regarding restrictions on the flow of privileged information between the affiliate and the specialist organization.

.07 No change.

.08 An off-Floor order for an account in which a member has an interest is to be treated as an on-Floor order if it is executed by the member who initiated it.

In addition to transactions originated on the Floor by an ROT for an account in which he has an interest, the following transactions are considered on-Floor trading:

(a) - (b) No change.

(c) Any transaction for the account of an RSQT.

.09 Orders given out by an ROT to commission brokers --An on-Floor order given by an ROT [Trader] to a commission broker, for an account in which the ROT has [I]an interest, is subject to all the Rules restricting ROTs. When an ROT gives out such an order on the Floor to another member, the order must be so marked to indicate that it is for an account in which the ROT has [i]an interest, unless it is exempt from this Rule, in order that the other member may know whether it may be entitled to priority or parity.

.10 RESERVED [Orders given out by an ROT to specialists --An on-Floor order given to a specialist by an ROT for an account in which he has an interest may not have the privilege of a “Stop” and it is subject to the provisions of paragraphs (d) and (e) of this Rule. In addition, such order which establishes or increases a position is subject to the provisions of Commentary .12 of

this Rule.]

.11 Pair-offs before opening --An ROT cannot acquire a “long” option by pairing off with a sell order before the opening, unless all off-Floor bids at that price are filled.

.12 The number of ROT[']s in a trading crowd who are establishing or increasing a position may temporarily be limited when, in the judgment of two Floor Officials, the interests of a fair and orderly market are served by such limitation.

.13 Within each quarter an ROT must execute in person, and not through the use of orders, a specified number of contracts, such number to be determined from time to time by the Committee on Options.

.14 - .17 No change.

.18 RESERVED

### **Openings In Options**

**Rule 1017.** (a) – (d) No change.

(e) With respect to Streaming Quote Options, SQTs and RSQTs may participate in opening transactions by submitting electronic quotations to interact with opening orders.

(f) This Rule 1017 shall be effective as a pilot, which will expire 180 days following the initial deployment of the Exchange’s electronic options trading platform, Phlx XL.

Commentary:

.01 Pre-Opening. (i) Prior to the opening of the underlying security on the primary market, the specialist shall:

(A) determine from Floor Brokers, and from orders resting on the limit order book, the size and prices of those orders which are near the previous closing prices of those options in which the specialist is assigned.

(B) consider markets from ROTs in the crowd in addition to electronic quotations submitted by SQTs and RSQTs (“SQT/RSQT Quotations”).

(C) determine the specialist’s own quote in each series.

(ii) No change.

.02 No change.

.03 Opening Price. (a) No change.

(b) (i) - (v) No change.

(vi) Once the opening trade price in a series has been disseminated to OPRA, the specialist, ROTs, RSQTs and SQTs trading such series shall be required to fulfill their respective quoting obligations under Rule 1014.

(c) No change.

(d) The specialist will not open a series if one of the following conditions is met:

(i) The opening price is not within an acceptable range, as described in Commentary .03(a) above, unless a specific exemption is given by a Floor Official in the interest of a fair and orderly market;

(ii) The opening trade would leave a market order imbalance (i.e., there are more market orders to buy or to sell for the particular series than can be satisfied by the market orders, limit orders and specialist, [or] SQT and RSQT quotations on the

opposite side).

(iii) No change.

(e) If one of the conditions described in sub-paragraphs (d)(i)-(iii) above is met, the specialist will request bids and offers from ROTs in the crowd and, in the case of Streaming Quote Options, SQTs and RSQTs that are assigned in the option. Such ROTs, RSQTs and/or SQTs shall respond to such a request immediately. The opening will be delayed until responses to the specialist's request have been received and the consequent opening price is deemed by a Floor Official to be compatible with a fair and orderly market.

(f) No change.

**Philadelphia Stock Exchange Automated Options Market (AUTOM) and Automatic Execution System (AUTO-X)**

**Rule 1080.** (a) – (b) No change.

(c) \*\*\*

(i) – (ii) No change.

(iii) Book Sweep. Book Sweep is a feature of AUTOM which, when engaged, does the following:

(A) Respecting non-Streaming Quote Options, when the bid or offer generated by the Exchange's Auto-Quote system (or by a proprietary quoting system provided for in Commentary .02 of this Rule called "Specialized Quote Feed" or "SQF"), matches or crosses the Exchange's best bid or offer in a particular series as established by an order on the limit order book, orders on the limit order book in that series will be automatically

executed and allocated among crowd participants signed onto the Wheel. If Book Sweep is not engaged at the time the Auto-Quote or SQF bid or offer matches or crosses the Exchange's best bid or offer represented by a limit order on the book, the specialist may manually initiate the Book Sweep feature. Book Sweep shall be engaged when AUTO-X is engaged, and shall be disengaged when AUTO-X is disengaged in accordance with Rule 1080(c)(iv) and Rule 1080(e). Eligible orders on the limit order book will be automatically executed up to the size associated with the quote that matches or crosses such limit orders.

(B) Respecting Streaming Quote Options, when the bid or offer generated by the Exchange's Auto-Quote system, SQF, or by an SQT or RSQT (as defined in Rule 1014(b)(ii)) matches or crosses the Exchange's best bid or offer in a particular series as established by an order on the limit order book, orders on the limit order book in that series will be automatically executed and automatically allocated in accordance with Exchange rules. If Book Sweep is not engaged at the time the Auto-Quote, SQF, RSQT or SQT bid or offer matches or crosses the Exchange's best bid or offer represented by a limit order on the book, the specialist, RSQT, or SQT may manually initiate the Book Sweep feature.

(iv) No change.

(d) - (e) No change.

(f) No change.

(g) AUTO-X Contra-Party Participation— The contra-side to automatically executed orders may be: (i) a Wheel Participant; or (ii) a booked customer limit order.

(A) No change.

(B) Book Match – For purposes of this sub-paragraph, the contra-side to automatically executed inbound marketable orders shall be a limit order on the book or specialist, RSQT and/or SQT electronic quotes (“electronic quotes”) at the disseminated price where: (1) the Exchange’s disseminated size includes limit orders on the book and/or electronic quotes at the disseminated price; and (2) the disseminated price is the National Best Bid or Offer. This feature is called Book Match.

(h)- (j) No change.

(k) Electronic Streaming Quotations. The Options Committee may, on an issue-by-issue basis, determine the specific issues in which [Streaming Quote Traders (“]SQTs[”)], as defined in Exchange Rule 1014(b)(ii)] may generate and submit option quotations if such SQT is physically present on the Exchange floor, and RSQTs may generate and submit option quotations from [on] off the floor of the Exchange, electronically [through an electronic interface with AUTOM, via an Exchange approved proprietary electronic quoting device]. Such issues shall be known as “Streaming Quote Options.”

Commentary:

.01 (a) – (b) No change.

(i) No change.

(ii) Respecting non-Streaming Quote Options, [S]specialists [and SQTs, respectively,] determine which model to select per option and may change models during the trading day. Each pricing model requires the specialist [and SQT, respectively,] to input various parameters, such as interest rates, volatilities (delta, vega, theta, gamma, etc.) and dividends. [Respecting non-

Streaming Quote Options, t]The specialist may, but is not required to (a) consult with and/or (b) agree with the trading crowd in setting these parameters or selecting a model, but the members of the trading crowd are not required to provide input in these decisions, and in all cases, the specialist has the responsibility and authority to make the final determination.

(c) - (d) No change.

.02 - .07 No change.

### **Firm Quotations**

**Rule 1082.** (a) Definitions.

(i) No change.

(ii) The term “disseminated size” shall mean with respect to the disseminated price for any quoted options series:

(A) respecting non-Streaming Quote options (as defined in Rule 1080(k)), at least the sum of the size associated with: (1) limit orders; and (2) specialists’ quotations generated by Auto-Quote or Specialized Quote Feed as described in Rule 1080, Commentary .01 (which represents the collective quotation size of the specialist and any ROTs bidding or offering at the disseminated price unless an ROT has expressly indicated otherwise in a clear and audible manner).

(B) respecting Streaming Quote Options, at least the sum of the size associated with limit orders, specialists’ quotations, [and Streaming Quote Traders’] SQTs’ quotations, and RSQTs’ (as defined in Rule 1014(b)(ii)(B)) quotations.

(C) (1) If an SQT or RSQT’s (other than a Directed SQT or RSQT) quotation size in a particular series in a Streaming Quote Option is exhausted, such SQT or RSQT’s

quotation shall be deleted from the Exchange's disseminated quotation until the time the SQT or RSQT revises his/her quotation.

(2) If the Exchange's disseminated size in a particular series in a Streaming Quote Option is exhausted at that particular price level, and [the Exchange shall disseminate the next best available quotation. If] no specialist, [or] SQT or RSQT has revised their quotation immediately following the exhaustion of the Exchange's disseminated size at such price level, the Exchange shall automatically disseminate the specialist's most recent disseminated price prior to the time of such exhaustion with a size of one contract.

(iii) - (iv) No change.

(b) (i) No change.

(ii) With respect to Streaming Quote Options, in the event an SQT, RSQT or specialist in a Streaming Quote Option has electronically submitted on the Exchange bids or offers for a Streaming Quote Option, each such SQT, RSQT or specialist member shall be considered a "responsible broker or dealer" for that bid or offer, up to the size associated with such responsible broker or dealer's bid or offer.

(c) - (d) No change.

Commentary:

.01 No change.

.02 Locked Markets. In the event that an SQT, RSQT, and/or specialist's electronically submitted quotations in Streaming Quote Options interact with the electronically submitted

quotations of other SQTs, RSQTs and/or the specialist, resulting in the dissemination of a “locked” quotation (e.g., \$1.00 bid - 1.00 offer), the following shall occur:

(a) The Exchange will disseminate the locked market and both quotations will be deemed “firm” disseminated market quotations;

(b) A “counting period” of one second will begin during which SQTs, RSQTs and/or specialists whose quotations are locked may eliminate the locked market. Provided, however, that in accordance with subparagraph (a) above, such SQT, RSQT and/or specialist shall be obligated to execute orders at their disseminated quotation. During the “counting period” SQTs and specialists located in the Crowd Area in which the option that is the subject of the locked market is traded will continue to be obligated to respond to Floor Brokers as set forth in Rule 1014, Commentary .05(c), and will continue to be obligated for one contract in open outcry to other SQTs, non-SQT ROTs, and specialists. If at the end of the one-second counting period the quotations remain locked, the locked quotations will automatically execute against each other in accordance with the allocation algorithm set forth in Rule 1014(g)(vii).

The quotation that is locked may be executed by an order during the one-second counting period.

.03 Crossed Markets. The Exchange will not disseminate an internally crossed market (e.g., \$1.10 bid, 1.00 offer). If an SQT, RSQT or specialist electronically submits a quotation in a Streaming Quote Option (“incoming quotation”) that would cross an existing quotation (“existing quotation”), the Exchange will: (i) change the incoming quotation such that it locks the existing quotation; (ii) send a notice to the SQT, RSQT or specialist that submitted the existing quotation indicating that its quotation was crossed; and (iii) send a notice to the

specialist, [or] SQT or RSQT that submitted the incoming quotation, indicating that its quotation crossed the existing quotation and was changed. Such a locked market shall be handled in accordance with Commentary .01 above. During the one-second counting period, if the existing quotation is cancelled subsequent to the time the incoming quotation is changed, the incoming quotation will automatically be restored to its original terms.

### **Application for Assignment in Streaming Quote Options**

**Rule 507.** (a) When a Streaming Quote Option, as defined in Rule 1080(k), is to be assigned or reassigned by the Committee, the Committee will solicit applications from all eligible Streaming Quote Traders (“SQTs”) and Remote Streaming Quote Traders (“RSQTs”), as defined in Rule 1014(b)(ii).

(b)(i) An application for assignment in Streaming Quote Options shall be submitted in writing to the Exchange's designated staff and shall include, at a minimum, the name of the SQT or RSQT applicant and written verification from the Exchange’s Membership Services Department that such SQT or RSQT applicant is qualified as a Registered Options Trader.

(ii) No application for assignment in Streaming Quote Options shall be approved by the Committee without written certification signed by an officer (Vice President or above) of the Exchange’s Financial Automation Department indicating that (A) the SQT or RSQT applicant has sufficient technological ability to support his/her continuous quoting requirements as set forth in Rule 1014(b)(ii), and (B) the SQT or RSQT applicant has successfully completed, or is scheduled to complete, testing of its quoting system with the Exchange.

(iii) (A) This Rule 507 places no limit on the number of qualifying ROTs that may become SQTs or RSQTs; any applicant that is qualified as an ROT in good standing, and that

satisfies the technological readiness and testing requirements described in sub-paragraph (b)(ii) above, shall be approved as an SQT. However, based on system constraints, capacity restrictions or other factors relevant to the maintenance of a fair and orderly market, the Board may defer, for a period to be determined in the Board's discretion, approval of qualifying applications for SQT or RSQT status pending any action required to address the issue of concern to the Board. The Board may not defer a determination of the approval of the application of any SQT or RSQT applicant or place any limitation(s) on access to Phlx XL on any SQT or RSQT applicant unless the basis for such limitation(s) or deferral have been objectively determined by the Board, subject to Securities and Exchange Commission approval or effectiveness pursuant to a rule change filing under Section 19(b) of the Securities Exchange Act of 1934, as amended. The Committee shall provide written notification to any SQT or RSQT applicant whose application is the subject of such limitation(s) or deferral, describing the objective basis for such limitation(s) or deferral.

(B) In addition to the above requirements, an RSQT applicant must demonstrate to the Committee that it has:

(1) Significant market-making and/or specialist experience in a broad array of securities;

(2) Superior resources, including capital, technology and personnel;

(3) Demonstrated history of stability, superior electronic capacity, and superior operational capacity;

(4) Proven ability to interact with order flow in all types of markets;

(5) Existence of order flow commitments;

(6) Willingness to accept allocations as an RSQT in options overlying 400 or more securities; and

(7) Willingness and ability to make competitive markets on the Phlx and otherwise to promote the Phlx in a manner that is likely to enhance the ability of the Phlx to compete successfully for order flow in the options it trades.

(c) - (d) No change.

(e) If an SQT or RSQT seeks to withdraw from acting as such in a Streaming Quote Option, it should so notify the Committee at least three business days prior to the desired effective date of such withdrawal.

(f) During the first six months of the Exchange's program to allow SQTs and RSQTs to submit electronic option quotations, an SQT or RSQT applicant member or member organization that has, for at least the immediately preceding twelve months: (i) been a member of the Exchange; and (ii) maintained a continuous presence as an ROT in the trading crowd associated with the Streaming Quote Option(s) that are the subject of the application, shall be guaranteed an assignment in the Streaming Quote Option, provided that such member organization has satisfied the requirements set forth in paragraph (b)(ii) of this Rule 507. SQT and RSQT applicants that have been granted trading privileges in Streaming Quote Options pursuant to this Rule 507(f) shall not be required to re-apply for such privileges after the initial six-month period.

(g) No change.

Amendments to Option Floor Procedure Advices

### **A-12 Opening Rotations and SORT Procedures**

It is the responsibility of the Specialist to arrange the price at which an option series opens and

re-opens on the Exchange. Unless a specific exemption is given by a Floor Official, an opening transaction in an equity option series may only be arranged at a price that does not fall outside of the previous session's closing quote in the option by more than the differential between the closing sale in the underlying security and the opening sale in the underlying security.

The Specialist must accept and include in the opening for equity options all market orders which are placed on the book five minutes or more prior to the opening of the underlying security, unless exempted by a Floor Official. Market orders have precedence over limit orders at an opening regardless of account type (i.e. customer, Firm, market maker, Specialist) except that a limit order to buy which is at a higher limit than the price at which the option is to be opened and a limit order to sell which is at a lower limit than the price at which the option is to be opened are to be treated as market orders in connection with an opening (PHLX Rule 1017). Limit orders at the opening price are afforded participation on the opening in accordance with the Exchange's parity/priority rule (PHLX Rule 1014).

Openings and re-openings in options are to be conducted by way of rotation procedures or by way of SORT procedures, as provided by Exchange Rule 1047. Rotation procedures allow a brief period of auction pricing for each option series during which bids and offers, including, with respect to Streaming Quote Options, bids and offers submitted electronically by SQTs and/or RSQTs, and transactions for that option class may normally only occur in that series. SORT procedures allow, but do not require, a Specialist in any series for which no opening interest to buy or sell has been received to open such series with a quote without prior auction pricing. To ensure that buy and sell interests are properly represented in those series in which received, Specialists must follow the procedures below:

(i) – (iii) No change.

FINE SCHEDULE No change.

### **B-3 Trading Requirements**

(a) An ROT (other than an RSQT) is required to trade in person, and not through the use of orders, the greater of 1,000 contracts or 50% of his contract volume on the Exchange each quarter. Also, at least 50% of an ROT's trading activity in each quarter must be in assigned options. No application by an ROT to change options assignments will be approved unless such ROT is in compliance with the above requirements at the time the application for change is made.

FINE SCHEDULE No change.

(b) For any calendar quarter, in addition to the requirements of paragraph (a) above, in order for an ROT (other than an RSQT) to receive specialist margin treatment for off-floor orders in accordance with Rule 1014, Commentary .01, the ROT must execute the greater of 1,000 contracts or 80% of his total contracts that quarter in person (not through the use of orders) and 75% of his total contracts that quarter in assigned options. Violations of this trading requirement are subject to Business Conduct Committee review.

### **B-6 Priority of Options Orders for Equity Options and Index Options by Account Type**

#### **(EQUITY OPTION AND INDEX OPTION ONLY)**

**Section A - D** No change.

#### **Section E**

Allocation of the Remainder of the Order Among Specialist and ROTs on Parity. After the application of this Advice to an Initiating Order, the Remainder of the Order shall be allocated by the Allocating Participant (as defined in Rule 1014(g)(vi)) as follows:

(A) No change.

(B) Size. The term “stated size” [in relation to a crowd participant and] in respect of an order or electronic quotation shall mean:

(1) in the case of orders handled manually by the specialist:

(a)(i) if a crowd participant (including the specialist) has actually stated a size (“Actual Size”), such crowd participant's stated size shall be his or her Actual Size;

(ii) if the specialist, an SQT or RSQT is disseminating an electronic quotation at the Exchange’s disseminated price in a particular series at the time of the execution of an Initiating Order in such series, such specialist, SQT or RSQT’s disseminated size at the Exchange’s disseminated price shall be his or her Actual Size, and such specialist, SQT and/or RSQT shall be deemed a “crowd participant” for purposes of this Advice;

(b) - (c) No change.

(2) No change.

(C) No change.

(D) Waiver. (1) Any ROT (other than an RSQT) or specialist may, in his or her sole discretion, offer to waive, in whole or in part, any part of a trade to which they were entitled to be allocated (an “Offer to Waive”).

(a) - (c) No change.

(E) - (G)

**Section F** No change.

FINE SCHEDULE No change.

## **F-7 [Bids and Offers] Size of Exchange's Disseminated Bid or Offer**

[All bid and offer prices shall be general ones and shall not be specified for acceptance by particular members.

In the absence of a stated size to any bid or offer voiced or displayed on the Options Floor, the person responsible for such bid and offer is deemed to be quoting for one contract, except in those instances where predetermined volume guarantees are provided for the facilitation of specific account types. Floor traders (Specialists and ROTs) are, however, required to trade more than one contract in connection with the execution of a customer order pursuant to Advice A-11.]

The size of any disseminated bid or offer by the Exchange shall be, with respect to the disseminated price for any quoted options series, equal to:

(a) respecting non-Streaming Quote options (as defined in Rule 1080(k), at least the sum of the size associated with: (1) limit orders; and (2) specialists' quotations generated by Auto-Quote or Specialized Quote Feed as described in Rule 1080, Commentary .01 (which represents the collective quotation size of the specialist and any ROTs bidding or offering at the disseminated price unless an ROT has expressly indicated otherwise in a clear and audible manner).

(b) respecting Streaming Quote Options, at least the sum of the size associated with limit orders, specialists' quotations, [and] SQTs' quotations, and RSQTs' quotations.

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

In its filing with the Commission, 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. Phlx has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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 new category of Exchange market-making participant on the Phlx XL trading platform - the RSQT.

Definitions

Proposed Phlx Rule 1014(b)(ii)(C) would define a “non-SQT ROT” as an ROT who is neither a Streaming Quote Trader (“SQT”)<sup>3</sup> nor an RSQT. Proposed Phlx Rule 1014(b)(ii)(B) would define an RSQT as an ROT that is a member<sup>4</sup> or member organization<sup>5</sup> 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 could be an individual or a member organization, whereas an SQT must be an individual. Under the Exchange’s rules, such member or member organization must

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<sup>3</sup> An SQT is an ROT who has received permission from the Exchange to generate and submit option quotations electronically through an electronic interface with AUTOM via an Exchange approved proprietary electronic quoting device in eligible options to which such SQT is assigned. See Exchange Rule 1014(b)(ii)(A).

<sup>4</sup> The term “member” means a holder of a permit which has not been terminated in accordance with the By-Laws and the rules of the Exchange. See Exchange By-Law Article I, Section 1-1(p).

<sup>5</sup> The term “member organization” means a corporation, partnership (general or limited), limited liability partnership, limited liability company, business trust, or similar organization, transacting business as a broker or a dealer in securities and which has the status of a member organization. See Exchange By-Law Article I, Section 1-1(q).

have a natural person or person associated with that member organization who is a permit holder.<sup>6</sup>

Proposed Phlx Rule 1014(b)(ii)(B) would also make clear that, although an RSQT is a new category of ROT, an RSQT may only submit such quotations electronically from off the floor of the Exchange.<sup>7</sup> Further, the rule would prohibit any person who is either directly or indirectly affiliated with an RSQT to be a specialist, RSQT, SQT, or non-SQT ROT in options in which such affiliated RSQT is assigned. The purpose of this provision is to prevent multiple affiliated parties from quoting electronically in the same option and thus receiving multiple automatic allocations for the same or affiliated beneficial account owners. Finally, an RSQT may trade in a market-making capacity only in classes of options in which he is assigned, because the RSQT is a ROT with market-making obligations.

#### Appointment of RSQTs

Currently, the Options Allocation, Evaluation and Securities Committee (“OAESC”)<sup>8</sup> has the authority to appoint on-floor SQTs under Exchange Rule 507 and to assign SQTs in one or more Streaming Quote Options.<sup>9</sup> The proposed amendments to Phlx Rule 507 would authorize

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<sup>6</sup> See Exchange Rule 908(b).

<sup>7</sup> Exchange Rule 1014 defines an ROT as a regular member or a foreign currency options participant of the Exchange located on the trading floor. Notwithstanding this provision, an RSQT would be permitted only to submit electronic quotations from off the floor of the Exchange.

<sup>8</sup> The OAESC 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. See Exchange By-Law Article X, Section 10-7. See also Exchange Rule 500.

<sup>9</sup> Streaming Quote Options are the specific issues in which SQTs may generate and submit option quotations from on the floor of the Exchange. See Exchange Rule 1080(k). The proposed rule change would expand the definition of Streaming Quote Options to include those issues in which RSQTs may submit electronic quotations from off the floor of the Exchange.

the OAESC to appoint and assign RSQTs in one or more Streaming Quote Options in a similar fashion to the current practice of assigning SQTs in Streaming Quote Options. Proposed Phlx Rule 507 would set forth the solicitation, application, and review process to be followed by the OAESC in appointing RSQTs.

The current requirements for SQT applicants for assignment in Streaming Quote Options would apply to RSQT applicants as well. Specifically, RSQTs would be required to submit an application for assignment in writing to the Exchange, and the proposed amendments to Phlx Rule 507(b)(ii) would mandate that no application for assignment as an RSQT in Streaming Quote Options would be approved by the OAESC without written certification signed by an officer (Vice President or above) of the Exchange's Financial Automation Department<sup>10</sup> indicating that the RSQT applicant has sufficient technological ability to support his/her continuous quoting requirements as set forth in Phlx Rule 1014(b)(ii) and the RSQT applicant has successfully completed, or is scheduled to complete, testing of its quoting system with the Exchange.

The Exchange expects to approve and appoint RSQTs who demonstrate additional qualifications that would serve to enhance the overall business of the Exchange. Accordingly, in addition to the above requirements, an RSQT applicant must demonstrate to the OAESC that it has: (1) significant market-making and/or specialist experience in a broad array of securities; (2) superior resources, including capital, technology, and personnel; (3) demonstrated history of stability, superior electronic capacity, and superior operational capacity; (4) proven ability to

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<sup>10</sup> The Exchange's Financial Automation Department is responsible for the design, development, implementation, testing, and maintenance of the Exchange's automated trading systems, surveillance systems, and back office systems. It is also responsible for monitoring the quality of performance and operational readiness of such systems, in addition to user training and validation of user technology as it pertains to such users' interface with the Exchange's systems.

interact with order flow in all types of markets; (5) existence of order flow commitments; (6) willingness to accept assignments as an RSQT in options overlying 400 or more securities; and (7) willingness and ability to make competitive markets on Phlx and otherwise to promote Phlx in a manner that is likely to enhance the ability of Phlx to compete successfully for order flow in the options it trades.<sup>11</sup> “Willingness to promote Phlx” includes assisting in meeting and educating market participants, maintaining communications with member firms in order to be responsive to suggestions and complaints, responding to suggestions and complaints, and other like activities.

The Exchange represents that it intends to use the final factor listed above to take into consideration which of the applicants would best be able to enhance the competitiveness of the Exchange. The Exchange would not apply this factor in any way to restrict, either directly or indirectly, RSQTs’ activities as market makers or specialists on other exchanges or to restrict how RSQTs handle orders held by them in a fiduciary capacity to which they owe a duty of best execution.

The Exchange would use the factor relating to the existence of order flow commitments to evaluate existing order flow commitments between the RSQT applicant and order flow providers. A future change to, or termination of, any such commitments would not be used by the Exchange at any point in the future to terminate or take remedial action against an RSQT. Furthermore, the Exchange would not take remedial action solely because orders subject to any such commitments were not subsequently routed to the Exchange. As part of the approval of an RSQT, the Exchange would be permitted to place conditions on the approval based on the operations of the applicant and the number of options in which the RSQT applicant may be

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<sup>11</sup> This is similar to Chicago Board Options Exchange, Inc. (“CBOE”) Rule 8.92.

assigned. Additionally, an RSQT would not be permitted to transfer its approval to act as an RSQT unless permitted to do so by the Exchange.

The proposed amendments to Phlx Rule 507(b)(iii) would clarify that, as in the case of SQTs, the Exchange's Board of Governors may defer qualifying applications for RSQT status, based on system constraints, capacity restrictions, or other factors relevant to the maintenance of a fair and orderly market. The basis for such deferral, however, would be required to have been objectively determined by the Board, subject to Commission approval or effectiveness pursuant to a filing under Section 19(b) of the Act, as amended. In such an event, the OAESC would be required to provide written notification to any SQT or RSQT applicant whose application is the subject of such limitation(s) or deferral, describing the objective basis for such limitation(s) or deferral.

#### RSQT Obligations

An RSQT would be responsible to quote continuous, two-sided markets in not less than 60% of the series in each Streaming Quote Option in which such RSQT is assigned.<sup>12</sup> RSQTs' obligation would increase, however, for RSQTs who receive Directed Orders (as defined in Phlx Rule 1080(l)(i)(A)).<sup>13</sup> Specifically, a Directed RSQT (as defined in Phlx Rule 1080(l)(i)(C)) would be responsible to quote continuous, two-sided markets in not less than 100% of the series in each Streaming Quote Option in which such Directed RSQT receive Directed Orders.

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<sup>12</sup> For example, if an RSQT is assigned in one Streaming Quote Option that includes five series (A, B, C, D, and E), such RSQT would be required to quote continuous, two-sided markets in three of those series in order to fulfill the 60% quoting requirement. If such an RSQT initially submits quotations in series A, B, and C, and the size associated with the quotation in Series A is exhausted, such SQT would be required either to refresh its quotation in Series A while continuing to submit quotations in Series B and C, or to submit new quotations in any three of the five series, in order to fulfill the 60% quoting requirement.

<sup>13</sup> See SR-Phlx-2004-73.

RSQT quotations would be subject to the same minimum size requirement as that imposed on SQTs. Current Phlx Rule 1014(b)(ii)(B) allows SQTs to stream electronic quotations with a minimum size of one contract for a period of time following the deployment of an option as a Streaming Quote Option trading on Phlx XL, after which such quotation must be for a minimum of 10 contracts. The rule would be amended to impose the same minimum size requirements on RSQTs and renumbered as Phlx Rule 1014(b)(ii)(D).

#### ROT Obligations and RSQTs

Exchange Rule 1014 and the commentaries thereto impose certain rights and obligations on ROTs. Because of the unique nature of an RSQT (*i.e.*, participating as an Exchange market maker from off the floor of the Exchange), the proposal would amend various sections of the Commentary to Phlx Rule 1014 to clarify the obligations that would apply to RSQTs.

First, for clarity, Commentary .01 to Phlx Rule 1014 would be amended to state that an RSQT electing to engage in Exchange options transactions is designated as a specialist on the Exchange for all purposes under the Act and the rules and regulations thereunder with respect to options transactions initiated and effected by him in his capacity as an ROT.<sup>14</sup>

Commentary .01 also imposes certain minimum “in-person” trading requirements applicable to ROTs in order to preserve specialist margin treatment. Because RSQTs submitting electronic quotations from off the floor of the Exchange could not possibly fulfill the “in-person” requirement, the Exchange proposes to amend Commentary .01 to exclude RSQTs from this requirement.

Similarly, Commentary .03 requires that at least 50% of the trading activity in any quarter (measured in terms of contract volume) of an ROT must ordinarily be in classes of options to

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<sup>14</sup> See Section 11(b) of the Act, 15 U.S.C. 78k(b), and Rule 11b-1 thereunder, 17 CFR 240.11b-1.

which he is assigned. RSQTs may only submit electronic quotations from off the floor in options in which they are assigned (resulting in 100% of their quarterly trading activity measured in terms of contract volume). Therefore, the Exchange proposes to amend Commentary .03 to exclude RSQTs from the 50% obligation, because it does not make sense to apply such a requirement.

The Exchange also proposes to adopt Commentary .06 to Phlx Rule 1014. Commentary .06 requires RSQTs to maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in options assigned to the RSQT or act as a specialist or market maker in any security underlying options assigned to the RSQT, and otherwise comply with the requirements of Phlx Rule 1020 regarding restrictions on the flow of privileged information between the affiliate and the specialist organization.

Commentary .08 currently describes certain ROT transactions that are deemed “on-floor” trading for purposes of the rule. The Exchange proposes to adopt Commentary .08(c) to deem any transaction for the account of an RSQT as on-floor trading in order to ensure that RSQTs may effect off-floor transactions in their market maker accounts as for purposes of margin treatment.

As a housekeeping matter, the Exchange proposes to delete Commentary .10 to Phlx Rule 1014, relating to orders given out by an ROT to specialists. The purpose of this proposal is to remain consistent with the Exchange’s current proposed rule change relating to limit order display, which requires ROTs who wish to place limit orders on the limit order book to do so electronically via interface with the AUTOM System.<sup>15</sup> An ROT can no longer “give out” an

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<sup>15</sup> See SR-Phlx-2004-73.

order to a specialist but instead must place the order on the limit order book electronically, thus obviating the need for Commentary .10.

### Trade Allocation

Currently, Exchange Rule 1014(g)(vii) governs the allocation of trades executed in Streaming Quote Options traded on Phlx XL. The proposed rule change would afford RSQTs the same entitlement to receive contracts under the algorithm described in the rule as SQTs.

Phlx Rule 1014(g)(vii)(A) currently provides that, if one Phlx XL Participant (including the specialist, an SQT, or a non-SQT ROT) is quoting alone at the disseminated price and his quote is not matched by another Phlx XL Participant prior to execution, such Phlx XL Participant would be entitled to receive a number of contracts up to the size associated with his/her quote. The proposed rule change would expand the definition of “Phlx XL Participant” to include an RSQT.

Currently, Phlx Rule 1014(g)(vii)(B) governs the automatic allocation algorithm that applies to orders or electronic quotes in Streaming Quote Options that result in automatic executions when two or more Phlx XL Participants have quotes or booked limit orders at the Exchange’s disseminated price.<sup>16</sup> Under current Exchange rules, orders in Streaming Quote Options traded on Phlx XL for 5 contracts or fewer are allocated first to the specialist, provided that the specialist is quoting at the Exchange’s disseminated price. Other Phlx XL Participants quoting at the execution price are entitled to receive contracts under the algorithm contained in

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<sup>16</sup> Phlx Rules 119, 120, and 1014(g) are the general rules concerning the establishment of parity and priority in the execution of orders on the options floor. The trade allocation algorithm in Phlx Rule 1014(g)(vii) generally does not contemplate that price-time priority applies to quotes and orders in Streaming Quote Options. Accordingly, Phlx Rule 1014(g)(vii)(B)(3) states that, notwithstanding the first sentence of Phlx Rule 1014(g)(i), neither Phlx Rule 119(a)-(d) and (f), nor Phlx Rule 120 (insofar as it incorporates those provisions by reference) shall apply to the allocation of automatically executed trades in Streaming Quote Options.

Exchange Rule 1014(g)(vii)(B)(1)(b), which includes a weighted percentage of contracts to be allocated among Phlx XL Participants on parity (including the specialist) on an equal basis and a weighted percentage of contracts to be allocated among Phlx XL Participants on parity on a size pro rata basis.<sup>17</sup> The proposed rule change would include RSQTs in this algorithm applicable to orders for greater than 5 contracts. The algorithm in Phlx Rule 1014(g)(vii)(B)(1)(b) would not apply to a Directed Specialist, SQT, or RSQT. The algorithm applicable to Phlx XL trades that involve a Directed Specialist, SQT, or RSQT is contained in Phlx Rule 1080(l).<sup>18</sup>

#### Trade Allocation of Non-Electronic Orders

The proposed rule change would provide that current rules applicable to out-of-crowd SQTs regarding participation in non-electronic orders traded in the crowd would apply to RSQTs as well. Specifically, RSQTs would not be permitted to participate in trades stemming from such a non-electronic order unless the order is executed at the price quoted by the RSQT at the time of execution.

The proposal would further clarify the allocation algorithm to be applied by the person responsible to allocate such orders by adding a new definition of “Actual Size” to Phlx Rule 1014(g)(v)(B), the Exchange’s rule governing the allocation of orders traded in the crowd. Specifically, if the specialist, an SQT, or RSQT is disseminating an electronic quotation at the Exchange’s disseminated price in a particular series at the time of the execution of an order in such series, such specialist, SQT, or RSQT’s disseminated size at the Exchange’s disseminated price would be his or her Actual Size. Actual Size is the number of contracts for each crowd participant on which the person responsible for allocating the trade (“Allocating Participant”)

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<sup>17</sup> See Securities Exchange Act Release No. 50788 (December 3, 2004), 69 FR 71860 (December 10, 2004) (SR-Phlx-2004-57).

<sup>18</sup> See SR-Phlx-2004-91.

bases allocation of the order among crowd participants on parity. The purpose of this provision is to establish a definition of Actual Size for specialists, out-of crowd SQTs, and RSQTs whose electronically submitted quotations are on parity with other crowd participants. Because the rest of Phlx Rule 1014(g)(v) refers to allocation of orders to “crowd participants” on parity, such specialist, SQT, and/or RSQT would be deemed a crowd participant for purposes of this rule.

The Exchange proposes to amend Phlx Rule 1014(g)(v)(D) which permits any ROT or specialist to, in his or her sole discretion, offer to waive, in whole or in part, any part of a trade to which he was entitled to be allocated (“Offer to Waive”). The proposed rule change would exclude RSQTs from the provisions of the rule. An RSQT would not be permitted to waive any part of a trade to which he is entitled to be allocated. Because an RSQT is not physically present on the floor of the Exchange, it would be impractical to permit an RSQT to offer to waive all or a portion of his entitlement, since he could not verbalize such an offer and would not be able to communicate such an offer to waive electronically. Furthermore, the crowd participants would have no means to communicate their acceptance or rejection of such an offer to waive. Therefore, as a practical matter, the Exchange proposes to exclude RSQTs from the provisions contained in Phlx Rule 1014(g)(v)(D).

Finally, the proposal would amend Exchange Rule 1014(g)(vi), which describes who must function as the Allocating Participant in non-electronic orders executed in the crowd. Generally, the Floor Broker representing the order or the specialist is required to be the Allocating Participant. Current Phlx Rule 1014(g)(vi)(iii), however, states that where there is no floor broker and no specialist is involved in the transaction, the largest participant must be the Allocating Participant. The rule would be amended to provide that the largest on-floor participant must be the Allocating Participant, because if an RSQT or out-of-crowd SQT is the

largest participant, it is virtually impossible to allocate the order from another crowd on the floor or from a remote location off the floor. Similarly, current Phlx Rule 1014(g)(vi)(iv) states that if there is only one seller and one buyer (no Floor Broker and no specialist is involved) the seller must be the Allocating Participant. However, if the seller is an RSQT (and thus not on the floor of the Exchange), the RSQT could not allocate the order in the crowd. Accordingly, the Exchange proposes to amend Phlx Rule 1014(g)(vi)(iv) to provide that, if the seller or the buyer is an RSQT, the on-floor participant in the transaction would be required to be the Allocating Participant.<sup>19</sup> This provision would now cover each trading situation.

As a housekeeping matter, Phlx Rule 1014(g)(vi)(i) - (iv) would be renumbered for consistency with the numbering of other Exchange rules.

#### Elimination of "SQT Zones"

Currently, Commentary .05(b) to Phlx Rule 1014 provides that an SQT may be assigned to (and thus submit quotes electronically in) all of the options located within a specified physical zone on the Exchange Options Floor ("SQT Zone"), provided that such SQT is physically present in such SQT Zone. Each member organization must currently have at least one SQT physically present in each SQT Zone in which such member organization submits electronic quotations. The number and location of SQT Zones will be determined by the Options Committee.

Currently, the entire Exchange floor is considered one SQT Zone. Therefore, the proposed rule change would delete the rule concerning SQT Zones and establish that an SQT or RSQT may be assigned to (and thus submit quotes electronically in) any option traded on Phlx

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<sup>19</sup> The Exchange believes that it is more practical to require the on-floor participant to allocate the transaction, because the RSQT is not physically present on the floor of the Exchange.

XL for which they are approved by the Exchange. The elimination of this provision would allow SQTs and RSQTs to stream electronic quotations floor-wide without consideration of physical boundaries. SQTs would continue to be required to be physically present on the Exchange floor in order to submit electronic quotations in Streaming Quote Options. Because the entire exchange has been considered one SQT Zone, this deletion would have no practical effect. The Exchange no longer envisions dividing the options trading floor into various SQT Zones.

#### RSQT Participation in Openings

Phlx Rule 1017 currently permits SQTs to participate in opening transactions by submitting electronic quotations to interact with opening orders. Under the proposed rule change, RSQTs would be permitted to participate in openings in the same manner as SQTs. Commentary .01 to Phlx Rule 1017 currently requires specialists to consider markets from ROTs in the crowd in addition to electronic quotations submitted by SQTs prior to the opening of the underlying security on the primary market. Phlx Rule 1017 would be amended to require specialists to consider RSQT quotations in the pre-opening period. Phlx Rule 1017 would also be amended to require RSQTs to fulfill their quoting requirements under Phlx Rule 1014, as discussed above, once the opening trade price in a series has been disseminated to the Option Price Reporting Authority. Finally, if the specialist determines that a series will not open due to an opening price that is not within an acceptable range or an order imbalance, the specialist currently requests bids and offers from ROTs in the crowd and, in the case of Streaming Quote Options, SQTs. Phlx Rule 1017 would be amended to provide that the specialist would also request bids and offers from RSQTs that are assigned in the option. As with the current rules applicable to ROTs and SQTs, RSQTs would be required to respond to such a request immediately. The opening would be delayed until responses to the specialist's request have been

received and the consequent opening price is deemed by a Floor Official to be compatible with a fair and orderly market.

### Book Sweep

Currently, Exchange Rule 1080(c)(iii)(B) governs a feature of AUTOM known as "Book Sweep" as it relates to Streaming Quote Options trading on Phlx XL. When the specialist or an SQT has engaged the Book Sweep feature, and when such a specialist or SQT submits a quotation that locks or crosses a limit order on the book that represents the Exchange's best bid or offer, such limit order would be executed automatically up to the size associated with the specialist or SQT's quotation and would be automatically allocated in accordance with Exchange rules. Book Sweep functions only in situations where the Exchange's disseminated best bid or offer is represented by a limit order on the limit order book and such bid or offer is or is equal to the National Best Bid/Offer ("NBBO"). The proposed rule change would amend Phlx Rule 1080(c)(iii)(B) to state that an RSQT quotation would also initiate the Book Sweep Function under these conditions. The specialist, RSQT, or SQT may manually initiate the Book Sweep feature by sending a manual quote in situations where the specialist, SQT, or RSQT's automatic generation of electronic quotations is suspended due to, for example, a system malfunction. Eligible orders on the limit order book would be automatically executed up to the size associated with the quote that matches or crosses such limit orders. Orders on the limit order book are not eligible for Book Sweep when the NBBO is crossed (i.e., 2.10 bid, 2 offer).

### Book Match

Book Match is a feature of AUTOM that currently provides automatic executions for

inbound AUTOM-delivered customer and off-floor broker-dealer<sup>20</sup> orders against customer limit orders on the book. Phlx Rule 1080(g) states that in Streaming Quote Options the contra-side to automatically executed inbound eligible orders can be a limit order on the book or specialist and/or SQT electronic quotes (“electronic quotes”) at the disseminated price, where the Exchange’s disseminated size includes a limit order on the book and/or electronic quotes at the disseminated price. Phlx Rule 1080 would be amended to provide that the contra-side to an inbound eligible order can be an RSQT electronic quote. As with Book Sweep, Book Match would not be engaged when the Exchange’s disseminated price represented by a limit order on the book is not the NBBO. In these situations, incoming orders would be subject to manual handling by the specialist.

#### Additional Amendment to Phlx Rule 1080

Phlx Rule 1080, Commentary .01(b)(ii) would be amended in order to clarify that the specialist determines which options pricing model to select per option in non-Streaming Quote Options only. Respecting Streaming Quote Options, each specialist, SQT, and RSQT is a “responsible broker or dealer” (as described below) for his proprietary electronic quotation. Therefore, each specialist, SQT, and RSQT may select the options pricing model that is appropriate for him.

#### Firm Quotations

Exchange Rule 1082, Firm Quotations, would be amended in a number of ways to capture the firm quote requirements applicable to RSQTs. First, Phlx Rule 1082(a)(ii)(B), which

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<sup>20</sup> Exchange Rule 1080(b)(i)(C) defines an “off-floor broker-dealer” as a broker-dealer that delivers orders from off the floor of the Exchange for the proprietary account(s) of such broker-dealer, including a market maker located on an exchange or trading floor other than the Exchange’s trading floor who elects to deliver orders via AUTOM for the proprietary account(s) of such market maker.

currently defines the Exchange's "disseminated size" respecting Streaming Quote Options as at least the sum of the size associated with limit orders, specialists' quotations, and SQT quotations, would be amended to expand the definition of disseminated size to include RSQT quotations.

Second, the proposed amended Phlx Rule 1082 would be applied to RSQT quotations in Streaming Quote Options in the same manner as it is applied to SQT quotations. Specifically:

- If an SQT or RSQT's (other than a Directed SQT or RSQT's) quotation size in a particular series in a Streaming Quote Option is exhausted, such RSQT's quotation would be deleted from the Exchange's disseminated quotation until the time the RSQT revises his/her quotation.
- If the Exchange's disseminated size in a particular series in a Streaming Quote Option 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, the Exchange would automatically disseminate the specialist's most recent disseminated price (which was that particular price level) prior to the time of such exhaustion with a size of one contract.
- In the event an SQT, RSQT, or specialist in a Streaming Quote Option has electronically submitted on the Exchange bids or offers for a Streaming Quote Option, each such SQT, RSQT, or specialist member would be considered a "responsible broker or dealer" for that bid or offer, up to the size associated with such responsible broker or dealer's bid or offer.
- In the event that an RSQT bid or offer locks another Phlx XL Participant's electronic bid or offer, a "counting period" of one second would begin during which Phlx XL Participants, including the RSQT whose quotation is locked, may eliminate the locked

market. Provided, however, that such RSQT (and any Phlx XL Participant whose electronic bid or offer is locked with another electronic bid/offer) would be required to execute orders at their disseminated quotation.

- In the event of a crossed market (i.e., 1.10 bid, 1 offer) wherein an incoming quotation crosses an existing quotation, the Exchange would: (i) change the incoming quotation such that it locks the existing quotation; (ii) send a notice to the SQT, RSQT, or specialist that submitted the existing quotation indicating that its quotation was crossed; and (iii) send a notice to the specialist, SQT, or RSQT that submitted the incoming quotation, indicating that its quotation crossed the existing quotation and was changed. Such a locked market is handled in accordance with the rules relating to locked quotations as stated above.

#### Amendments to Option Floor Procedure Advices

In addition to the proposed amendments to Exchange rules, the Exchange also proposes amendments to certain Exchange Option Floor Procedure Advices (“OFPAs”) in order to make them applicable to RSQTs. The Exchange proposes to amend OFPA A-12, Opening Rotations and SORT Procedures, to clarify that bids and offers may be submitted by RSQTs during opening rotations.<sup>21</sup> The Exchange also proposes amendments to OFPA B-3, Trading Requirements, which includes the same “in-person” trading requirement applicable to ROTs that is included in current Commentary .01 to Phlx Rule 1014 and the same obligation for ROTs to conduct 50% of their quarterly trading activity in assigned options contained in Commentary .03

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<sup>21</sup> Rotation procedures allow a brief period of auction pricing for each option series during which bids and offers, including, with respect to Streaming Quote Options, bids and offers submitted electronically by SQTs (and, under the proposal, RSQTs), and transactions for that option class may normally only occur in that series. See Exchange Rule 1047 and OFPA A-12.

to such Phlx Rule. Because, as stated above, the in-person requirement and the 50% quarterly volume requirement in assigned issues would not apply to RSQTs, OFPA B-3 would be amended to exclude RSQTs from those requirements.

OFPA B-6, Priority of Options Orders for Equity Options and Index Options by Account Type, includes the same trade allocation algorithm for orders represented in the crowd by Floor Brokers and specialists as contained in Phlx Rule 1014(g)(v). Therefore, the Exchange proposes to amend the provisions in Section E of OFPA B-6 relating to Actual Size and Waiver that are identical to the proposed amendments to Phlx Rule 1014(g)(v).

Finally, the Exchange proposes to amend OFPA F-7, Bids and Offers, in a number of ways. As a housekeeping matter, the Exchange proposes to delete the paragraphs in current OFPA F-7 that provide that all bid and offer prices are general and shall not be specified for acceptance by particular members and, that in the absence of a stated size to any bid or offer voiced or displayed on the Options Floor, the person responsible for such bid and offer is deemed to be quoting for one contract. The purpose of this provision is to make OFPA F-7 consistent with another Exchange proposal relating to the acceptance by particular members of Directed Orders<sup>22</sup> and to make it consistent with Phlx Rule 1014(g)(v) and OFPA B-6, each of which addresses crowd participants' "stated size" differently. The Exchange proposes to further amend OFPA F-7 to define the Exchange's disseminated size as defined in proposed Phlx Rule 1082(a)(ii). Finally, in order to more specifically describe the content of proposed amended OFPA F-7, the Exchange proposes to change the title from "Bids and Offers" to "Size of Exchange's Disseminated Bid or Offer."

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<sup>22</sup> See SR-Phlx-2004-91.

## Summary

The Exchange believes that its proposal to adopt rules respecting RSQTs is an important step forward in the evolution of the Exchange's trading systems towards more electronic trading of options on the Exchange via Phlx XL.

### 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act<sup>23</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>24</sup> in particular, in that it is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system, and to protect investors and the public interest, by allowing a new category of market maker, the RSQT, to quote competitively from off the floor of the Exchange, thereby increasing the depth and liquidity in the Exchange's markets, and allowing the Exchange to remain competitive for order flow by adding additional liquidity to the Exchange's markets, enhancing the ability of order flow providers to fulfill their duty of best execution on behalf of their customers.

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

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

No written comments were either solicited or received.

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<sup>23</sup> 15 U.S.C. 78f(b).

<sup>24</sup> 15 U.S.C. 78f(b)(5).

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 Phlx consents, the Commission shall: (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 Number SR-Phlx-2004-90 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-Phlx-2004-90. 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. Copies of the filing also will be available for inspection and copying at the principal office of Phlx. 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-2004-90 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>25</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>25</sup> 17 CFR 200.30-3(a)(12).