

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52667; File No. SR-Phlx-2005-25)

October 25, 2005

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Granting Approval to a Proposed Rule Change and Amendments No. 2, 3, and 5 Thereto Relating to the Adoption of New Rules That Would Establish an Automated Opening System on the Exchange

I. Introduction

On April 21, 2005, the Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹, and Rule 19b-4² thereunder, a proposed rule change that would establish an automated opening system on the Exchange. The Exchange submitted Amendments No. 1,³ 2,⁴ and 3⁵ to its proposal on June 1, 2005, September 1, 2005, and September 14, 2005, respectively. The proposed rule change, as amended, was published for comment in the Federal Register on September 22, 2005.⁶ No comments were received on the proposal. The Phlx submitted

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Form 19b-4, dated June 1, 2005 (“Amendment No. 1”). Amendment No. 1 replaced the original filing in its entirety.

⁴ See Form 19b-4, dated September 1, 2005 (“Amendment No. 2”). Amendment No. 2 replaced Amendment No. 1 in its entirety.

⁵ See Form 19b-4, dated September 14, 2005 (“Amendment No. 3”). In Amendment No. 3, Phlx, in part, deleted proposed rule text to clarify that during a manual opening all market orders are to be executed at one price.

⁶ See Securities Exchange Act Release No. 52448 (September 15, 2005), 70 FR 55650.

Amendment No. 4⁷ on September 23, 2005, and Amendment No. 5⁸ on September 26, 2005. This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

In July 2004, the Exchange began trading options on its new electronic options trading platform, Phlx XL.⁹ Because Phlx XL does not currently include an automated opening functionality, specialists are currently required to open option series manually. The proposed rule change would establish a fully automated opening system for options traded on Phlx XL as part of the Phlx XL system.

Pre-Opening

For a period of time before the scheduled opening in the underlying security (and not less than one hour as determined by the Options Committee with notice to the membership via Exchange circular), Phlx XL will accept orders and quotes during the “Pre-Opening Phase.” The Phlx XL system will disseminate to specialists, Streaming Quote Traders (“SQTs”), Remote Streaming Quote Traders (“RSQTs”), and non-SQT ROTs who are required to submit continuous two-sided electronic quotations pursuant to

⁷ See Form 19b-4, dated September 23, 2005. The Exchange subsequently submitted Amendment No. 5, which was intended to supercede and replace Amendment No. 4. As a result, the Exchange withdrew Amendment No. 4 on October 19, 2005. See Form 19b-4, dated October 19, 2005.

⁸ See Form 19b-4, dated September 26, 2005. In Amendment No. 5, the Exchange made technical changes to accurately reflect the differences between proposed rule language and current rule text, as well as made technical changes to better conform Exhibits 4 and 5 to each other. The Act does not require notice and comment for technical amendments.

⁹ See Securities Exchange Act Release No. 50100 (July 27, 2004), 69 FR 44612 (August 3, 2004) (SR-Phlx-2003-59).

Exchange Rule 1014(b)(ii)(E)¹⁰ (collectively, for purposes of proposed Phlx Rule 1017, “Phlx XL participants”) information about resting orders on the book that remain from the previous trading session and orders submitted prior to the opening.

Calculation of Opening Price

The system will calculate an Anticipated Opening Price (“AOP”) and Anticipated Opening Size (“AOS”) when a quote or trade has been disseminated by the primary market for the underlying security, under the conditions set forth below. The specialist assigned in the particular option must enter opening quotes not later than one minute following the dissemination of a quote or trade by the primary market for the underlying security.

An AOP may be calculated only if: (i) the Exchange has received market orders, or the book is crossed (highest bid is higher than the lowest offer) or locked (highest bid equals the lowest offer); and (ii) either (A) the specialist’s quote has been submitted; (B) the quotes of at least two Phlx XL participants that are required to submit continuous, two-sided quotes in 100% of the series in all option issues in which such Phlx XL participant is assigned (“100% participants”),¹¹ have been submitted within two minutes of the opening trade or quote on the primary market for the underlying security (or such shorter time as determined by the Options Committee and disseminated to the

¹⁰ Exchange Rule 1014(b)(ii)(E) requires non-SQT ROTs who transact more than 20% of their contract volume in an option electronically versus in open outcry during a particular calendar quarter to submit proprietary electronic quotations in such an option during the subsequent calendar quarter for a certain number of series in such option, depending on the percent of total volume transacted electronically versus in open outcry on the Exchange in such option.

¹¹ An example of a 100% participant is a new category of ROT on the Exchange known as a “Directed SQT” or a “Directed RSQT,” defined as an SQT or RSQT that receives a Directed Order. See Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91).

membership via Exchange Circular); or (C) if neither the specialist's quote¹² nor the quotes of two 100% participants have been submitted within two minutes of the opening trade or quote on the primary market for the underlying security (or such shorter time as determined by the Options Committee and disseminated to the membership via Exchange Circular), one 100% participant has submitted its quote.

Opening Order/Quote Imbalance

In situations where an AOP may be calculated (i.e., when the conditions described above are present) and there is an order/quote imbalance, the system will immediately send an imbalance notice indicating the imbalance side (buy or sell) and the AOP and AOS (an "Imbalance Notice") to Phlx XL participants assigned to the options class provided that the primary market for the underlying security has disseminated an opening quote or trade. Phlx XL participants may then submit their opening or revised opening quotes. Thereafter the system will disseminate an updated Imbalance Notice every five seconds (or such shorter period as determined by the Options Committee and disseminated to membership via Exchange Circular) until the series is open. If no imbalance exists, no Imbalance Notice will be sent, and the system will establish an opening price as described below.

Actual Opening Price

The proposal would establish the opening price of a series in situations where there is no opening quote/order imbalance. Proposed Phlx Rule 1017(c)(i) would define the opening price as the price at which the maximum quantity of contracts would be

¹² For example, a specialist may not submit a quote due to systems malfunctions. A specialist, however, who fails to submit opening quotes within one minute of the opening on the primary market would be subject to possible disciplinary action.

traded. The proposed rule would establish a series of “tie-breakers” that the system would follow in establishing the opening price when two or more prices would satisfy the maximum quantity criteria. Specifically, when the maximum quantity of contracts could be traded at two or more prices, the system would establish the opening price based on the following criteria, in order: (1) the price at which the greatest number of customer orders would be traded; (2) the price at which the maximum number of Phlx XL participants would trade; and (3) the price that is closest to the closing price from the previous trading session.

Priority on Openings

The system will give priority to market orders first (including a limit order to buy which is at a higher price than the price at which the option is to be opened and a limit order to sell which is at a lower price than the price at which the option is to be opened, which will be treated as market orders), then to resting limit orders at the opening price.

Contingency, Hedge, and Synthetic Option Orders

Contingency Orders, Hedge Orders, and Synthetic Option Orders, as defined in Exchange Rule 1066, are not considered in the determination of the opening price, and do not participate in the opening trade because such order types generally include two or more option components, and may also include a stock component.

Floor-Brokered Orders

To be considered in the determination of the opening price and to participate in the opening trade, orders represented by Floor Brokers must be entered onto the book electronically.

Inbound Orders and Quotes Received While the System Completes the Opening Trade

Inbound orders and quotes will not be included in the calculation of the opening price for a brief period established by the system (and thus not within the discretion of any Phlx XL participant) while the system is in the process of completing the opening trade. During such brief period, such inbound orders and quotes will be entered into the Phlx XL system in order of their arrival.

Proposed Rule 1017(d) would provide that, as the opening price is determined by series, the system will disseminate through OPRA the opening trade price, if any, and then the quote after the series is open. The system will process and open the series for a given option in random order. If there are no orders in a particular series when the underlying security opens, the Exchange will disseminate quotations at the best bid and offer in such series submitted by Phlx XL participants assigned in the particular option.

Situations in Which the Option Series Will Not Open

The proposed rule would set forth three conditions under which the system will not open a series. First, the system will not open a series when there is no quote from the specialist or a 100% participant. Second, the system will not open a series when the opening price is not within an acceptable range (as determined by the Options Committee and announced to Exchange members and member organizations by way of Exchange Circular) compared to the highest offer and the lowest bid (e.g., the upper boundary of the acceptable range may be 125% of the highest quote offer and the lower boundary may be 75% of the lowest quote bid). Third, the system will not open a series when 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 limit orders, market orders and quotes on the other side of the market).

No Specialist or 100% Participant Quote or Quote Outside Acceptable Range

If the specialist or a Phlx XL participant with a 100% quoting requirement is not quoting as described in proposed Phlx Rule 1017(e)(i), or if the opening price is not within an acceptable range as described in proposed Phlx Rule 1017(e)(ii), proposed Phlx Rule 1017(f) would provide that two Floor Officials may authorize the manual opening of the affected series where necessary to ensure a fair and orderly market. In such a circumstance, the Exchange's existing rules concerning manual openings would apply.¹³

Manual Opening by Specialist

Proposed Phlx Rule 1017(g)(i) would provide that if a condition or the absence of a required condition not otherwise covered by the proposed rule would prevent an opening trade to occur, the specialist may, with prior notification to Market Surveillance staff, determine to open a series manually in the interest of a fair and orderly market, subject to the approval of two Floor Officials within five minutes of the opening of the affected series. Manual openings would be required to be conducted in accordance with current Commentary .01 - .03 of Exchange Rule 1017.

Index Options

Under the proposal, with respect to automated openings in an Industry or Market Index conducted pursuant to Phlx Rule 1017, the specialist may engage the automated opening system to open such options when underlying securities representing 50% of the

¹³ See, e.g., the Commentary to Phlx Rule 1017, Phlx Rules 1047, 1047A, and OFPAs A-12, A-14 and G-2.

current index value of all the securities underlying the index have opened for trading on the primary market. The system will automatically open all index options when underlying securities representing 100% of the current index value of all the securities underlying the index have opened for trading on the primary market.¹⁴

Reopening Following a Trading Halt

The procedure described in the proposed Rule may be used to reopen an option after a trading halt.

Conforming Amendments to Current Exchange Rules and OFPAs

In addition to the proposed amendments to Exchange Rule 1017, the Exchange is proposing various conforming amendments to current Exchange rules and OFPAs that relate to openings and re-openings following a trading halt, as well as deleting references to obsolete procedures and modifying certain processes.

The Exchange proposes to delete Commentary .03(d)(iii) from Exchange Rule 1017, which currently states that the specialist will not open a series when there is a market on opening order with no corresponding order. The Exchange currently does not accept market on opening orders and thus Commentary .03(d)(iii) is unnecessary.

The Exchange proposes to amend Exchange Rules 1047 and 1047A and OFPAs A-12 and G-2 to reflect an automated opening conducted pursuant to Exchange Rule 1017 shall be considered a “trading rotation” for purposes of these rules and OFPAs. These rules would also be amended to include the term “Market Surveillance officer” to conform to current Exchange staff structure.

¹⁴ The Exchange proposes to amend Phlx Rule 1047A and OFPA G-2 to require the opening of an Industry Index when 100% of the current index value of all the securities underlying the index have opened for trading on the primary market.

Exchange Rule 1047(c) would be amended to reflect that two Floor Officials (with the concurrence of a Market Surveillance officer) and not the appropriate Floor Standing Committee as reflected in the current rule would have the authority, respecting a particular class or series of option, to delay the opening, to halt and reopen after a halt, and to open where the underlying stock or ETF has not opened.

Exchange Rule 1047 would be further amended to delete all references to the Series Opening Request Ticket (“SORT”) Procedure, an obsolete procedure that is no longer in use on the Exchange. The Exchange proposes a similar amendment to OFPA A-12 Opening Rotations and SORT Procedures.

Commentary .02 to Exchange Rule 1047 would be amended to require the specialist to inform the Market Surveillance staff in the event that trading in an underlying stock or Exchange-Traded Fund Share has not opened in the primary market for such stock or Exchange-Traded Fund Share within a reasonable time after the opening of business, or, in the event that current quotations for any underlying foreign currency are for any reason unavailable. Market Surveillance staff would then take the appropriate steps to determine the cause of such delay or unavailability, rather than the chairman of the appropriate Floor Standing Committee or his delegate on the floor, as the rule currently provides.

For consistency, OFPA A-12 would be amended to establish that the acceptable range within which the opening price must be established, would apply to both automated openings and manual openings conducted pursuant to Exchange Rule 1017 and the Commentary thereto. A similar amendment is proposed respecting OFPA A-14, Equity Option and Index Option Opening Parameters. The Exchange also proposes to delete

references to Super Cap Index options from OFPA G-2, because the Exchange no longer lists this product.

Deployment of the Automated Opening System

The Exchange represents that it would deploy the automated opening system on an issue-by-issue basis. According to the Exchange, at least 10 issues would be deployed on the system within four weeks from the date of Commission approval of the proposed rule change, and all options traded on the Exchange would be deployed on the system within twelve weeks of such approval.

III. Discussion

After careful consideration, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, the requirements of Section 6 of the Act.¹⁵ Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹⁶ which requires, in part, that the rules of an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.¹⁷

The Commission believes that the proposed automated opening system may facilitate an expedited opening of options on Phlx and thereby improve market efficiency for all market participants. Moreover, the Commission believes that the proposed rules

¹⁵ 15 U.S.C. 78f.

¹⁶ 15 U.S.C. 78f(b)(5).

¹⁷ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

should provide transparency to all market participants with respect to the manner in which an opening price is determined on the Exchange and ensure that the opening is conducted in a fair and orderly fashion.

The Commission also believes that the Exchange's proposal to allow two Floor Officials with the concurrence of a Market Surveillance Officer, rather than the appropriate Floor Standing Committee, to, among other things, delay the opening, halt and reopen after a halt, and open where the underlying stock or ETF has not opened, may facilitate the decision making process. Furthermore, the Commission notes that this approval structure is substantially similar to an existing rule of the American Stock Exchange LLC.¹⁸

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁹ that the proposed rule change (SR-Phlx-2005-25), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁰

Jonathan G. Katz
Secretary

¹⁸ See Amex Rule 918(c).

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ 17 CFR 200.30-3(a)(12).