

that its quotes are firm. AUTOM customers would be duly notified via electronic message from AUTOM that such quotes are again included in the calculation of NBBO.

III. Discussion

After careful review, the Commission finds that the proposed rule change, as amended by Amendment Nos. 2, 3, 4, and 5, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange¹⁵ and, in particular, the requirements of Section 6 of the Act¹⁶ and the rules and regulations thereunder. The Commission finds specifically that the proposed rule change is consistent with Section 6(b)(5) of the Act¹⁷ because it provides objective criteria and well-defined procedures for excluding another market's quote from the Phlx's determination of the NBBO, which should increase the likelihood that Phlx's NBBO will more accurately reflect the actual state of the market at a given time. Specifically, the Commission notes that the determination of the Chairman of the Options Committee or his designee (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials) to exclude unreliable quotes is limited to circumstances in which the away market has either directly communicated or confirmed that its quotes are unreliable. In this way, the discretion afforded to Phlx officials to determine that another market's options quotes are unreliable is appropriately limited. Moreover, the record keeping requirements and other proposed procedures are not unreasonable.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (SR-Phlx-2001-35), as amended by Amendment Nos. 1, 2, 3, 4, and 5, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland,
Deputy Secretary.

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¹⁵ In approving this proposed rule change, the Commission notes that it has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁶ 15 U.S.C. 78f.

¹⁷ 15 U.S.C. 78f(b)(5).

¹⁸ *Id.*

¹⁹ 17 CFR 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45932; File No. SR-Phlx-00-93]

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Granting Approval to that Portion of Proposed Rule Change Not Previously Granted Accelerated Approval, as Amended by Amendment Nos. 4, 5, 6, and 7 thereto, Relating to Providing Automatic Executions for Public Customer Orders at the NBBO

May 15, 2002.

I. Introduction

On September 18, 2001, January 15, 2002, March 1, 2002, March 8, 2002, and April 3, 2002, 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-4 thereunder,² Amendment Nos. 3,³ 4,⁴ 5,⁵ 6,⁶ and 7,⁷ respectively, to a proposed rule change⁸ relating to providing automatic executions for public customer orders at the national best bid or offer ("NBBO"). The Commission published for comment the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated September 18, 2001 ("Amendment No. 3").

⁴ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated January 15, 2002 ("Amendment No. 4). Amendment No. 4 superseded and replaced Amendment No. 3 in its entirety.

⁵ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated February 28, 2002 ("Amendment No. 5").

⁶ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated March 7, 2002 ("Amendment No. 6").

⁷ See letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated April 2, 2002 ("Amendment No. 7").

⁸ The Exchange filed this proposed rule change pursuant to the requirements of Section IV.B.h.(i)(bb) of the Commission's September 11, 2000 Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Act, which required the Phlx (as well as the other floor-based options exchanges) to adopt new, or amend existing, exchange rules concerning automatic quotation and execution systems which specify the circumstances, if any, by which automatic execution systems would be disengaged or operated in any manner other than the normal manner set forth in the exchange's rules; and, requires the documentation of the reasons for each decision to disengage an automatic execution system or operate it in any manner other than the normal manner. See Securities Exchange Act Release No. 43268 (September 11, 2000), Administrative Proceeding File No. 3-10282.

proposed rule change, along with Amendment Nos. 1 and 2, in the **Federal Register** on December 14, 2000,⁹ and granted partial accelerated approval to those portions of the proposed rule change and Amendment Nos. 1 and 2 relating to the automatic execution of eligible orders at the NBBO, provided that the NBBO is not better than the specialist's best bid or offer ("BBO") by a predetermined "step-up parameter." Amendment Nos. 4, 5, 6, and 7, were published for comment in the **Federal Register** on April 15, 2002.¹⁰ The Commission received no comments on Amendment Nos. 4, 5, 6, and 7. This order approves that portion of the proposed rule change not previously granted accelerated approval, as amended by Amendment Nos. 4, 5, 6, and 7.

II. Description of the Proposal

In the Original Filing, the Phlx proposed an enhancement to AUTO-X, the automatic execution feature of the Exchange's Automated Options Market ("AUTOM") System, that would allow AUTO-X eligible orders to be automatically executed at the NBBO, provided that the NBBO is not better than the specialist's BBO by a predetermined "step-up parameter."¹¹ This enhancement is known as the "NBBO Step-Up Feature." The Commission granted accelerated approval to this part of the Original Filing. In addition, in the Original Filing, the Phlx proposed to permit the Chairman of the Options Committee or his designee (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials) to determine that, if the NBBO Step-Up Feature was activated and quotes in certain automatic step-up options on the Exchange or other markets were deemed not to be reliable, such unreliable quotes would be excluded from the calculation of NBBO and customers would receive an automatic execution at NBBO based

⁹ See Securities Exchange Act Release No. 43684 (December 6, 2000), 65 FR 78237 (December 14, 2000) ("Original Filing"). The Commission received one comment letter on the Original Filing. See letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, Inc. ("CBOE"), to Mr. Jonathan G. Katz, Secretary, Commission, dated February 8, 2001. In its comment letter, CBOE recommended that the Phlx amend its rule to require the Exchange to make and keep a written record of decisions to remove an exchange from the Phlx's calculation of the National Best Bid or Offer ("NBBO") and to notify an exchange when its markets have been removed from the Phlx's NBBO calculation. In response to CBOE's comments, Phlx proposed Amendment Nos. 5 and 6.

¹⁰ See Securities Exchange Act Release No. 45757 (April 9, 2002), 67 FR 19605 (April 15, 2002).

¹¹ For a full discussion of Phlx's proposal, see the Original Filing.

on the remaining markets whose quotes were not deemed to be unreliable. The Original Filing proposed that quotes would be determined to be unreliable due to Exchange communications or systems problems; fast markets; delays in the dissemination of quotes because of queues on the Options Price Reporting Authority ("OPRA") which would likely render such quotes stale; or if the Exchange is advised by another exchange that it is experiencing communication or system problems that would cause its disseminated quotes to be unreliable. The Commission did not approve this part of the Original Filing and the Phlx subsequently filed Amendment Nos. 3, 4, 5, 6, and 7 with the Commission.¹²

In Amendment No. 4, the Phlx proposed to limit the factors that the Chairman of the Options Committee or his designee¹³ (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials), may rely upon to determine that quotes in options on the Exchange or another market or markets are unreliable.¹⁴ Such determination could be made by way of notification from another market that its quotes are not firm or are unreliable; administrative message from the Option Price Reporting Authority ("OPRA") indicating that another market's quotes are unreliable; quotes received from another market designated as "not firm" using the appropriate indicator; and/or telephonic or electronic inquiry to, and verification from, another market that its quotes are not firm.¹⁵ In addition, AUTOM customers would be duly notified via electronic message from AUTOM that such quotes are excluded from the calculation of NBBO.¹⁶

Further, where the Chairman of the Options Committee or his designee (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials), determines that responsible brokers or dealers on the Exchange or another market or markets previously relieved of their obligations under the

Commission's Quote Rule¹⁷ are no longer subject to such relief, the quotations of such responsible broker or dealer would be included in the calculation of the NBBO for such options. Such determination would be permitted to be made by way of notification from another market that its quotes are firm; administrative message from OPRA indicating that another market's quotes are no longer unreliable; and/or telephonic or electronic inquiry to, and verification from, another market that its quotes are firm.¹⁸ AUTOM customers would be duly notified via electronic message from AUTOM that such quotes are again included in the calculation of NBBO.¹⁹

In Amendment No. 5, the Exchange: (1) Clarified that pursuant to the proposed rule change it would be permitted to determine to exclude quotes from its calculation of the NBBO on a series-by-series basis or class-by-class basis, or to determine to exclude all options quotes from an exchange, where appropriate; (2) represented that it maintains, on a daily basis, records of each instance in which it determines to exclude quotes from another exchange from the Exchange's calculation of the NBBO on a daily basis; and (3) stated that it would notify other exchanges of the determination to exclude its quotes from the Exchange's calculation of the NBBO and of any determination to re-include such exchange's quotes in the Exchange's calculation of the NBBO.²⁰

In Amendment No. 6, the Phlx proposed to require the Exchange to maintain a record of each instance in which another exchange's quotes are excluded from the Exchange's calculation of the NBBO, and to notify such other exchange that its quotes have been so excluded.²¹

In Amendment No. 7, the Phlx proposed to amend the rule text to provide that documentation of each instance in which another exchange's quotes are excluded from the Exchange's calculation of NBBO would include: identification of the option(s) affected by such action; the date and time such action was taken and concluded; identification of the other exchange(s) whose quotes were excluded from the Exchange's calculation of NBBO; identification of the Chairman of the Options Committee, his designee, or two Floor Officials (as

applicable) who approved such action; the reasons for which such action was taken; and identification of the specialist and the specialist unit. The Exchange would maintain these documents pursuant to the record retention requirements of the Act and the rules and regulations thereunder.²²

III. Discussion

After careful review, the Commission finds that the portion of the proposed rule change not previously granted accelerated approval, as amended by Amendment Nos. 4, 5, 6, and 7, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange²³ and, in particular, the requirements of Section 6 of the Act²⁴ and the rules and regulations thereunder. The Commission finds specifically that the proposed rule change is consistent with Section 6(b)(5) of the Act²⁵ because it provides objective criteria and well-defined procedures for excluding another market's quote from the Phlx's determination of the NBBO, which should increase the likelihood that Phlx's NBBO will more accurately reflect the actual state of the market at a given time. Specifically, the Commission notes that the determination of the Chairman of the Options Committee or his designee (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials) to exclude unreliable quotes is limited to circumstances in which the away market has either directly communicated or confirmed that its quotes are unreliable. In this way, the discretion afforded to Phlx officials to determine that another market's options quotes are unreliable is appropriately limited. Moreover, the record keeping requirements and other proposed procedures are not unreasonable.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁶ that the portion of the proposed rule change not previously granted accelerated approval (SR-Phlx-00-93), as amended by Amendment Nos. 4, 5, 6, and 7, is approved.

²² See Amendment No. 7, *supra* note 6.

²³ In approving this proposed rule change, the Commission notes that it has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁴ 15 U.S.C. 78f.

²⁵ 15 U.S.C. 78f(b)(5).

²⁶ *Id.*

¹² This proposal would apply to all situations in which the NBBO Step-Up Feature was engaged. The Commission, in a separate order, is approving a related proposed rule change regarding the exclusion of certain quotes from the Phlx's calculation of the NBBO when the NBBO Step-Up Feature is not engaged. See Securities Exchange Act Release No. 45931 (May 15, 2002) (File No. SR-Phlx-2001-35).

¹³ Such designee must be a member of the Options Committee.

¹⁴ See Amendment No. 4, *supra* note 3.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Rule 11Ac1-1 under the Act, 17 CFR 240.11Ac1-1.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ See Amendment No. 5, *supra* note 4.

²¹ See Amendment No. 6, *supra* note 5.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁷

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45927; File No. SR-Phlx-2001-24]

Self-Regulatory Organizations; Order Granting Approval of a Proposed Rule Change and Amendment No. 4 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to the Manual Handling of Certain AUTOM Orders by Specialists

May 15, 2002.

On March 2, 2001, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² relating to the manual handling of certain Exchange Automated Options Market ("AUTOM") orders by Exchange specialists.³ The Phlx filed Amendment

Nos. 1,⁴ 2,⁵ 3,⁶ and 4⁷ to the proposed rule change, respectively. The proposed rule change, as amended, was published for public comment in the **Federal Register** on February 20, 2002.⁸ The Commission received no comments on the proposal. On May 15, 2002, the Phlx filed Amendment No. 5 to the proposed rule change.⁹ This order approves the proposed rule change, as amended.

I. Description of the Proposal

The Phlx proposes to adopt Phlx Rule 1080(c)(iv) to codify that an options order otherwise eligible for the Exchange's Automated Execution System ("AUTO-X") will instead be manually handled by the specialist in

⁴ See Letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated April 12, 2001 ("Amendment No. 1"). Amendment No. 1 designates the proposed rule change as filed pursuant Section 19(b)(2) of the Act, and the Exchange requests that the proposed rule change is given accelerated effectiveness. 15 U.S.C. 78s(b)(2).

⁵ See Letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated July 2, 2001 ("Amendment No. 2"). Amendment No. 2 corrects technical errors to the proposed rule text.

⁶ See Letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated August 7, 2001 ("Amendment No. 3"). Amendment No. 3 updates the proposed rule text that refers to a pilot program that permits the Exchange to automatically execute option contracts within a 15 second period. In addition, Amendment No. 3 corrects technical errors to the proposed rule text.

⁷ See Letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated December 10, 2001 ("Amendment No. 4"). Amendment No. 4 replaces the original filing in its entirety and modifies earlier revisions by: (1) Clarifying the calculation of a zero bid by the Exchange's Autoquote System; (2) clarifying the Exchange's audit trail and other documentation in cases which AUTO-X is disengaged; (3) clarifying the authority of the Exchange's Options Committee to restrict the use of AUTO-X on the Exchange; and (4) updating the proposed rule text that refers to the pilot program that permits the Exchange to automatically execute option contracts within a 15 second period.

⁸ See Securities Exchange Act Release No. 45436 (February 12, 2002), 67 FR 7728.

⁹ See Letter from Richard S. Rudolph, Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division, Commission, dated May 14, 2002 ("Amendment No. 5"). Amendment No. 5: (1) Deletes references in the purpose section of the proposed rule change regarding the AUTO-X Disengagement Log, which does not apply to the nine codified circumstances under which an incoming order would be manually handled by an Exchange specialist; (2) amends proposed rule text to provide that any restriction by the Options Committee on the use of Auto-X will be clearly communicated to its membership and users of the Exchange's Automated Options Market ("AUTOM") via an electronic message and an information circular; and (3) amends the proposed rule text to provide that, to the extent one of the nine codified circumstances under proposed Phlx Rule 1080(c)(iv) occur, the Exchange's AUTO-X system has the ability to identify inbound orders that are not eligible for automatic execution.

certain circumstances. The Exchange also proposes to cross-reference Phlx Rule 1080(c)(i), "AUTO-X on the NBBO (NBBO Feature)," in cases in which AUTO-X will not execute at the Exchange's disseminated quotation.

Currently, Phlx Rule 1080 governs the operation of AUTOM and AUTO-X. AUTO-X is addressed primarily in Phlx Rule 1080(c), which provides that only certain order types are eligible for AUTO-X. Phlx Rule 1080(c) also provides that AUTO-X is a feature of AUTOM that automatically executes public customer market and marketable limit orders up to the number of contracts permitted by the Exchange for certain strike prices and expiration months in equity options and index options, unless the Options Committee determines otherwise.

According to the Phlx, AUTO-X automatically executes eligible orders using the Exchange disseminated quotation and then automatically routes execution reports to the originating member organization. In all other circumstances, AUTOM orders that are not eligible for AUTO-X would be executed manually in accordance with Exchange rules. Phlx Rule 1080 currently enumerates some of the situations where an order may not be automatically executed.

The Phlx proposes to codify nine additional situations in which an otherwise AUTO-X eligible order would not automatically execute. The first case is when the Exchange's disseminated market crosses or locks the disseminated market of another options exchange. Second, stop, stop limit, market on closing, market on opening, and all-or-none orders do not automatically execute because these orders consist of contingencies, such as price, time, or size that the AUTOM system cannot address. Third, pre-market orders received when the AUTOM system is not open for trading are not eligible for automatic execution. Fourth, when the disseminated market is produced during an opening or other rotation, incoming orders will not automatically execute.¹⁰ Fifth, when the specialist posts a bid or offer that is better than the specialist's own bid or offer, incoming orders will not automatically execute.¹¹ Sixth, because certain options are subject to the NBBO Feature, as described in Phlx Rule 1080(c)(i), when the NBBO Feature is

¹⁰ The Phlx notes that AUTO-X is engaged promptly after an option's opening, once there is an established price against which an automatic execution can occur.

¹¹ According to the Phlx, the bid or offer could represent a customer order or a price-improving bid or offer by a Registered Options Trader ("ROT").

²⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Exchange filed this proposed rule change pursuant to the requirements of Section IV.B.h.(i)(bb) of the Commission's September 11, 2000 Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Act, which required the Phlx (as well as the other floor-based options exchanges) to adopt new, or amend existing rules concerning automatic quotation and execution systems which specify the circumstances, if any, by which automated execution systems would be disengaged or operated in any manner other than the normal manner set forth in the exchange's rules; and, requires the documentation of the reasons for each decision to disengage an automatic execution system or operate it in any manner other than the normal manner. See Securities Exchange Act Release No. 43268 (September 11, 2000), Administrative Proceeding File No. 3-10282.