

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- 51126, File No. SR-Phlx-2004-90)

February 2, 2005

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

I. Introduction

On December 9, 2004, 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 a proposed rule change to establish a new category of options market-making participant on the Exchange, a Remote Streaming Quote Trader (“RSQT”). The Exchange also proposes to amend various Exchange rules to apply to and govern RSQTs. The proposed rule change was published for notice and comment in the Federal Register on December 27, 2004.³ No comment letters were received on the proposal. This order approves the proposed rule change.

II. Description of the Proposal

Under the proposal, an RSQT would be a Registered Options Trader (“ROT”) that is a member or a member organization with no physical trading floor presence who has received permission from the Exchange to generate and submit quotations electronically through the Exchange’s Automated Options Market System (“AUTOM”) in eligible options to which such RSQT has been assigned.⁴ An RSQT would be permitted to submit such quotations

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 50877 (December 17, 2004), 69 FR 77295.

⁴ AUTOM is the Exchange's electronic order delivery and reporting system, which provides for the automatic entry and routing of Exchange listed equity options and index options orders to the Exchange trading floor. See Phlx Rule 1080.

electronically only from off the floor of the Exchange.⁵ Also, an RSQT would be permitted to trade in a market-making capacity only in classes of options in which he is assigned.

A. Appointment of RSQTs

The Exchange's Options Allocation, Evaluation and Securities Committee ("OAESC") currently has the authority to appoint Streaming Quote Traders ("SQTs")⁶ under Phlx Rule 507 and to assign SQTs to one or more Streaming Quote Options.⁷ Under the proposal, the OAESC would appoint and assign RSQTs in one or more Streaming Quote Options in a fashion similar to the current practice of appointing and assigning SQTs in Streaming Quote Options. Phlx Rule 507, which sets forth the solicitation, application, and review process to be followed by the OAESC in appointing SQTs, would be modified to include RSQTs.

The current requirements for SQT applicants under Phlx Rule 507 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. 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 a written certification signed by an officer

⁵ Phlx 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 to submit electronic quotations only from off the floor of the Exchange. See proposed Phlx Rule 1014(b)(ii)(B).

⁶ An SQT is a ROT who has received permission from the Exchange to generate and submit option quotations electronically through AUTOM in eligible options to which such SQT is assigned. An SQT may submit such quotations only while such SQT is physically present on the floor of the Exchange. See Phlx Rule 1014(b)(ii)(A).

⁷ Streaming Quote Options are the specific issues in which SQTs may generate and submit option quotations from on the floor of the Exchange. See Phlx Rule 1080(k).

(Vice President or above) of the Exchange's Financial Automation Department⁸ 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 that the RSQT applicant has successfully completed, or is scheduled to complete, testing of its quoting system with the Exchange.

Phlx also proposes to approve and appoint RSQTs who demonstrate additional qualifications. Specifically, an RSQT applicant would be required to demonstrate 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 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.

The Exchange represents that any future changes to, or termination of, order flow commitments would not be used by the Exchange to terminate, or take remedial action against, an RSQT. Further, the Exchange would not take remedial action against an RSQT solely because orders subject to any such commitments were not subsequently routed to the Exchange. The Exchange also represents that the final factor listed above would not be applied in any way

⁸ 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.

to restrict, either directly or indirectly, RSQTs' activities as market makers or specialists on other exchanges or to restrict how RSQTs handle orders to which they owe a duty of best execution.

Finally, proposed amendments to Phlx Rule 1014 would prohibit any person who is either directly or indirectly affiliated with an RSQT from being a specialist, RSQT, SQT, or non-SQT ROT⁹ 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.

B. Limitations on Access Due to Systems Constraints

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 and subject to Commission approval or effectiveness pursuant to a filing under Section 19(b) of the Act, as amended.¹⁰ 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.

C. RSQT Obligations

Under the proposal, an RSQT would be required to quote continuous, two-sided markets in not less than 60% of the series in each Streaming Quote Option in which such RSQT is

⁹ A non-SQT ROT is a ROT who is neither an SQT nor an RSQT. See proposed Phlx Rule 1014(b)(ii)(C).

¹⁰ 15 U.S.C. 78s(b).

assigned.¹¹ An RSQT who receives Directed Orders (as defined in proposed Phlx Rule 1080(l)(i)(A)),¹² however, would be required to quote continuous, two-sided markets in not less than 100% of the series in each Streaming Quote Option in which such RSQT receive Directed Orders. Moreover, all RSQT quotations would be subject to the same minimum size requirement as that currently imposed on SQTs.

The proposal also would require an RSQT to maintain information barriers 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. Phlx further proposes to require that an RSQT comply with the requirements of Phlx Rule 1020 regarding restrictions on the flow of privileged information between the affiliate and the specialist organization.

D. Trade Allocation

Phlx Rule 1014(g)(vii) currently governs the allocation of trades executed in Streaming Quote Options traded on Phlx XL. Under the proposal, RSQTs would receive the same allocation under the algorithm described in the rule as SQTs. The proposal also provides that current rules applicable to out-of-crowd SQTs regarding participation in non-electronic orders traded in the crowd would apply to RSQTs. Specifically, an RSQT would not participate in a

¹¹ 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.

¹² See Securities Exchange Act Release No. 50856 (December 14, 2004) 69 FR 76817 (December 22, 2004) (notice of SR-Phlx-2004-91). The proposed provision regarding RSQTs who receive Directed Orders would have no relevance unless the separate proposal, that would create a Directed Order process, is approved by the Commission.

trade with a non-electronic order, unless the order is executed at the price quoted by the RSQT at the time of execution.

The proposal also would add a new definition of “Actual Size” to Phlx Rule 1014(g)(v)(B). A crowd participant’s Actual Size would be defined as the number of contracts on which the person responsible for allocating the trade bases allocation of the order among crowd participants on parity. Specifically, for orders handled manually by the specialist, if at the time of the execution of an order in a particular series a specialist, SQT, or RSQT is disseminating an electronic quotation at the Exchange’s disseminated price in that series, such specialist, SQT, or RSQT’s disseminated size would be his or her Actual Size. 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, or RSQT are deemed a crowd participant for purposes of this definition.

E. Elimination of "SQT Zones"

Commentary .05(b) to Phlx Rule 1014 provides that an SQT may be assigned to, and submit quotes electronically in, all of the options located within a specified physical zone on the Exchange Options Floor (“SQT Zone”). Because the entire Exchange floor is currently considered one SQT Zone, Phlx proposes to delete this provision. The elimination of this provision would allow SQTs and RSQTs to stream electronic quotations floor-wide.

F. Book Sweep

Phlx Rule 1080(c)(iii)(B) governs a feature of AUTOM known as "Book Sweep" as it relates to Streaming Quote Options traded on Phlx XL. When a specialist or an SQT has

engaged Book Sweep and such 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's or SQT's quotation.¹³ Phlx proposes that an RSQT quotation would also initiate Book Sweep. Under the proposal, an RSQT also would be permitted to manually initiate Book Sweep by sending a manual quote in situations where the RSQT's automatic generation of electronic quotations is suspended due to, for example, a system malfunction.

G. Book Match

Book Match is a feature of AUTOM that currently provides automatic executions for inbound AUTOM-delivered customer and off-floor broker-dealer¹⁴ 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. Under the proposal, the contra-side to an inbound eligible order could also be an RSQT electronic quote.

H. Firm Quotations

The Exchange proposes to amend Phlx Rule 1082 in a number of ways to capture the firm quote requirements applicable to RSQTs. Phlx also proposes to clarify that if the

¹³ 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.

¹⁴ Phlx 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.

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 his or her quotation immediately following the exhaustion of the Exchange's disseminated size at such price level, the Exchange would automatically disseminate the specialist's most recent disseminated price prior to the time of such exhaustion with a size of one contract.

I. Additional Amendments

Finally, the proposal amends Phlx's rules to clarify the obligations that would apply to RSQTs. 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 Phlx Rule 1014 and commentaries thereto to clarify the obligations that would apply to RSQTs. Moreover, the Exchange proposes to amend certain Exchange Option Floor Procedure Advices to make them applicable to RSQTs. Likewise, the Exchange proposes to amend Phlx Rule 1017 to permit RSQTs to participate in opening transactions by submitting electronic quotations to interact with opening orders. Lastly, the Exchange would amend Phlx Rule 1080, Commentary .01(b)(ii) to clarify that the specialist determines which options pricing model to select per option in non-Streaming Quote Options only.

III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange¹⁵ and, in particular, the requirements of Section 6 of the Act.¹⁶ Specifically, the Commission finds that the proposal to add a new category of options market-making

¹⁵ The Commission has considered the amended proposed rule change's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁶ 15 U.S.C. 78f.

participant, RSQT, to the Phlx XL trading platform is consistent with Section 6(b)(5) of the Act¹⁷ in that the proposal has been designed to promote just and equitable principles of trade, and to protect investors and the public interest.

A. Appointment of RSQTs

RSQTs must meet the current requirements applicable for SQT applicants for assignment in Streaming Quote Options. The Commission believes that these requirements are consistent with the Act.

In addition, although RSQTs are expected to demonstrate additional qualifications, including 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, the Commission emphasizes that Phlx should not interpret this proposed obligation to in any way directly or indirectly restrict a market participant that is appointed as an RSQT on Phlx from performing market-making or specialist activities on other markets.

Under the proposal, RSQTs are also expected to demonstrate the existence of order flow commitments. The Commission notes, however, that any future change to, or termination of, order flow commitments may not be used by the Exchange to terminate, or take remedial action against, an RSQT. Also, the Exchange would not be permitted to take remedial action against an RSQT solely because orders subject to any such commitments were not subsequently routed to the Exchange.

Finally, Phlx rules prohibit any person who is either directly or indirectly affiliated with an RSQT from being a specialist, RSQT, SQT, or non-SQT ROT in options in which such

¹⁷ 15 U.S.C. 78f(b)(5).

affiliated RSQT is assigned. The Commission believes this prohibition is important because of the potential for allocations of trades to be based, in part, on a Phlx XL Participant's quote or order at the best bid or offer, not based on the size of such Participant's quote or order.¹⁸

B. Limitations on Access Due to Systems Constraints

In addition, the Commission notes that proposed amendments to Phlx Rule 507(b)(iii), which would allow the Exchange's Board of Governors to defer qualifying applications for RSQT status based on systems constraints, capacity restrictions, or other relevant factors, grant the Exchange no authority at this time. Specifically, the proposed amendments to Phlx Rule 507(b)(iii) would not permit Phlx to place any limitations on its members under this rule, unless such limitations were objectively established and filed with the Commission under Section 19(b) of the Act.¹⁹

C. RSQT Obligations

Proposed Phlx Rule 1014 sets forth the obligations that an RSQT would be required to fulfill. Specifically, an RSQT would be required 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. The Commission believes that these obligations for RSQTs are consistent with the Act. In particular, the Commission believes that RSQTs' affirmative obligations are sufficient to justify the benefits they receive as market makers.²⁰ In this regard, the Commission believes that Phlx rules impose such affirmative obligations on RSQTs.

¹⁸ See Securities Exchange Act Release No. 50788 (December 3, 2004), 69 FR 71860 (December 10, 2004) (SR-Phlx-2004-57).

¹⁹ 15 U.S.C. 78s(b).

²⁰ For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve if the credit is to be used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange. See 12 CFR 221.5(c)(6).

Under the proposal, an RSQT also would be obligated 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 that act as a specialist or market maker in any security underlying options assigned to the RSQT. The Commission believes that the requirement that there be an information barrier between an RSQT and its affiliates should reduce the opportunity for unfair trading advantages and misuse of material, non-public information.

D. Trade Allocation

The Commission believes that the trade allocation algorithm that would apply to RSQTs is consistent with the Act. The Commission believes that treating RSQTs and SQTs the same under Phlx Rule 1014(g)(vii) should encourage RSQTs to quote competitively.

E. Book Sweep and Book Match

The Commission notes that Phlx proposes to include RSQT quotes in the Exchange's Book Sweep and Book Match features. The Commission believes that including RSQT quotes in Book Match, and allowing RSQT quotes to initiate Book Sweep, should result in customers receiving quicker, more efficient executions of trades.

F. Firm Quotations

The Commission believes that the proposed amendments to the Exchange's Firm Quote requirements are consistent with the Act. The Commission notes that, among other things, the proposal clarifies that the Exchange will automatically disseminate a quotation if the 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 its quotation immediately following the exhaustion. The Commission believes that this clarification more accurately

describes the size for which the specialist is firm when the disseminated size in a particular series has been exhausted.

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5) of the Act.²¹

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²² that the proposed rule change (SR-Phlx-2004-90) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²³

Margaret H. McFarland
Deputy Secretary

²¹ 15 U.S.C. 78f(b)(5).

²² 15 U.S.C. 78s(b)(2).

²³ 17 CFR 200.30-3(a)(12).