Proposed Rule Change by Philadelphia Stock Exchange
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

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<th>Initial</th>
<th>Amendment</th>
<th>Withdrawal</th>
<th>Section 19(b)(2)</th>
<th>Section 19(b)(3)(A)</th>
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Pilot: Extension of Time Period for Commission Action

Date Expires

Exhibit 2 Sent As Paper Document

Exhibit 3 Sent As Paper Document

**Description**

Provide a brief description of the proposed rule change (limit 250 characters).

Proposed rule change relating to the Exchange's Obvious Error rule.

**Contact Information**

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name: Richard

Last Name: Rudolph

Title: Vice President and Counsel

E-mail: Richard.Rudolph@phlx.com

Telephone: (215) 496-5074

Fax: (215) 496-6729

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date: 11/11/2005

By Richard S. Rudolph

Vice President and Counsel

(Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.
| Exhibit 1 - Notice of Proposed Rule Change | The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3) |

| Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications | Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G. |

| Exhibit 3 - Form, Report, or Questionnaire | Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change. |

| Exhibit 4 - Marked Copies | The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working. |

| Exhibit 5 - Proposed Rule Text | The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change. |

| Partial Amendment | If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission’s permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions. |
1. **Text of the Proposed Rule Change**

The Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")\(^1\) and Rule 19b-4 thereunder,\(^2\) proposes to amend Exchange Rule 1092, Obvious Errors. The proposed amendments to Rule 1092 would: (1) change the definition of “obvious error” to mean a transaction that occurs at an execution price that differs from the Theoretical Price by at least the maximum allowable bid/ask differential; (2) change the definition of “Theoretical Price” for purposes of determining whether an execution price constitutes an “obvious error;” and (3) clarify when a transaction may be nullified due to an erroneous quote in the underlying security.

A notice of the proposed rule change for publication in the Federal Register is attached hereto as Exhibit 1. The text of the proposed rule change is set forth below. Brackets indicate deletions; underlining indicates new text.

**Obvious Errors**

**Rule 1092.** The Exchange shall either nullify a transaction or adjust the execution price of a transaction that results in an Obvious Error as provided in this Rule.

(a) Definition of Obvious Error. For purposes of this Rule only, an Obvious Error will be deemed to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for a series by an amount equal to at least the amount shown below:

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</tr>
<tr>
<td>Above $10 to $20</td>
<td>$.80</td>
</tr>
<tr>
<td>Above $20</td>
<td>$1.00</td>
</tr>
</tbody>
</table>

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(i) If the Theoretical Price of the option is less than $3.00:

   (A) during regular market conditions (including rotations), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount of 35 cents or more; or,

   (B) during unusual market conditions (i.e., the Exchange has declared an unusual market condition status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount of 50 cents or more.

(ii) If the Theoretical Price of the option is $3.00 or more:

   (A) during regular market conditions (including rotations), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least two times the maximum bid/ask spread allowed for the series, so long as such amount is 50 cents or more; or

   (B) during unusual market conditions (i.e., the Exchange has declared an unusual market condition status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least three times the maximum bid/ask spread allowed for the series, so long as such amount is 50 cents or more.

(b) Definition of Theoretical Price. For purposes of this Rule only, the Theoretical Price of an option is:

   (i) if the series is traded on at least one other options exchange, the mid-point of the National Best Bid and Offer (“NBBO”), just prior to the transaction [on the exchange that has the most total volume in that option over the most recent 60 calendar days]; or

   (ii) if there are no quotes for comparison purposes, as determined by two Floor Officials and designated personnel in the Exchange’s Market Surveillance Department.

(c) Absent Mutual Agreement as provided in Rule 1092(c)(iii) below, parties to a trade may have a trade nullified or its price adjusted if:

   (i) No change.

   (ii) one of the conditions below is met:

       (A) – (B) No change.

       (C) The trade resulted from
(1) an erroneous print disseminated by the underlying market which is later cancelled or corrected by the underlying market. In order to be adjusted or nullified, however, the trade must be the result of an erroneous print that is higher or lower than the average trade in the underlying security during a two-minute period before and after the erroneous print by an amount at least five times greater than the average quote width for such underlying security during the same period (where such erroneous print resulted in a trade higher or lower than the average trade in the underlying security during the time period encompassing two minutes before and after the erroneous print, by an amount at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the erroneous print. For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question)); or

(2) an erroneous quote in the underlying security. An erroneous quote occurs when the underlying security has a width of at least $1.00 and has a width at least five times greater than the average quote width for such underlying security on the primary market during the time period encompassing two minutes before and after the dissemination of such quote. If the primary market for the underlying security is closed during the four minute time period, an erroneous quote shall be determined by measuring the average quote width of the National Best Bid or Offer in the underlying market other than the primary market.

For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question). For purposes of this Rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question).

(D) RESERVED. (The trade resulted from an erroneous quote in the Primary Market for the underlying security that has a width of at least $1.00 and that width is at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the dissemination of such quote. For the purposes of this rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute
time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question); ]

(E) - (G) No change.

(iii) No change.

(d) - (f) No change.

Commentary:

.01 No change.

.02 [ The Theoretical Price will be determined under paragraph (b)(i) of this Rule as follows: (i) the bid price from the exchange providing the most total volume in the option over the most recent 60 calendar days will be used with respect to an erroneous bid price entered on the Exchange, and (ii) the offer price from the exchange providing the most total volume in the option over the most recent 60 calendar days will be used with respect to an erroneous offer price entered on the Exchange.

.03 ] The price to which a transaction is adjusted under paragraph (c)(ii) of this Rule will be determined as follows: (i) the bid price from the exchange disseminating the National Best Bid for the series at the time of the transaction that was the result of an obvious error will be used with respect to an erroneous offer price entered on the Exchange, and (ii) the offer price from the exchange disseminating the National Best Offer for the series at the time of the transaction that was the result of an obvious error will be used with respect to an erroneous bid price entered on the Exchange. If there are no quotes for comparison purposes, the adjustment price will be determined by two Floor Officials and Market Surveillance.

2. Procedures of the Self-Regulatory Organization

The Exchange’s Executive Committee, pursuant to delegated authority, approved the proposal for filing with the Securities and Exchange Commission (“SEC” or “Commission”) on November 10, 2005.

Questions and comments on the proposed rule change may be directed to Richard S. Rudolph, Vice President and Counsel, at (215) 496- 5074, or Edith Hallahan, Senior Vice President and Deputy General Counsel, at (215) 496-5179.
3. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis
   for, the Proposed Rule Change

   a. Purpose

   The purpose of the proposed rule change is to modernize the Exchange’s Obvious Error rule so that it addresses issues raised by the increasingly electronic options marketplace.

   Definition of Obvious Error

   Currently, Exchange Rule 1092(a) defines “obvious error” as the execution price of a transaction that is higher or lower than the Theoretical Price (if the Theoretical Price is less than $3.00) for the series by an amount of 35 cents or more; or, during unusual market conditions (i.e., the Exchange has declared an unusual market condition status for the option in question), by an amount of 50 cents or more. Where the Theoretical Price is $3.00 or more, “obvious error” is defined as the execution price of a transaction that is higher or lower than the Theoretical Price for the series by an amount equal to at least two times the allowable maximum bid/ask spread for the series, so long as the amount is 50 cents or more, and three times the allowable bid/ask spread during unusual market conditions.

   The proposed rule change would re-define “obvious error” by deeming an “obvious error” to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for a series by an amount equal to at least the amount shown below:

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The Exchange believes that the proposed new definition of “obvious error” will facilitate the efficient determination by Floor Officials as to whether a trade resulted from an obvious error by setting minimum amounts by which the transaction price differs from the Theoretical Price without requiring such Floor Officials to conduct an inquiry into the volume of all exchanges each time they review a transaction under the rule. The proposed definition of “obvious error” would apply during both normal and unusual market conditions, thus further streamlining the Floor Officials’ review process.

**Definition of Theoretical Price**

Currently, Rule 1092(b) defines “Theoretical Price” as the last bid or offer, just prior to the transaction, on the exchange that has the most total volume in that option over the most recent 60 calendar days; or if there are no quotes for comparison purposes, as determined by two Floor Officials and designated personnel in the Exchange's Market Surveillance Department.

The proposed rule change would define “Theoretical Price” as, respecting series traded on at least one other options exchange, the mid-point of the National Best Bid and Offer (“NBBO”) just prior to the transaction.

Currently, all options exchanges, including the Phlx, have rules permitting specialists and market makers to disseminate electronic quotations with a bid/ask differential of up to $5.00, regardless of the price of the bid. For the most part, such quotations do not reflect the NBBO. Under the current Exchange rule, the Theoretical Price, defined as the last bid or offer just prior to the transaction on the market with the

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3 See, e.g., Exchange Rule 1014(c)(i)(B).
highest volume, could differ from the NBBO by a significant amount if the bid/ask differential on such market in the series is $5.00 wide. In order to account for this potential discrepancy between the Theoretical Price as established by rule and the actual NBBO, the proposal would re-define the term “Theoretical Price” to mean the mid-point of the NBBO just prior to the transaction. This should provide Exchange Floor Officials with a more accurate measure of the price on which to base their determination that a transaction resulted from an obvious error, based on the actual NBBO instead of a quotation with a bid/ask differential of $5.00.

For consistency, the Exchange proposes to delete Commentary .02, which references the Theoretical Price as currently defined, from the rule.

Erroneous Print or Quote in the Underlying Security

The proposed rule change would also address the situation where a transaction may be nullified due to an erroneous print or an erroneous quote in the underlying security.

Erroneous Print

A trade would be nullified due to an erroneous print disseminated by the market for the underlying security that is later cancelled or corrected by that market. In order to be adjusted or nullified, however, the trade must be the result of an erroneous print that is higher or lower than the average trade in the underlying security during a two-minute period before and after the erroneous print by an amount at least five times greater than the average quote width for such underlying security during the same period. This is consistent with the current rule, and for ease of reference will be consolidated into proposed new Rule 1092(c)(ii)(C)(1).
**Erroneous Quote**

The proposal would clarify the situation in which a trade would be nullified due to an erroneous quote in the underlying security. An erroneous quote occurs when the underlying security has a width of at least $1.00 and has a width at least five times greater than the average quote width on the primary market for such underlying security during the time period encompassing two minutes before and after the dissemination of such quote. The proposed rule change would provide that, if the primary market for the underlying security is closed during the four minute time period, an erroneous quote shall be determined by measuring the average quote width of the National Best Bid or Offer in the underlying market other than the primary market. The purpose of this provision is to adopt an objective standard for the measurement of an erroneous quote in the underlying market when the primary market is closed.

Currently, Exchange Rule 1092(c)(ii)(D) permits a trade to be nullified or adjusted only when the erroneous quote is disseminated by the primary market for the underlying security. The instant proposal would eliminate the limitation in the rule that requires the erroneous quote to be disseminated by the primary market.

Exchange members and member organizations that engage in options market making use options pricing models that base the option price on, among other things, the price of the underlying security. In most cases the underlying security trades not only on

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4 The term “primary market” in respect of an underlying stock or Exchange-Traded Fund Share means the principal market in which the underlying stock or Exchange-Traded Fund Share is traded. See Exchange Rule 1000(b)(31).

5 The price of an option is not completely dependent on supply and demand. Exchange option specialists and Registered Options Traders (“ROTs”) use automated pricing models that price options based on the
the primary market but also on multiple exchanges and electronic communications networks (“ECNs”). Most options pricing models price options based in part on the best quotation disseminated by any market on which the underlying security trades. Therefore, an erroneous quotation disseminated by a market other than the primary market can, and often does, result in an obvious error in a transaction involving the overlying option. Additionally, because the primary market in the underlying security generally closes before the markets trading the overlying options, options pricing models base the price of the overlying option in part on the price of the underlying security on markets other than the primary market when the primary market for the underlying security is closed.

Because most of the securities underlying options trade on multiple exchanges and ECNs, an erroneous quote in the underlying security on any market for the underlying security could result in an obvious error in a transaction involving the overlying option. The Exchange believes that the limitation allowing the nullification or adjustment of a transaction due only to an erroneous quote on the primary market for the underlying security does not reflect the actual number of markets on which the underlying security is traded. The result of this limitation is to place customers and market makers at undue risk of obvious errors in options transactions that occur when an option pricing model bases the option price in part on an erroneous quote in a market other than the primary market for the underlying security. The Exchange therefore proposes to delete this limitation from the rule.

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price of the underlying security and on basic measures of risk as well. See Exchange Rule 1080, Commentary .01.
b. **Statutory Basis**

The Exchange believes that its proposal is consistent with Section 6(b) of the Act\(^6\) in general, and furthers the objectives of Section 6(b)(5) of the Act\(^7\) in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest, by establishing objective definitions of Theoretical Price and “obvious error” that address issues raised by the increasingly electronic options marketplace.

4. **Self-Regulatory Organization’s Statement on Burden on Competition**

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

5. **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.

6. **Extension of Time Period for Commission Action**

The Exchange does not consent to an extension of the time period for Commission action.

7. **Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**


\(^7\) 15 U.S.C. 78f(b)(5).
The Exchange requests accelerated approval in order to adopt rules that are currently in effect on other exchanges, as cited below.

8. **Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

   The proposed rule change is based, in part, on International Securities Exchange, Inc. (“ISE”) Rule 720\(^8\) and Chicago Board Options Exchange, Inc. (“CBOE”) Rule 6.25.\(^9\)

9. **Exhibits**

   1. Notice of proposed rule for publication in the *Federal Register*.

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Exhibit 1

SECURITIES AND EXCHANGE COMMISSION
(Release No.                  ; File No. SR-Phlx-2005-73)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the
Philadelphia Stock Exchange, Inc. Relating to the Exchange’s Obvious Error Rule

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)\(^1\), and
Rule 19b-4\(^2\) thereunder, notice is hereby given that on ______________________ 2005,
the Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) filed with the Securities
and Exchange Commission (“SEC” or “Commission”) the proposed rule change as
described in Items I, II, and III, below, which Items have been prepared by the 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

The Phlx, pursuant to Section 19(b)(1) and Rule 19b-4 thereunder,\(^3\) proposes to
amend Exchange Rule 1092, Obvious Errors. The proposed amendments to Rule 1092
would: (1) change the definition of “obvious error” to mean a transaction that occurs at
an execution price that differs from the Theoretical Price by at least the maximum
allowable bid/ask differential; (2) change the definition of “Theoretical Price” for
purposes of determining whether an execution price constitutes an “obvious error;” and
(3) clarify when a transaction may be nullified due to an erroneous quote in the
underlying security. The text of the proposed rule change is set forth below.


\(^3\) 17 CFR 240.19b-4.
Brackets indicate deletions; underlining indicates new text.

**Obvious Errors**

**Rule 1092.** The Exchange shall either nullify a transaction or adjust the execution price of a transaction that results in an Obvious Error as provided in this Rule.

(a) Definition of Obvious Error. For purposes of this Rule only, an Obvious Error will be deemed to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for a series by an amount equal to at least the amount shown below:

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[(i) If the Theoretical Price of the option is less than $3.00:

(A) during regular market conditions (including rotations), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount of 35 cents or more; or,

(B) during unusual market conditions (i.e., the Exchange has declared an unusual market condition status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount of 50 cents or more.

(ii) If the Theoretical Price of the option is $3.00 or more:

(A) during regular market conditions (including rotations), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least two times the maximum bid/ask spread allowed for the series, so long as such amount is 50 cents or more; or

(B) during unusual market conditions (i.e., the Exchange has declared an unusual market condition status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least three times the maximum bid/ask spread allowed for the series, so long as such amount is 50 cents or more.]

(b) Definition of Theoretical Price. For purposes of this Rule only, the [t] Theoretical Price of an option is:
(i) if the series is traded on at least one other options exchange, the [last bid or offer] mid-point of the National Best Bid and Offer ("NBBO"), just prior to the transaction [, on the exchange that has the most total volume in that option over the most recent 60 calendar days]; or

(ii) if there are no quotes for comparison purposes, as determined by two Floor Officials and designated personnel in the Exchange's Market Surveillance Department.

(c) Absent Mutual Agreement as provided in Rule 1092(c)(iii) below, parties to a trade may have a trade nullified or its price adjusted if:

   (i) No change.

   (ii) one of the conditions below is met:

      (A) – (B) No change.

      (C) The trade resulted from

      (1) an erroneous print disseminated by the underlying market which is later cancelled or corrected by the underlying market. In order to be adjusted or nullified, however, the trade must be the result of an erroneous print that is higher or lower than the average trade in the underlying security during a two-minute period before and after the erroneous print by an amount at least five times greater than the average quote width for such underlying security during the same period [where such erroneous print resulted in a trade higher or lower than the average trade in the underlying security during the time period encompassing two minutes before and after the erroneous print, by an amount at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the erroneous print. For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question)]; or

      (2) an erroneous quote in the underlying security. An erroneous quote occurs when the underlying security has a width of at least $1.00 and has a width at least five times greater than the average quote width for such underlying security on the primary market during the time period encompassing two minutes before and after the dissemination of such quote. If the primary market for the underlying security is closed during the four minute time period, an erroneous quote shall be determined by measuring the average quote width of the National Best Bid or Offer in the underlying market other than the primary market.
For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question). For purposes of this Rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question).

(D) RESERVED. [ The trade resulted from an erroneous quote in the Primary Market for the underlying security that has a width of at least $1.00 and that width is at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the dissemination of such quote. For the purposes of this rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question); ]

(E) - (G) No change.

(iii) No change.

(d) - (f) No change.

Commentary:

.01 No change.

.02 [ The Theoretical Price will be determined under paragraph (b)(i) of this Rule as follows: (i) the bid price from the exchange providing the most total volume in the option over the most recent 60 calendar days will be used with respect to an erroneous bid price entered on the Exchange, and (ii) the offer price from the exchange providing the most total volume in the option over the most recent 60 calendar days will be used with respect to an erroneous offer price entered on the Exchange.

.03 ] The price to which a transaction is adjusted under paragraph (c)(ii) of this Rule will be determined as follows: (i) the bid price from the exchange disseminating the National Best Bid for the series at the time of the transaction that was the result of an obvious error will be used with respect to an erroneous offer price entered on the Exchange, and (ii) the offer price from the exchange disseminating the National Best Offer for the series at the time of the transaction that was the result of an obvious error will be used with respect to an erroneous bid price entered on the Exchange. If there are no quotes for comparison
purposes, the adjustment price will be determined by two Floor Officials and Market Surveillance.

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

In its filing with the Commission, the Phlx included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The 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 modernize the Exchange’s Obvious Error rule so that it addresses issues raised by the increasingly electronic options marketplace.

Definition of Obvious Error

Currently, Exchange Rule 1092(a) defines “obvious error” as the execution price of a transaction that is higher or lower than the Theoretical Price (if the Theoretical Price is less than $3.00) for the series by an amount of 35 cents or more; or, during unusual market conditions (i.e., the Exchange has declared an unusual market condition status for the option in question), by an amount of 50 cents or more. Where the Theoretical Price is $3.00 or more, “obvious error” is defined as the execution price of a transaction that is higher or lower than the Theoretical Price for the series by an amount equal to at least two times the allowable maximum bid/ask spread for the series, so long as the amount is
50 cents or more, and three times the allowable bid/ask spread during unusual market conditions.

The proposed rule change would re-define “obvious error” by deeming an “obvious error” to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for a series by an amount equal to at least the amount shown below:

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</tbody>
</table>

The Exchange believes that the proposed new definition of “obvious error” will facilitate the efficient determination by Floor Officials as to whether a trade resulted from an obvious error by setting minimum amounts by which the transaction price differs from the Theoretical Price without requiring such Floor Officials to conduct an inquiry into the volume of all exchanges each time they review a transaction under the rule. The proposed definition of “obvious error” would apply during both normal and unusual market conditions, thus further streamlining the Floor Officials’ review process.

Definition of Theoretical Price

Currently, Rule 1092(b) defines “Theoretical Price” as the last bid or offer, just prior to the transaction, on the exchange that has the most total volume in that option over the most recent 60 calendar days; or if there are no quotes for comparison purposes, as determined by two Floor Officials and designated personnel in the Exchange's Market Surveillance Department.
The proposed rule change would define “Theoretical Price” as, respecting series traded on at least one other options exchange, the mid-point of the National Best Bid and Offer (“NBBO”) just prior to the transaction.

Currently, all options exchanges, including the Phlx, have rules permitting specialists and market makers to disseminate electronic quotations with a bid/ask differential of up to $5.00, regardless of the price of the bid.⁴ For the most part, such quotations do not reflect the NBBO. Under the current Exchange rule, the Theoretical Price, defined as the last bid or offer just prior to the transaction on the market with the highest volume, could differ from the NBBO by a significant amount if the bid/ask differential on such market in the series is $5.00 wide. In order to account for this potential discrepancy between the Theoretical Price as established by rule and the actual NBBO, the proposal would re-define the term “Theoretical Price” to mean the mid-point of the NBBO just prior to the transaction. This should provide Exchange Floor Officials with a more accurate measure of the price on which to base their determination that a transaction resulted from an obvious error, based on the actual NBBO instead of a quotation with a bid/ask differential of $5.00.

For consistency, the Exchange proposes to delete Commentary .02, which references the Theoretical Price as currently defined, from the rule.

Erroneous Print or Quote in the Underlying Security

The proposed rule change would also address the situation where a transaction may be nullified due to an erroneous print or an erroneous quote in the underlying security.

⁴ See, e.g., Exchange Rule 1014(c)(i)(B).
Erroneous Print

A trade would be nullified due to an erroneous print disseminated by the market for the underlying security that is later cancelled or corrected by that market. In order to be adjusted or nullified, however, the trade must be the result of an erroneous print that is higher or lower than the average trade in the underlying security during a two-minute period before and after the erroneous print by an amount at least five times greater than the average quote width for such underlying security during the same period. This is consistent with the current rule, and for ease of reference will be consolidated into proposed new Rule 1092(c)(ii)(C)(1).

Erroneous Quote

The proposal would clarify the situation in which a trade would be nullified due to an erroneous quote in the underlying security. An erroneous quote occurs when the underlying security has a width of at least $1.00 and has a width at least five times greater than the average quote width on the primary market for such underlying security during the time period encompassing two minutes before and after the dissemination of such quote. The proposed rule change would provide that, if the primary market for the underlying security is closed during the four minute time period, an erroneous quote shall be determined by measuring the average quote width of the National Best Bid or Offer in the underlying market other than the primary market. The purpose of this provision is to adopt an objective standard for the measurement of an erroneous quote in the underlying market when the primary market is closed.
Currently, Exchange Rule 1092(c)(ii)(D) permits a trade to be nullified or adjusted only when the erroneous quote is disseminated by the primary market\textsuperscript{5} for the underlying security. The instant proposal would eliminate the limitation in the rule that requires the erroneous quote to be disseminated by the primary market.

Exchange members and member organizations that engage in options market making use options pricing models that base the option price on, among other things, the price of the underlying security.\textsuperscript{6} In most cases the underlying security trades not only on the primary market but also on multiple exchanges and electronic communications networks (“ECNs”). Most options pricing models price options based in part on the best quotation disseminated by any market on which the underlying security trades. Therefore, an erroneous quotation disseminated by a market other than the primary market can, and often does, result in an obvious error in a transaction involving the overlying option. Additionally, because the primary market in the underlying security generally closes before the markets trading the overlying options, options pricing models base the price of the overlying option in part on the price of the underlying security on markets other than the primary market when the primary market for the underlying security is closed.

Because most of the securities underlying options trade on multiple exchanges and ECNs, an erroneous quote in the underlying security on any market for the

\footnotesize{\textsuperscript{5} The term “primary market” in respect of an underlying stock or Exchange-Traded Fund Share means the principal market in which the underlying stock or Exchange-Traded Fund Share is traded. \textit{See} Exchange Rule 1000(b)(31).}

\footnotesize{\textsuperscript{6} The price of an option is not completely dependent on supply and demand. Exchange option specialists and Registered Options Traders (“ROTs”) use automated pricing models that price options based on the price of the underlying security and on basic measures of risk as well. \textit{See} Exchange Rule 1080, Commentary .01.}
underlying security could result in an obvious error in a transaction involving the
overlying option. The Exchange believes that the limitation allowing the nullification or
adjustment of a transaction due only to an erroneous quote on the primary market for the
underlying security does not reflect the actual number of markets on which the
underlying security is traded. The result of this limitation is to place customers and
market makers at undue risk of obvious errors in options transactions that occur when an
option pricing model bases the option price in part on an erroneous quote in a market
other than the primary market for the underlying security. The Exchange therefore
proposes to delete this limitation from the rule.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act\textsuperscript{7} in
general, and furthers the objectives of Section 6(b)(5) of the Act\textsuperscript{8} in particular, in that it
is designed to promote just and equitable principles of trade, to remove impediments to and
perfect the mechanism of a free and open market and a national market system, and, in
general, to protect investors and the public interest, by establishing objective definitions of
Theoretical Price and “obvious error” that address issues raised by the increasingly
electronic options marketplace.

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

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

\textsuperscript{7} 15 U.S.C. 78f(b).

\textsuperscript{8} 15 U.S.C. 78f(b)(5).
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.

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

The Exchange requests accelerated approval in order to adopt rules that are currently in effect on other exchanges.

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. Please include File Number SR-Phlx-2005-73 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-2005-73. 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 the 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-2005-73 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. 9

Margaret H. McFarland
Deputy Secretary

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