Proposed Rule Change by Philadelphia Stock Exchange

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial Amendment Withdrawal

Section 19(b)(2)  ✓  Section 19(b)(3)(A)  Section 19(b)(3)(B)

Rule

Pilot Extension of Time Period for Commission Action Date Expires

19b-4(f)(5)  19b-4(f)(6)

Description

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

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 11/22/2006

By Richard S. Rudolph Vice President and Counsel

Name

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.

Richard Rudolph,
The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

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).

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.

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.

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.

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 various Exchange rules in order to establish a six-month pilot period beginning on January 26, 2007 (the “pilot”), during which certain options would be quoted and traded on the Exchange in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying the Nasdaq-100 Index Tracking Stock (“QQQQ”)\(^3\) would be quoted and traded in minimum increments of $0.01 for all series regardless of the price. A list of all such options would be communicated to membership via Exchange circular.

A notice of the proposed rule change for publication in the Federal Register is attached hereto as Exhibit 1. The text of the Exchange circular describing the proposed rule change, including a list of options included in the pilot is attached as Exhibit 2. The amended text of the proposed rule change indicating any additions to, or deletions from, the immediately preceding filing is attached hereto as Exhibit 4. The text of the proposed rule change is set forth below.

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\(^3\) The Nasdaq-100®, Nasdaq-100 Index®, Nasdaq®, The Nasdaq Stock Market®, Nasdaq-100 Shares℠, Nasdaq-100 Trust℠, Nasdaq-100 Index Tracking Stock℠, and QQQ℠ are trademarks or service marks of The Nasdaq Stock Market, Inc. ("Nasdaq") and have been licensed for use for certain purposes by the Philadelphia Stock Exchange pursuant to a License Agreement with Nasdaq. The Nasdaq-100 Index® (the Index) is determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 Trust℠, or the beneficial owners of Nasdaq-100 Shares℠. Nasdaq has complete control and sole discretion in determining, comprising, or calculating the Index or in modifying in any way its method for determining, comprising, or calculating the Index in the future.
Minimum Increments

Rule 1034. (a) Except as provided in sub-paragraph (i)(B) below, [A] all options on stocks, index options, and Exchange Traded Options quoting in decimals at $3.00 or higher shall have a minimum increment of $.10, and all options on stocks and index options quoting in decimals under $3.00 shall have a minimum increment of $.05.

(i) (A) However, the Board of Governors may establish different minimum trading increments. The Exchange will designate any such change as a stated policy, practice or interpretation with respect to the administration of Rule 1034, within the meaning of Section 19(b)(3)(A) of the Exchange Act and will file a proposed rule change with the Securities and Exchange Commission to be effective upon filing.

(B) For a six-month pilot period beginning on January 26, 2007 (the “pilot”), certain options shall be quoted and traded on the Exchange in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying the Nasdaq-100 Index Tracking Stock (“QQQQ”)® shall be quoted and traded in minimum increments of $0.01 for all series regardless of the price. A list of such options shall be communicated to membership via Exchange circular.

(C) On or before the last day of the fourth month of the pilot, the Exchange shall prepare and submit an analytical report to the Securities and Exchange Commission (“Commission”) that addresses the impact of the first three months of the pilot on the quality of the Exchange’s markets and option quote traffic and capacity.

(ii) – (iii) No change.

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

Rule 1080. (a) - (b) No change.

(c)*****

(i) - (iii) No change

(iv) Except as otherwise provided in this Rule, in the following circumstances, an order otherwise eligible for automatic execution will instead be manually handled by the specialist:
(A) RESERVED [when the Exchange’s disseminated market is crossed by more than one minimum trading increment (as defined in Exchange Rule 1034) (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange by more than one minimum trading increment];

(B) - (F) No change.

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(v) – (vi) No change.

(d) – (h) No change.

(i) Zero-bid option series. The AUTOM System will convert market orders to sell a particular option series to limit orders to sell with a limit price of [$.05] the minimum trading increment applicable to such series that are received when:

(A) – (B) No change.

(j) – (l) No change.

Commentary: No change.

Firm Quotations

Rule 1082. (a) Definitions.

(i) No change.

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

(A) Except as provided in sub-paragraph (a)(ii)(C)(3) below, [A] at least the sum of the size associated with limit orders, specialists’ quotations, SQTs’ quotations, and RSQTs’ (as defined in Rule 1014(b)(ii)(B)) quotations.

(B) (1) If an SQT or RSQT’s (other than a Directed SQT or RSQT) quotation size in a particular series in a Streaming Quote Option is exhausted or removed by the Risk Monitor Mechanism, such SQT or RSQT’s quotation shall be deleted from the Exchange’s disseminated quotation until the time the SQT or RSQT revises his/her quotation.

(2) If the Exchange’s disseminated size in a particular series in a Streaming Quote option is exhausted at that particular price level, and no specialist, SQT or RSQT has revised their quotation immediately following the exhaustion of the Exchange's disseminated size at such price level, the Exchange shall automatically provide two-sided quotes that
comply with the Exchange’s rules concerning quote spread parameters on behalf of the specialist until such time as the specialist revises the quotation, with a size of one contract.

(C) The Exchange shall disseminate an updated bid and offer price, together with the size associated with such bid and offer, when:

(1) the Exchange’s disseminated bid or offer price increases or decreases;

(2) the size associated with the Exchange’s disseminated bid or offer decreases; or

(3) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which shall never exceed 20%, shall be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular.

(iii) – (iv) No change.

(b) – (d) No change.

Commentary: No change.

Order Protection

Rule 1085. (a) No change.

(b) Exceptions to Trade-Through Liability. The provisions of paragraph (a) pertaining to the satisfaction of Trade-Throughs shall not apply under the following circumstances:

(1) – (9) No change.

(10) the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed [by not more than one minimum trading increment (as defined in Exchange Rule 1034)], or crosses the disseminated market of another options exchange [by not more than one minimum trading increment].

(c) – (d) No change.
F-7 Size of Exchange's Disseminated Bid or Offer

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

Except as provided below, [A] at least the sum of the size associated with limit orders, specialists' quotations, SQTs' quotations, and RSQTs' quotations.

The Exchange shall disseminate an updated bid and offer price, together with the size associated with such bid and offer, when:

(i) the Exchange’s disseminated bid or offer price increases or decreases;

(ii) The size associated with the Exchange’s disseminated bid or offer decreases;

or

(iii) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which shall never exceed 20%, shall be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular.

FINE SCHEDULE

Fine not applicable

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 13, 2006.

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 establish a six-month pilot program during which certain options would be quoted and traded in increments of $.01. The purpose of this Amendment No. 1, which replaces the previous filing in its entirety, is to clarify the Exchange’s handling of executions during crossed markets, and to include the above-mentioned Exchange circular as part of the proposal.

Scope of the Pilot

Proposed Rule 1034(a)(i)(B) would state that the pilot would begin on January 26, 2007, and would extend for a six-month period. There would be 13 options included in the pilot as determined by the Commission, subject to a rollout schedule to be determined. The rollout would begin January 26, 2007. The options included in the pilot are:

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Underlying Security</th>
</tr>
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<tbody>
<tr>
<td>IWM</td>
<td>Ishares Russell 2000</td>
</tr>
<tr>
<td>QQQQ</td>
<td>QQQQ</td>
</tr>
<tr>
<td>SMH</td>
<td>SemiConductor Holders</td>
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<td>GE</td>
<td>General Electric</td>
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<td>AMD</td>
<td>Advanced Micro Devices</td>
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<td>WFMI</td>
<td>Whole Foods</td>
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<td>TXN</td>
<td>Texas Instruments</td>
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<tr>
<td>A</td>
<td>Agilent Tech Inc.</td>
</tr>
</tbody>
</table>
Changes to Minimum Increments

The Exchange proposes to adopt Rule 1034(a)(i)(B), which would provide that the option included in the pilot would be quoted in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying QQQQ would be quoted and traded in minimum increments of $0.01 for all series regardless of the price. A list of all such options would be communicated to membership via Exchange circular.

Automatic Executions During Crossed Markets

The Exchange anticipates that the instance of crossed markets (where the bid price is greater than the offer price) will increase in options traded in penny increments. Accordingly, the Exchange proposes to amend its rules concerning automatic executions during crossed markets, and its exemption from Trade-Through liability when a Trade-Through occurs due to an automatic execution when the Exchange’s disseminated market is crossed, or crosses the disseminated market of another options exchange, and the Exchange’s disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the National Best Bid or Offer (“NBBO”).

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4 “Trade-Through” means a transaction in an options series at a price that is inferior to the National Best Bid or Offer (“NBBO”), but shall not include a transaction that occurs at a price that is one minimum quoting increment inferior to the NBBO provided a Linkage Order is contemporaneously sent to each Participant Exchange disseminating the NBBO for the full size of the Participant Exchange's bid (offer) that represents the NBBO. See Exchange Rule 1083(t).
Currently, orders on the Exchange that are otherwise eligible for automatic execution are handled manually by the specialist when the Exchange’s disseminated market is crossed by more than one minimum trading increment (as defined in Exchange Rule 1034) (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange by more than one minimum trading increment. The effect of this is that the Exchange currently provides automatic executions during crossed markets when the Exchange’s disseminated market is crossed by not more than one minimum trading increment, or crosses the disseminated market of another options exchange by not more than one minimum trading increment, and the Exchange’s disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the NBBO.

The Exchange proposes to delete Rule 1080(c)(iv)(A), which would thereby mean that the Exchange will provide automatic executions in options where the Exchange’s disseminated market is the NBBO and is crossed, or crosses the disseminated market of another options exchange, regardless of the amount by which such market is crossed.

Trade-Throughs

Currently, Exchange Rule 1085(b) affords Exchange members several exemptions from Trade-Through liability and the requirements under Exchange rules and the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage concerning

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5 See Exchange Rule 1080(c)(iv)(A).


7 The Exchange provides automatic executions only when its disseminated market is the NBBO. See Exchange Rule 1080(c)(iv)(E).

satisfaction of Trade-Throughs. Among the exemptions from such liability and satisfaction responsibility is current Exchange Rule 1085(b)(10), which provides an exemption when the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed by not more than one minimum trading increment (as defined in Exchange Rule 1034), or crosses the disseminated market of another options exchange by not more than one minimum trading increment.

In order to be consistent with the proposed rule change (described above) to provide automatic executions when the Exchange’s disseminated market is the NBBO regardless of the amount by which the market is crossed, the Exchange proposes to amend the rule to state that there would be an exemption from such liability and satisfaction responsibility when the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed, or crosses the disseminated market of another options exchange. The proposed rule change would delete the current language contained in Rule 1085(b)(10) that limits the exemption from Trade-Through and satisfaction liability to automatic executions at the NBBO during markets that are crossed by one minimum trading increment. The Exchange believes that the proposed rule change would facilitate the prompt resolution of crossed markets by permitting automatic executions when the Exchange’s disseminated market is crossed, or crosses the disseminated market of another options exchange, regardless of the amount by which the market is crossed.
Report to the Commission

Proposed Rule 1034(a)(i)(C) would require the Exchange to prepare and submit an analytical report (“report”) to the Commission that addresses the impact of the first three months of the pilot on the quality of the Exchange’s markets and option quote traffic and capacity on or before the last day of the fourth month of the pilot. The purpose of this provision is to comply with the Commission’s mandate that the Exchange submit such a report within the time frame specified in the rule.

Zero-Bid Option Series

Currently, Exchange Rule 1080(i) states that the Exchange’s AUTOM System will convert market orders to sell a particular option series to limit orders to sell with a limit price of $.05 that are received when the bid price for such series is zero. The proposal would amend Rule 1080(i) to state that the system will convert such orders to limit orders to sell with a limit price of the minimum trading increment applicable to such series. The effect of this respecting options quoted and traded in minimum increments of $0.01 would be that such conversion would be to a limit order to sell at $0.01, rather than $0.05.

Quote Mitigation

The Exchange recognizes that quoting and trading in $.01 increments will most assuredly result in a greater number of quotations submitted in options that are included in the pilot. Therefore, in order to mitigate quote traffic, the Exchange proposes to amend Rule 1082, Firm Quotations, by adopting new Rule 1082(a)(ii)(C), which would modify the Exchange’s definition of “disseminated size” such that the Exchange will disseminate fewer updated quotations.
Specifically, proposed Rule 1082(a)(ii)(C) would set forth the conditions under which the Exchange would disseminate updated quotations based on changes in the Exchange’s disseminated price and/or size. The proposed rule would require the Exchange to disseminate an updated bid and offer price, together with the size associated with such bid and offer, when: (1) the Exchange’s disseminated bid or offer price increases or decreases; (2) the size associated with the Exchange’s disseminated bid or offer decreases; or (3) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which would never exceed 20%, would be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular. The percentage size increase necessary to give rise to a refreshed quote may vary from issue to issue, depending, without limitation, on the liquidity, average volume, and average number of quotations submitted in the issue.

Proposed Rule 1080(b)(ii)(C) would not be limited to options included in the pilot, and would thus apply to all options traded on the Exchange.

The Exchange believes that the limitation on dissemination of quotations that increase in size by a nominal amount should significantly mitigate the amount of options quote traffic on the Exchange, and addresses issues of options quote capacity on the Exchange and in the National Market System.

In addition to the measures proposed above concerning mitigation of quote traffic on the Exchange, the Exchange has filed, or submitted to the Commission in draft, other proposed rule changes that the Exchange believes should reduce the number of quotations generated on the Exchange.
Specifically, the Commission recently approved a proposed rule change stating that, on a six-month pilot basis, Streaming Quote Traders (“SQTs”), Remote Streaming Quote Traders (“RSQTs”), and SQTs and RSQTs that receive Directed Orders (“DSQTs” and “DRSQTs” respectively) are deemed not to be assigned in any option series until the time to expiration for such series is less than nine months. Accordingly, the market making obligations described in Exchange Rule 1014(b)(ii)(D) do not apply to SQTs, RSQTs, DSQTs and DRSQTs respecting series with an expiration of nine months or greater, and thus they would be required to submit fewer quotes.

Additionally, the Exchange filed a proposed rule change authorizing the Exchange’s Options Allocation, Evaluation and Securities Committee (“OAESC”), to assign trading privileges in options to SQTs and RSQTs, by “root symbol,” as applied by the Options Clearing Corporation (“OCC”) such that an SQT or RSQT, on request, may

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9 An SQT is an Exchange Registered Options Trader (“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 only submit such quotations while such SQT is physically present on the floor of the Exchange. See Exchange Rule 1014(b)(ii)(A).

10 An RSQT is an ROT that is a member or member organization with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically through AUTOM in eligible options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. See Exchange Rule 1014(b)(ii)(B).

11 The term “Directed Order” means any customer order (other than a stop or stop-limit order as defined in Rule 1066) to buy or sell which has been directed to a particular specialist, RSQT, or SQT by an Order Flow Provider. See Exchange Rule 1080(l)(i)(A).


13 The OAESC is a standing committee of the Exchange that has jurisdiction over the allocation, retention and transfer of the privileges to deal in all options to, by and among members on the options and foreign currency options trading floors. It is responsible for appointing specialists, alternate or assistant specialists or odd-lot dealers on the options and foreign currency options trading floors. It also establishes standards for the periodic review and evaluation of their performance and is empowered to suspend or revoke their appointments upon showing of reasonable cause therefor. See Exchange By-Law Article X, Section 10-7(a). See also, Exchange Rule 500.
be assigned in only certain series of an option.\textsuperscript{14} The market making obligations applicable to SQTs and RSQTs thus would not apply to series in which an SQT or RSQT is not assigned, which should reduce the number of quotations required to be submitted.

The Exchange has also submitted a separate draft proposal to establish a maximum number of quoting participants that may be assigned to a particular equity option at any one time.\textsuperscript{15} This would limit the number of participants quoting in a particular equity option and thus should limit the number of quotations submitted in such equity options.

In another separate draft submission, the Exchange has proposed to establish monthly Performance Evaluations by the Exchange of its member organizations that have SQTs and RSQTs, to determine whether they have fulfilled performance standards relating to, among other things, quality of markets, efficient quote submission to the Exchange (including quotes submitted through a third party vendor), competition, observance of ethical standards, and administrative factors.\textsuperscript{16} Under that proposal, failure to meet established minimum performance requirements could result in restriction by the OAESC of additional options assignments; suspension, termination, or restriction of an existing assignment on one or more options; or suspension, termination, or restriction of an SQT’s or RSQT’s status as such. The Exchange believes that such evaluations and possible consequences for failure to meet specific minimum standards should encourage efficient quoting and use of the Exchange’s capacity and bandwidth by

\textsuperscript{14} See SR-Phlx-2006-53.

\textsuperscript{15} See SR-Phlx-2006-49.

\textsuperscript{16} See SR-Phlx-2006-51.
providing a disincentive for SQTs and RSQTs to submit quotations that do not improve
the Exchange’s disseminated price or materially increase the Exchange’s disseminated
size.

b. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the
Act\(^\text{17}\) in general, and furthers the objectives of Section 6(b)(5) of the Act\(^\text{18}\) 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
rules concerning the pilot while simultaneously mitigating quote traffic.

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.

\(^{17}\) 15 U.S.C. 78f(b).

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

Not applicable.

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 Chicago Board Options Exchange, Inc. (“CBOE”) Rule 6.13.¹⁹

9. **Exhibits**

   1. Notice of proposed rule for publication in the Federal Register.
   2. Text of the Exchange Circular describing the pilot.
   3. The amended text of the proposed rule change indicating any additions to or deletions from the immediately preceding filing.

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Exhibit 1

SECURITIES AND EXCHANGE COMMISSION
(Release No.      ; File No. SR-Phlx-2006-74)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to a Pilot Program to Quote and Trade Options in Penny Increments

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 ______________________ 2006, 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) of the Act 3 and Rule 19b-4 thereunder, 4 proposes to amend various Exchange rules in order to establish a six-month pilot period beginning on January 26, 2007 (the “pilot”), during which certain options would be quoted and traded on the Exchange in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying the

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Nasdaq-100 Index Tracking Stock (“QQQQ”)\(^5\) would be quoted and traded in minimum increments of $0.01 for all series regardless of the price. A list of all such options would be communicated to membership via Exchange circular. The text of the proposed rule change is set forth below.

Brackets indicate deletions; underlining indicates new text

**Minimum Increments**

**Rule 1034.** (a) Except as provided in sub-paragraph (i)(B) below, [A] all options on stocks, index options, and Exchange Traded Options quoting in decimals at $3.00 or higher shall have a minimum increment of $.10, and all options on stocks and index options quoting in decimals under $3.00 shall have a minimum increment of $.05.

(i) (A) However, the Board of Governors may establish different minimum trading increments. The Exchange will designate any such change as a stated policy, practice or interpretation with respect to the administration of Rule 1034, within the meaning of Section 19(b)(3)(A) of the Exchange Act and will file a proposed rule change with the Securities and Exchange Commission to be effective upon filing.

(B) For a six-month pilot period beginning on January 26, 2007 (the “pilot”), certain options shall be quoted and traded on the Exchange in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying the Nasdaq-100 Index Tracking Stock (“QQQQ”)\(^\circledR\) shall be quoted and traded in minimum increments of $0.01 for all series regardless of the price. A list of such options shall be communicated to membership via Exchange circular.

(C) On or before the last day of the fourth month of the pilot, the Exchange shall prepare and submit an analytical report to the Securities and Exchange Commission (“Commission”) that addresses the impact of the first three months of the pilot on the quality of the Exchange’s markets and option quote traffic and capacity.

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\(^5\) The Nasdaq-100®, Nasdaq-100 Index®, Nasdaq®, The Nasdaq Stock Market®, Nasdaq-100 Shares℠, Nasdaq-100 Trust℠, Nasdaq-100 Index Tracking Stock℠, and QQQ℠ are trademarks or service marks of The Nasdaq Stock Market, Inc. (Nasdaq) and have been licensed for use for certain purposes by the Philadelphia Stock Exchange pursuant to a License Agreement with Nasdaq. The Nasdaq-100 Index® (the Index) is determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 Trust℠, or the beneficial owners of Nasdaq-100 Shares℠. Nasdaq has complete control and sole discretion in determining, comprising, or calculating the Index or in modifying in any way its method for determining, comprising, or calculating the Index in the future.
(ii) – (iii) No change.

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

Rule 1080. (a) - (b) No change.

(c)*****

(i) - (iii) No change

(iv) Except as otherwise provided in this Rule, in the following circumstances, an order otherwise eligible for automatic execution will instead be manually handled by the specialist:

(A) RESERVED [when the Exchange’s disseminated market is crossed by more than one minimum trading increment (as defined in Exchange Rule 1034) (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange by more than one minimum trading increment];

(B) - (F) No change.

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(v) – (vi) No change.

(d) – (h) No change.

(i) Zero-bid option series. The AUTOM System will convert market orders to sell a particular option series to limit orders to sell with a limit price of [.05] the minimum trading increment applicable to such series that are received when:

(A) – (B) No change.

(j) – (l) No change.

Commentary: No change.

Firm Quotations

Rule 1082. (a) Definitions.

(i) No change.

(ii) The term “disseminated size” shall mean with respect to the disseminated price for any quoted options series:
(A) Except as provided in sub-paragraph (a)(ii)(C)(3) below, [A] at least the sum of the size associated with limit orders, specialists’ quotations, SQTs’ quotations, and RSQTs’ (as defined in Rule 1014(b)(ii)(B)) quotations.

(B) (1) If an SQT or RSQT’s (other than a Directed SQT or RSQT) quotation size in a particular series in a Streaming Quote Option is exhausted or removed by the Risk Monitor Mechanism, such SQT or RSQT’s quotation shall be deleted from the Exchange’s disseminated quotation until the time the SQT or RSQT revises his/her quotation.

(2) If the Exchange’s disseminated size in a particular series in a Streaming Quote option is exhausted at that particular price level, and no specialist, SQT or RSQT has revised their quotation immediately following the exhaustion of the Exchange's disseminated size at such price level, the Exchange shall automatically provide two-sided quotes that comply with the Exchange’s rules concerning quote spread parameters on behalf of the specialist until such time as the specialist revises the quotation, with a size of one contract.

(C) The Exchange shall disseminate an updated bid and offer price, together with the size associated with such bid and offer, when:

(1) the Exchange’s disseminated bid or offer price increases or decreases;

(2) the size associated with the Exchange’s disseminated bid or offer decreases; or

(3) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which shall never exceed 20%, shall be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular.

(iii) – (iv) No change.

(b) – (d) No change.

Commentary: No change.

Order Protection

Rule 1085. (a) No change.

(b) Exceptions to Trade-Through Liability. The provisions of paragraph (a) pertaining to the satisfaction of Trade-Throughs shall not apply under the following circumstances:
(1) – (9) No change.

(10) the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed [by not more than one minimum trading increment (as defined in Exchange Rule 1034)], or crosses the disseminated market of another options exchange [by not more than one minimum trading increment].

c) – (d) No change.

F-7 Size of Exchange's Disseminated Bid or Offer

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

Except as provided below, [A] at least the sum of the size associated with limit orders, specialists' quotations, SQTs' quotations, and RSQTs' quotations.

The Exchange shall disseminate an updated bid and offer price, together with the size associated with such bid and offer, when:

(i) the Exchange’s disseminated bid or offer price increases or decreases;

(ii) The size associated with the Exchange’s disseminated bid or offer decreases; or

(iii) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which shall never exceed 20%, shall be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular.

FINE SCHEDULE

Fine not applicable

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 establish a six-month pilot program
during which certain options would be quoted and traded in increments of $.01. The
purpose of this Amendment No. 1, which replaces the previous filing in its entirety, is to
clarify the Exchange’s handling of executions during crossed markets, and to include the
above-mentioned Exchange circular as part of the proposal.

Scope of the Pilot

Proposed Rule 1034(a)(i)(B) would state that the pilot would begin on January 26,
2007, and would extend for a six-month period. There would be 13 options included in
the pilot as determined by the Commission, subject to a rollout schedule to be
determined. The rollout would begin January 26, 2007. The options included in the pilot
are:

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Underlying Security</th>
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<tbody>
<tr>
<td>IWM</td>
<td>Ishares Russell 2000</td>
</tr>
<tr>
<td>QQQQ</td>
<td>QQQQ</td>
</tr>
<tr>
<td>SMH</td>
<td>SemiConductor Holders</td>
</tr>
<tr>
<td>GE</td>
<td>General Electric</td>
</tr>
<tr>
<td>AMD</td>
<td>Advanced Micro Devices</td>
</tr>
</tbody>
</table>
Changes to Minimum Increments

The Exchange proposes to adopt Rule 1034(a)(i)(B), which would provide that the option included in the pilot would be quoted in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying QQQQ would be quoted and traded in minimum increments of $0.01 for all series regardless of the price. A list of all such options would be communicated to membership via Exchange circular.

Automatic Executions During Crossed Markets

The Exchange anticipates that the instance of crossed markets (where the bid price is greater than the offer price) will increase in options traded in penny increments. Accordingly, the Exchange proposes to amend its rules concerning automatic executions during crossed markets, and its exemption from Trade-Through\(^6\) liability when a Trade-
Through occurs due to an automatic execution when the Exchange’s disseminated market is crossed, or crosses the disseminated market of another options exchange, and the Exchange’s disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the National Best Bid or Offer ("NBBO").

Currently, orders on the Exchange that are otherwise eligible for automatic execution are handled manually by the specialist when the Exchange’s disseminated market is crossed by more than one minimum trading increment (as defined in Exchange Rule 1034) (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange by more than one minimum trading increment. The effect of this is that the Exchange currently provides automatic executions during crossed markets when the Exchange’s disseminated market is crossed by not more than one minimum trading increment, or crosses the disseminated market of another options exchange by not more than one minimum trading increment, and the Exchange’s disseminated price on the opposite side of the market for the incoming order establishes, or is equal to, the NBBO.

The Exchange proposes to delete Rule 1080(c)(iv)(A), which would thereby mean that the Exchange will provide automatic executions in options where the Exchange’s Participant Exchange disseminating the NBBO for the full size of the Participant Exchange's bid (offer) that represents the NBBO. See Exchange Rule 1083(t).

7 See Exchange Rule 1080(c)(iv)(A).

disseminated market is the NBBO\(^9\) and is crossed, or crosses the disseminated market of another options exchange, regardless of the amount by which such market is crossed.\(^{10}\)

**Trade-Throughs**

Currently, Exchange Rule 1085(b) affords Exchange members several exemptions from Trade-Through liability and the requirements under Exchange rules and the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage concerning satisfaction of Trade-Throughs. Among the exemptions from such liability and satisfaction responsibility is current Exchange Rule 1085(b)(10), which provides an exemption when the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed by not more than one minimum trading increment (as defined in Exchange Rule 1034), or crosses the disseminated market of another options exchange by not more than one minimum trading increment.

In order to be consistent with the proposed rule change (described above) to provide automatic executions when the Exchange’s disseminated market is the NBBO regardless of the amount by which the market is crossed, the Exchange proposes to amend the rule to state that there would be an exemption from such liability and satisfaction responsibility when the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed, or crosses the disseminated market of another options exchange. The proposed rule change

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\(^9\) The Exchange provides automatic executions only when its disseminated market is the NBBO. See Exchange Rule 1080(c)(iv)(E).

would delete the current language contained in Rule 1085(b)(10) that limits the
exemption from Trade-Through and satisfaction liability to automatic executions at the
NBBO during markets that are crossed by one minimum trading increment. The
Exchange believes that the proposed rule change would facilitate the prompt resolution of
crossed markets by permitting automatic executions when the Exchange’s disseminated
market is crossed, or crosses the disseminated market of another options exchange,
regardless of the amount by which the market is crossed.

**Report to the Commission**

Proposed Rule 1034(a)(i)(C) would require the Exchange to prepare and submit
an analytical report (“report”) to the Commission that addresses the impact of the first
three months of the pilot on the quality of the Exchange’s markets and option quote
traffic and capacity on or before the last day of the fourth month of the pilot. The
purpose of this provision is to comply with the Commission’s mandate that the Exchange
submit such a report within the time frame specified in the rule.

**Zero-Bid Option Series**

Currently, Exchange Rule 1080(i) states that the Exchange’s AUTOM System
will convert market orders to sell a particular option series to limit orders to sell with a
limit price of $.05 that are received when the bid price for such series is zero. The
proposal would amend Rule 1080(i) to state that the system will convert such orders to
limit orders to sell with a limit price of the minimum trading increment applicable to such
series. The effect of this respecting options quoted and traded in minimum increments of
$0.01 would be that such conversion would be to a limit order to sell at $0.01, rather than
$0.05.
Quote Mitigation

The Exchange recognizes that quoting and trading in $.01 increments will most assuredly result in a greater number of quotations submitted in options that are included in the pilot. Therefore, in order to mitigate quote traffic, the Exchange proposes to amend Rule 1082, Firm Quotations, by adopting new Rule 1082(a)(ii)(C), which would modify the Exchange’s definition of “disseminated size” such that the Exchange will disseminate fewer updated quotations.

Specifically, proposed Rule 1082(a)(ii)(C) would set forth the conditions under which the Exchange would disseminate updated quotations based on changes in the Exchange’s disseminated price and/or size. The proposed rule would require the Exchange to disseminate an updated bid and offer price, together with the size associated with such bid and offer, when: (1) the Exchange’s disseminated bid or offer price increases or decreases; (2) the size associated with the Exchange’s disseminated bid or offer decreases; or (3) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which would never exceed 20%, would be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular. The percentage size increase necessary to give rise to a refreshed quote may vary from issue to issue, depending, without limitation, on the liquidity, average volume, and average number of quotations submitted in the issue. Proposed Rule 1080(b)(ii)(C) would not be limited to options included in the pilot, and would thus apply to all options traded on the Exchange.
The Exchange believes that the limitation on dissemination of quotations that increase in size by a nominal amount should significantly mitigate the amount of options quote traffic on the Exchange, and addresses issues of options quote capacity on the Exchange and in the National Market System.

In addition to the measures proposed above concerning mitigation of quote traffic on the Exchange, the Exchange has filed, or submitted to the Commission in draft, other proposed rule changes that the Exchange believes should reduce the number of quotations generated on the Exchange.

Specifically, the Commission recently approved a proposed rule change stating that, on a six-month pilot basis, Streaming Quote Traders (“SQTs”), 11 Remote Streaming Quote Traders (“RSQTs”), 12 and SQTs and RSQTs that receive Directed Orders (“DSQTs” and “DRSQTs” respectively) are deemed not to be assigned in any option series until the time to expiration for such series is less than nine months. 14 Accordingly, the market making obligations described in Exchange Rule 1014(b)(ii)(D)

11 An SQT is an Exchange Registered Options Trader (“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 only submit such quotations while such SQT is physically present on the floor of the Exchange. See Exchange Rule 1014(b)(ii)(A).

12 An RSQT is an ROT that is a member or member organization with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically through AUTOM in eligible options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. See Exchange Rule 1014(b)(ii)(B).

13 The term “Directed Order” means any customer order (other than a stop or stop-limit order as defined in Rule 1066) to buy or sell which has been directed to a particular specialist, RSQT, or SQT by an Order Flow Provider. See Exchange Rule 1080(l)(i)(A).

do not apply to SQTs, RSQTs, DSQTs and DRSQTs respecting series with an expiration of nine months or greater, and thus they would be required to submit fewer quotes.

Additionally, the Exchange filed a proposed rule change authorizing the Exchange’s Options Allocation, Evaluation and Securities Committee (“OAESC”),\textsuperscript{15} to assign trading privileges in options to SQTs and RSQTs, by “root symbol,” as applied by the Options Clearing Corporation (“OCC”) such that an SQT or RSQT, on request, may be assigned in only certain series of an option.\textsuperscript{16} The market making obligations applicable to SQTs and RSQTs thus would not apply to series in which an SQT or RSQT is not assigned, which should reduce the number of quotations required to be submitted.

The Exchange has also submitted a separate draft proposal to establish a maximum number of quoting participants that may be assigned to a particular equity option at any one time.\textsuperscript{17} This would limit the number of participants quoting in a particular equity option and thus should limit the number of quotations submitted in such equity options.

In another separate draft submission, the Exchange has proposed to establish monthly Performance Evaluations by the Exchange of its member organizations that have SQTs and RSQTs, to determine whether they have fulfilled performance standards relating to, among other things, quality of markets, efficient quote submission to the

\textsuperscript{15} The OAESC is a standing committee of the Exchange that has jurisdiction over the allocation, retention and transfer of the privileges to deal in all options to, by and among members on the options and foreign currency options trading floors. It is responsible for appointing specialists, alternate or assistant specialists or odd-lot dealers on the options and foreign currency options trading floors. It also establishes standards for the periodic review and evaluation of their performance and is empowered to suspend or revoke their appointments upon showing of reasonable cause therefor. See Exchange By-Law Article X, Section 10-7(a). See also, Exchange Rule 500.

\textsuperscript{16} See SR-Phlx-2006-53.

\textsuperscript{17} See SR-Phlx-2006-49.
Exchange (including quotes submitted through a third party vendor), competition, observance of ethical standards, and administrative factors. Under that proposal, failure to meet established minimum performance requirements could result in restriction by the OAESC of additional options assignments; suspension, termination, or restriction of an existing assignment on one or more options; or suspension, termination, or restriction of an SQT’s or RSQT’s status as such. The Exchange believes that such evaluations and possible consequences for failure to meet specific minimum standards should encourage efficient quoting and use of the Exchange’s capacity and bandwidth by providing a disincentive for SQTs and RSQTs to submit quotations that do not improve the Exchange’s disseminated price or materially increase the Exchange’s disseminated size.

2. **Statutory Basis**

The Exchange believes that its proposal is consistent with Section 6(b) of the Act \(^{19}\) in general, and furthers the objectives of Section 6(b)(5) of the Act \(^{20}\) 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 rules concerning the pilot while simultaneously mitigating quote traffic.

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

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\(^{18}\) *See SR-Phlx-2006-51.*

\(^{19}\) 15 U.S.C. 78f(b).

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.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which Phlx consents, the Commission shall: (a) by order approve such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission’s Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2006-74 on the subject line.

Paper comments:
- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-Phlx-2006-74. 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-2006-74 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. 21

Nancy M. Morris
Secretary

MEMORANDUM

TO: Members, Member Organizations, Participants, Participant Organizations

FROM: Richard S. Rudolph, Vice President and Counsel
Legal Department

DATE: October 28, 2005

RE: SEC approves Exchange’s Pnny Pilot Rules

The Securities and Exchange Commission (“SEC” or “Commission”) has approved a proposed rule change by the Exchange to establish a six-month pilot period beginning on January 26, 2007 (the “pilot”), during which certain options would be quoted and traded on the Exchange in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying the Nasdaq-100 Index Tracking Stock (“QQQQ”) would be quoted and traded in minimum increments of $0.01 for all series regardless of the price.

Scope of the Pilot

The pilot is scheduled to begin on January 26, 2007, and will extend for a six-month period. There will be 13 options included in the pilot, subject to a rollout schedule to be determined. The rollout will begin January 26, 2007. The options included in the pilot are:

<table>
<thead>
<tr>
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<td>SemiConductor Holders</td>
</tr>
<tr>
<td>GE</td>
<td>General Electric</td>
</tr>
</tbody>
</table>

1 The Nasdaq-100®, Nasdaq-100 Index®, Nasdaq®, The Nasdaq Stock Market®, Nasdaq-100 SharesSM, Nasdaq-100 TrustSM, Nasdaq-100 Index Tracking StockSM, and QQQSM are trademarks or service marks of The Nasdaq Stock Market, Inc. (Nasdaq) and have been licensed for use for certain purposes by the Philadelphia Stock Exchange pursuant to a License Agreement with Nasdaq. The Nasdaq-100 Index® (the Index) is determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 TrustSM, or the beneficial owners of Nasdaq-100 SharesSM. Nasdaq has complete control and sole discretion in determining, comprising, or calculating the Index or in modifying in any way its method for determining, comprising, or calculating the Index in the future.
Changes to Minimum Increments

New Rule 1034(a)(i)(B), provides that options included in the pilot will be quoted in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying QQQQ would be quoted and traded in minimum increments of $0.01 for all series regardless of the price.

Automatic Executions During Crossed Markets

The Exchange will provide automatic executions in options where the Exchange’s disseminated market is the NBBO and is crossed, or crosses the disseminated market of another options exchange, regardless of the amount by which such market is crossed.

Trade-Throughs

Exchange Rule 1085(b)(10), currently provides an exemption from Trade-Through liability when the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed by not more than one minimum trading increment (as defined in Exchange Rule 1034), or crosses the disseminated market of another options exchange by not more than one minimum trading increment.

New Rule 1085(b)(10) provides an exemption from Trade-Through liability when the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO regardless of the amount by which the market is crossed.

Report to the Commission

New Rule 1034(a)(i)(C) requires the Exchange to prepare and submit an analytical report (“report”) to the Commission that addresses the impact of the first three months of the pilot on the quality of the Exchange’s markets and option quote traffic and capacity on or before the last day of the fourth month of the pilot. The purpose of this provision is to comply with the Commission’s mandate that the Exchange submit such a report within the time frame specified in the rule.
Zero-Bid Option Series

Currently, Exchange Rule 1080(i) states that the Exchange’s AUTOM System will convert market orders to sell a particular option series to limit orders to sell with a limit price of $.05 that are received when the bid price for such series is zero. Amended Rule 1080(i) states that the system will convert such orders to limit orders to sell with a limit price of the minimum trading increment applicable to such series. The effect of this respecting options quoted and traded in minimum increments of $0.01 is that such conversion will be to a limit order to sell at $0.01, rather than $0.05.

Quote Mitigation

New Rule 1082(a)(ii)(C) sets forth the conditions under which the Exchange will disseminate updated quotations to the option Price Reporting Authority (“OPRA”) based on changes in the Exchange’s disseminated price and/or size. The Exchange will disseminate an updated bid and offer price, together with the size associated with such bid and offer, when: (1) the Exchange’s disseminated bid or offer price increases or decreases; (2) the size associated with the Exchange’s disseminated bid or offer decreases; or (3) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which would never exceed 20%, will be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular. The percentage size increase necessary to give rise to a refreshed quote may vary from issue to issue and is not limited to options included in the pilot.

The text of the new rules is set forth below.
Brackets indicate deletions; bold underlining indicates new text

**Minimum Increments**

**Rule 1034.** (a) Except as provided in sub-paragraph (i)(B) below, [A] all options on stocks, index options, and Exchange Traded Options quoting in decimals at $3.00 or higher shall have a minimum increment of $.10, and all options on stocks and index options quoting in decimals under $3.00 shall have a minimum increment of $.05.

(i) (A) However, the Board of Governors may establish different minimum trading increments. The Exchange will designate any such change as a stated policy, practice or interpretation with respect to the administration of Rule 1034, within the meaning of Section 19(b)(3)(A) of the Exchange Act and will file a proposed rule change with the Securities and Exchange Commission to be effective upon filing.

(B) For a six-month pilot period beginning on January 26, 2007 (the “pilot”), certain options shall be quoted and traded on the Exchange in minimum increments of $0.01 for all series in such options with a price of less than $3.00, and in minimum increments of $0.05 for all series in such options with a price of $3.00 or higher, except that options overlying the Nasdaq-100 Index Tracking Stock (“QQQQ”)® shall be quoted and traded in minimum increments of $0.01 for all series regardless of the price. A list of such options shall be communicated to membership via Exchange circular.

(C) On or before the last day of the fourth month of the pilot, the Exchange shall prepare and submit an analytical report to the Securities and Exchange Commission (“Commission”) that addresses the impact of the first three months of the pilot on the quality of the Exchange’s markets and option quote traffic and capacity.

(ii) – (iii) No change.

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

**Rule 1080.** (a) - (b) No change.

(c)*****

(i) - (iii) No change

(iv) Except as otherwise provided in this Rule, in the following circumstances, an order otherwise eligible for automatic execution will instead be manually handled by the specialist:
(A) RESERVED [when the Exchange’s disseminated market is crossed by more than one minimum trading increment (as defined in Exchange Rule 1034) (i.e., 2.10 bid, 2 offer), or crosses the disseminated market of another options exchange by more than one minimum trading increment];

(B) - (F) No change.

*****

(v) – (vi) No change.

(d) – (h) No change.

(i) Zero-bid option series. The AUTOM System will convert market orders to sell a particular option series to limit orders to sell with a limit price of $0.05 the minimum trading increment applicable to such series that are received when:

(A) – (B) No change.

(j) – (l) No change.

Commentary: No change.

Firm Quotations

Rule 1082. (a) Definitions.

(i) No change.

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

(A) Except as provided in sub-paragraph (a)(ii)(C)(3) below, [A] at least the sum of the size associated with limit orders, specialists’ quotations, SQTs’ quotations, and RSQTs’ (as defined in Rule 1014(b)(ii)(B)) quotations.

(B) (1) If an SQT or RSQT’s (other than a Directed SQT or RSQT) quotation size in a particular series in a Streaming Quote Option is exhausted or removed by the Risk Monitor Mechanism, such SQT or RSQT’s quotation shall be deleted from the Exchange’s disseminated quotation until the time the SQT or RSQT revises his/her quotation.

(2) If the Exchange’s disseminated size in a particular series in a Streaming Quote option is exhausted at that particular price level, and no specialist, SQT or RSQT has revised their quotation immediately following the exhaustion of the Exchange's disseminated size at such price level, the Exchange shall automatically provide two-sided quotes that comply with the Exchange’s rules concerning quote spread parameters on
behalf of the specialist until such time as the specialist revises the quotation, with a size of one contract.

(C) The Exchange shall disseminate an updated bid and offer price, together with the size associated with such bid and offer, when:

(1) the Exchange’s disseminated bid or offer price increases or decreases;

(2) the size associated with the Exchange’s disseminated bid or offer decreases; or

(3) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which shall never exceed 20%, shall be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular.

(iii) – (iv) No change.

(b) – (d) No change.

Commentary: No change.

Order Protection

Rule 1085. (a) No change.

(b) Exceptions to Trade-Through Liability. The provisions of paragraph (a) pertaining to the satisfaction of Trade-Throughs shall not apply under the following circumstances:

(1) – (9) No change.

(10) the Trade-Through was the result of an automatic execution when the Exchange’s disseminated market is the NBBO and is crossed [by not more than one minimum trading increment (as defined in Exchange Rule 1034)], or crosses the disseminated market of another options exchange [by not more than one minimum trading increment].

(c) – (d) No change.
F-7 Size of Exchange's Disseminated Bid or Offer

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

Except as provided below, [A] at least the sum of the size associated with limit orders, specialists' quotations, SQTs' quotations, and RSQTs' quotations.

The Exchange shall disseminate an updated bid and offer price, together with the size associated with such bid and offer, when:

(i) the Exchange’s disseminated bid or offer price increases or decreases;

(ii) the size associated with the Exchange’s disseminated bid or offer decreases; or

(iii) the size associated with the Exchange’s bid (offer) increases by an amount greater than or equal to a percentage (never to exceed 20%) of the size associated with previously disseminated bid (offer). Such percentage, which shall never exceed 20%, shall be determined on an issue-by-issue basis by the Exchange and announced to membership via Exchange circular.

FINE SCHEDULE

Fine not applicable
Exhibit 4

Brackets indicate deletions from previously submitted text

[Locked and Crossed Markets]

Rule 1086. (a) Eligible Market Maker Locking or Crossing a Market. An Eligible Market Maker that creates a Locked Market or a Crossed Market shall unlock (uncross) that market or shall direct a Principal Order through the Linkage to trade against the bid or offer that the Eligible Market Maker locked (crossed).

(b) Members Other than an Eligible Market Maker Locking or Crossing a Market. A Member other than an Eligible Market Maker that creates a Locked Market or a Crossed Market shall unlock (uncross) the market.

(c) The provisions of this Rule 1086 do not apply to situations where an Eligible Market Maker or a member other than an Eligible Market Maker books an order that would lock a market and contemporaneously sends through the Linkage a P/A Order or Principal Order for the full size of the bid or offer that was locked.

(d) Notwithstanding the provisions in Rules 1083(d) and (l), for purposes of this rule respecting options quoted in minimum increments of $0.01, the term “Crossed Market” means a market that is crossed by $0.05 or greater for series trading under $3.00, and by $0.10 or greater for series trading at $3.00 or higher. The Exchange may reduce such amount and announce such reduction to membership via Exchange circular.]