

MEMORANDUM

TO: Members and Member Organizations

FROM: John Dayton

DATE: December 18, 2007

RE: Elimination of Short Sale Price Test from Phlx Rules

The Securities and Exchange Commission (“Commission”) has noticed an immediately effective proposed rule change filed by the Exchange to amend Phlx Rules to reflect the elimination of any short sale price test, including any tick or bid test (“Price Test”) and the elimination of the “short exempt” marking requirement. Earlier this year, the Commission eliminated the Price Test and prohibited exchanges from adopting any Price Test of their own. The Commission also eliminated the “short exempt” marking requirement.

Phlx Rules 185, 455, 785 and 1072 contained language regarding the Price Test and the “short exempt” marking requirement. Phlx Rule 185 contained language regarding the entry, display and execution of sell short orders on XLE, the Phlx electronic equity trading system, that were previously subject to the Price Test. With the elimination of the Price Test, sell short orders will not be handled any differently than sell long orders by XLE and the amendments to this rule reflect this. Phlx Rule 455 stated that XLE would not execute a sell order unless effected in compliance with Rule 10a-1 under the Securities Exchange Act of 1934. Rule 10a-1 contained the Price Test and was eliminated by the Commission. The amendments to Phlx Rule 455 reflect this.

Phlx Rule 785 requires member organizations to make an automated submission of trading data, and included a requirement to mark orders as short exempt, where appropriate. With the elimination of the “short exempt” marking requirement, Phlx Rule 785 was amended to reflect this. Phlx Rule 1072 outlined the requirements on options specialists and Registered Options Traders (“ROTs”) regarding their use of an exception to the NASD bid test (which is a type of Price Test) available to hedging options transactions. The elimination of the Price Test will extend to the NASD bid test and therefore options specialist and ROTs will not need the exemption outlined in Phlx Rule 1072. Phlx Rule 1072 has been deleted to reflect this.

However, it is important to note all sell orders submitted to XLE are still required to be marked as long or short, pursuant to Commission and Phlx rules.

Questions regarding the proposed rule change may be directed to John Dayton at (215) 496-5162. Questions regarding XLE functionality may be directed to the XLE Help Desk at (215) 496-5311 or 1-877-678-PHLX.

Rule Text

Underling indicates additions; brackets indicate deletions

Rule 185.

Orders and Order Execution

(a) No Change

(b) No Change

(1) No Change

(A)-(D) No Change

(E) [Except when otherwise mandated by the applicable short sale test, a]All Limit Orders and Reserve Orders, once displayable at a price, will not be displayable at an inferior price regardless of the movement of the away Protected Quotation.

(2) No Change

(3) Pegged Order. A round or mixed lot limited price order to buy or sell, only on XLE, a stated amount of a security at a display price set to track (up, down or at) the current best Protected Bids or Offers (on either side of the market) in an amount specified by the XLE Participant in an increment permitted by Rule 125, provided, however that the display price will not lock or cross Protected Bids or Offers in a manner that would violate Rule 186. The tracking of the relevant Protected Bid or Offer for Pegged Orders will occur on a real-time basis, except that when the calculated price for the Pegged Order would exceed its limit price, it will no longer track and will remain displayed at its limit price. A Pegged Order must have at least a round lot portion of the size that is displayable and may have at least a round lot portion of the size that is not displayable by XLE, provided that the portion of the Pegged Order that is not displayable shall have the same price as the portion that is displayable. An XLE Participant may indicate during which contiguous XLE Trading Session(s) a Pegged Order shall remain eligible for execution. [An XLE Participant may not submit any Pegged Order marked sell short unless the applicable short sale test for that security has been suspended or is otherwise not in effect.]

(c)-(d) No Change

(e) Reserved.[XLE will not execute nor display at a price at which it could not execute any order marked short in violation of the applicable short sale test, including any exemptions, applicable to that security.]

(f)-(h) No Change

Rule 455.

Short Sales

[XLE shall not effect a sell order or sale of any security, except Nasdaq Global Market and Nasdaq Capital Market securities, unless such sell order or sale is effected in compliance with Securities and Exchange Commission Rule 10a-1 promulgated under the Securities Exchange Act of 1934.] XLE shall not effect a sell order or sale of any security unless such sell order is effected in compliance with Regulation SHO promulgated under the Securities Exchange Act of 1934.

Rule 785.

Automated Submission of Trading Data

A member or member organization shall submit such of the following trade data elements specified below in such automated format as may be prescribed by the Exchange from time to time, in regard to such transaction or transactions as may be subject of a particular request for information made by the Exchange:

(a) If the transaction was a proprietary transaction effected or caused to be effected by the member or member organization for any account in which such member or member organization, or any member, allied member, approved person, partner, officer, director, or employee thereof, is directly or indirectly interested, such member or member organization shall submit or cause to be submitted the following information:

1)-4) No Change

5) Number of shares, or quantity of bonds or options contracts for each specific transaction and whether each transaction was a purchase, sale, short sale, [exempt short sale,] and if an options contract whether open long or short or close long or short;

6)-8) No Change

(b)-(d) No Change

Rule 1072. Reserved.

[Reporting Requirements Applicable to Short Sales in NASD/NM Securities]

[This Rule is adopted in conjunction with the adoption of an addition to the Rules of Fair Practice of the NASD which imposes a bid test on short sales of stocks traded on the Nasdaq National Market subject to certain exemptions including, during a pilot period, an exemption for certain transactions of options market makers. This Rule will continue in effect only so long as the options market maker exemption from the NASD bid test remains in effect.]

[(a) No member shall initiate, accept or transmit for execution, or execute a sale of a Nasdaq National Market ("NM") security for its own account or for the account of another member unless the sale is clearly identified in a form and manner prescribed by the Securities and Exchange Commission's ("SEC") Rule 200 under the Securities Exchange Act of 1934 promulgated pursuant to Regulation SHO ("SEC Rule 200").]

[(b) For purposes of this Rule, a short sale shall have the same meaning as set forth in SEC Rule 200.]

[(c) A short sale may be designated as a bid test exempt sale if:]

[(1) the sale qualifies for an exemption from the short sale bid test established in the NASD Rules of Fair Practice; or]

[(2) the sale is by or for the account of a Specialist or Registered Options Trader ("ROT"), provided that the short sale is an exempt hedge transaction by or for a "qualified options market maker" in a designated Nasdaq/NM security underlying a class of stock options or included in an index underlying a class of index options which the Specialist has been allocated pursuant to Rule 511 or the ROT has been assigned pursuant to Rule 1014.]

[(i) An "exempt hedge transaction" shall mean a short sale in a Nasdaq/NM security that was effected to hedge, and in fact serves to hedge, an existing offsetting options position or an offsetting options position that was created in one or more transactions contemporaneous with the short sale, provided that:]

[(A) in the case of a stock option, when establishing the short position, the Specialist or ROT receives or is eligible to receive good faith margin pursuant to Section 220.12 of Regulation T under the Securities Exchange Act of 1934 for that transaction;]

[(B) in the case of an index option, (1) the Nasdaq/NM security sold short is a component security of the index underlying such index option, (2) at least 10% of the value of the index underlying

such index option is represented by one or more Nasdaq/NM securities, and (3) the current aggregate value of the Nasdaq/NM securities sold short does not exceed the aggregate current index value of the index options position being hedged;]

[(C) Notwithstanding the foregoing, a transaction unrelated to normal options market making activity, such as index arbitrage or risk arbitrage that is in either case independent of a Specialist or ROT's market making functions, will not be considered an "exempt hedge transaction."]

[(D) Transactions will be considered "contemporaneous" if they occur simultaneously or within the same brief period of time.]

(ii) A "designated Nasdaq/NM security" shall mean a Nasdaq/NM security which the Specialist or ROT has designated as qualifying for the exemption provided in this subparagraph (c)(2). Each ROT may designate the Nasdaq/NM securities underlying no more than 20 of the options or index options, which the ROT has been assigned as designated Nasdaq/NM securities. Each Specialist may designate all of the Nasdaq/NM securities underlying the options or index options which the Specialist has been allocated as designated Nasdaq/NM securities. Such designations shall be made in writing, and shall be filed with the Exchange's Market Surveillance Department. Except:]

[(A) With prior notification to an Options Exchange Official, an ROT may facilitate an options order initiated from off-floor and contemporaneously hedge the resulting option position with a short sale in applicable Nasdaq/NM securities as if such securities are designated securities under subparagraph (c)(2)(ii). A report describing the transaction shall be filed with the Department of Market Surveillance in a time, form and manner prescribed by the Exchange, with written Options Exchange Official approval indicated. The ROT must maintain a copy of the report as a record demonstrating that the sale was bid test exempt.]

[(B) Short sales of a security of a company involved in a publicly announced merger or acquisition by or for the account of a Specialist or ROT will be deemed to be an exempt hedge transaction, if the short sale was made to hedge existing or prospective positions (based on communicated indications of interest) in options on a security of another company involved in the merger or acquisition, where the option positions are or will be in a class of options for which the Specialist is registered or the ROT is assigned and were or will be an exempt hedge transaction as defined in subparagraph (c)(2) of this Rule.]

[(iii) A registered Specialist or ROT shall be considered to be a "qualified options market maker" in options on those Nasdaq/NM securities designated in accordance with subparagraph (c)(2)(ii) above for purposes of the exemption for qualified options market makers from the bid test established in the NASD Rules of Fair Practice, provided that the status of such Specialist or ROT as a qualified options market maker may be withdrawn, suspended or modified by the Exchange as the result of action of the Allocation, Evaluation and Securities Committee pursuant to Rule 511 or a proceeding by the Business Conduct Committee pursuant to Rule 960.]

[(A) An ROT may effect short sales as bid test exempt in a Nasdaq/NM security which the ROT has not designated as qualifying for the exemption provided in this Rule, if such security is a designated Nasdaq/NM security of an ROT of the same member organization and such affiliated ROT is not present on the trading floor or represented by a Floor Broker in the applicable trading crowd at the time of the bid test exempt sale.]

[(d) This Rule shall be in effect for an eighteen month pilot period commencing with its effective date, and may be modified or withdrawn upon termination of such pilot period however, if the exemption for options market makers from the short sale bid test contained in the NASD Rules of Fair Practice continues in effect, this rule will also continue in effect until it is modified or withdrawn.]

[(e) It will be deemed a violation of this rule when a member designates a sale for an account in which the member has no interest as a long sale where the member does not know or have reason to know that the beneficial owner of the account has, or as a result of such sale would have, a short position in the security, or when the member designates such a sale as a bid test exempt sale where the member does not know or have reason to know that the criteria for designating such sale as bid test exempt are not satisfied.]

[(f) If a member initiates, accepts for execution, transmits for execution or executes a short sale of a Nasdaq/NM security without clearly and properly identifying it as required by paragraph (a), or if a member designates a short sale as a bid test exempt sale under paragraph (c) but fails to satisfy all of the conditions of such designation, or even if all such conditions are satisfied, if the sale is made for the purpose of disrupting or manipulating the market in that security or a related option, such sale may constitute a violation of Exchange Rules 707 and 1014, as well as this Rule.]

[(g) Notwithstanding the foregoing, this Rule 1072 shall not be applicable to any short sales for which the SEC has suspended short sale price tests pursuant to its Rule 202T, including any short sales covered by the SEC's Pilot Program suspending certain short sale price provisions at Exchange Act Release No. 50104 (July 28, 2004), or any SEC

amendment(s) of the same.]

[Commentary: ...]

[.01 Once an underlying index has satisfied the 10% test in Section (c)(2)(i)(B)(2), the continued qualification of the index shall be reviewed at the end of each calendar quarter, and the index shall cease to qualify if the value of the index represented by the Nasdaq/NM securities is less than 8% at the end of any subsequent calendar quarter.]