Memorandum No. 0006-07
Release No. 34-54989

MEMORANDUM

TO: Members and Member Organizations
Participants and Participant Organizations

FROM: Legal Department

DATE: January 3, 2007

RE: Commission approval of SR-Phlx-2006-34, as amended (U.S. Dollar-Settled Options on the British Pound and the Euro)

Summary

On December 21, 2006, the Securities and Exchange Commission approved SR-Phlx-2006-34, as amended, which proposes the listing and trading of U.S. dollar-settled options on the British pound and the Euro (together, the "Currencies").[1] The proposed rule change includes amendments to permit trading of U.S. dollar-settled FCO on the Exchange's electronic trading platform for options, Phlx XL. A summary of the proposed rule change and approval order is set forth below.

Attention is directed in particular to the sections below captioned Strike Prices and Quoting Convention and Bids and Offers – Premium and Quoting Convention.

Contract Specifications and Amendments to FCO Rules

Background. U.S. dollar-settled FCOs are cash-settled, European-style options issued by The Options Clearing Corporation ("OCC") that allow holders to receive U.S.

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[1] See Securities and Exchange Commission Release No. 34-54989, available on the Exchange's website. The proposed rule change was amended twice and published for comment in the Federal Register on November 2, 2006. A third amendment was filed on December 14, 2006. The entire proposed rule change, including the text of all rule amendments, is available on the Exchange's website. The Exchange's existing, physical delivery options on the Currencies will not be affected by this proposal (except with respect to aggregation of contracts for purposes of position and exercise limits as discussed below) and will continue to trade as they do today, by open outcry.

dollars representing the difference between the current foreign exchange spot price and the exercise price of the option. Unlike other Phlx-traded FCOs, U.S. dollar-settled FCOs will be deemed to be exercised at expiration if the exercise settlement value is at least $ 1.00 per contract unless the clearing member instructs OCC not to exercise it pursuant to OCC rules. [2]

Delivery and Payment. Upon exercise of an in-the-money U.S. dollar-settled FCO structured as a call, the holder would receive, from OCC, U.S. dollars representing the difference between the exercise strike price and the closing settlement value of the U.S. dollar-settled FCO contract multiplied by the number of units of currency covered by the contract. Similarly, for a U.S. dollar-settled FCO structured as a put, the holder would receive U.S. dollars representing the excess of the exercise price over the closing settlement value of the U.S. dollar-settled FCO contract multiplied by the number of units of foreign currency covered by the contract

Contract Size. The contract sizes of the U.S. dollar-settled FCO contracts on the Currencies are 10,000 British pounds and 10,000 Euros. (By contrast, the contract sizes for the physical delivery options on the Currencies are 31,250 British pounds and 62,500 Euros.)

Expirations. The Exchange proposes to permit U.S. dollar-settled FCO contracts to be listed with expirations that are the same as the expirations permitted for equity index options pursuant to Phlx Rule 1101A, with the exception of long term option series and quarterly expiring FCOs which the Exchange does not propose to list. The Exchange does not anticipate listing FLEX U.S. dollar-settled foreign currency options at this time. The Exchange anticipates that, at least initially, it will list expirations at one, two, three, six, and nine months, and that the options will be on three of the months from the March, June, September, December cycle, plus two additional near term months (five months at all times). By way of example, in September, the U.S. dollar-settled FCOs would have the following months listed: October, November, December, March, and June. The expiration date for the consecutive and cycle month options would be 11:59 p.m. Eastern Time on the Saturday immediately following the third Friday of the expiration month.

Trading Hours. The Exchange will trade U.S. dollar-settled FCOs from 9:30 a.m. to 4:00 p.m. Eastern Time, Monday through Friday. These trading hours differ from the trading hours for the physical delivery FCO contracts because the U.S. dollar-settled FCOs would, unlike the Exchange's physical delivery FCOs, trade on Phlx XL. An expiring U.S. dollar-settled FCO contract would cease trading at 4:00 p.m. on the day prior to its expiration day. In order to facilitate trading of the U.S. dollar-settled FCOs on Phlx XL, trading would be permitted to occur after the settlement value is announced on

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[2] However, the normal expiration date exercise procedures do not apply in circumstances in which the fixing of the exercise settlement amount is delayed beyond the last trading day before expiration. <u>See</u> OCC Rule 2302 (setting forth the expiration date exercise procedures), and Securities Exchange Act Release No. 54395 (December 13, 2006) (order approving SR-OCC-2006-10).

the day prior to expiration. Unlike trading in physical delivery FCOs, trading in U.S. dollar-settled FCOs would not close on bank holidays.

Settlement Values; Dissemination of Information. The closing settlement value will be the day's announced Noon Buying Rate as determined by the Federal Reserve Bank of New York on the trading day prior to the expiration date. If Friday is an Exchange holiday, the closing settlement value for U.S. dollar-settled FCOs would be determined on the basis of the Noon Buying Rate on the preceding trading day, which would also be the last day of trading for the expiring option. If the Noon Buying Rate is not announced by 2:00 p.m. Eastern Time, the closing settlement value would be the most recently announced Noon Buying Rate, unless the Exchange determines to apply an alternative closing settlement value as a result of extraordinary circumstances. The closing settlement value would not be disseminated through the Options Price Reporting Authority ("OPRA"), but would be posted on the Exchange's Web site, where it would be publicly available to all visitors to the Exchange's Web site on an equal basis, without the need to enter any kind of password.

Position and Exercise Limits. Position and exercise limits for the U.S. dollar-settled FCOs would be the same as the position and exercise limits for the physical delivery contracts pursuant to Phlx Rules 1001 and 1002. For purposes of position and exercise limits, positions in U.S. dollar-settled FCO contracts would be aggregated with positions in the physical delivery contracts. However, each Euro U.S. dollar-settled option contract would count as one-sixth of a contract for purposes of position and exercise limits. Similarly, each British pound U.S. dollar-settled option contract would count as one-third of a contract for purposes of position and exercise limits. The other aggregation principles in Phlx Rule 1001 would continue to apply.

Strike Prices and Quoting Convention. The Exchange proposes to initially list exercise strike prices for each expiration around the current spot price at half-cent ($ .005) intervals up to five percent on each side. Thus, if the spot price initially were at 1.0000, the Exchange would list strikes in $ .005 intervals up to 1.0500 and down to .9500 for a total of twenty-one strike prices available for trading. The Exchange would not list any strike prices at intervals other than these $ .005 intervals. As the spot price for U.S. dollar settled FCO moves, the Exchange would list new strike prices that, at the time of listing, do not exceed the spot price by more than 5% and are not less than the spot price by 5%. For example, if at the time of initial listing the spot price of the Euro is at 1.0000, the strike prices the Exchange would list would be .9500 to 1.0500. If the spot price then moves to 1.0500, the Exchange may list additional strikes at the following prices: 1.0550 to 1.1000. In that event, the Exchange would delist any previously-listed series outside of the current ten percent band that have no open interest. In addition, new strikes may be added during the life of the option in accordance with Phlx Rule 1012.

Strike prices would be expressed without reference to the first two decimal places. Minimum quoting increments and maximum quote spreads would also reflect this convention, as discussed below. For example, assuming that the actual spot value of the Euro is $ 1.00, a strike could be listed at $ 1.0050 and would be expressed as $ 100.50.

Similarly, the minimum quoting increment would be $ .0005 (expressed as $ .05), if the bid is less than $ .0300 (expressed as $ 3.00), or $ .0010 (expressed as $ .10), if the bid equals or exceeds $ .0300 (expressed as $ 3.00). Bids could be made at $ .0330 (expressed as $ 3.30), at $ .0340 (expressed as $ 3.40), and so forth. Offers could be made at $ .0350 (expressed as $ 3.50), at $ .0360 (expressed as $ 3.60), and so forth. Maximum quote spread parameters for bids and offers made in open outcry would range from $ .0025 (expressed as $ .25), to $ .0100 (expressed as $ 1.00), depending upon the size of the prevailing bid. Thus, a market maker could bid $ .0330 (expressed as $ 3.30) and offer $ .0370 (expressed as $ 3.70). Following open rotation, however, quotes may be made electronically with a difference not to exceed $ .0500 (expressed as $ 5.00) between the bid and the offer regardless of the price of the bid.

Bids and Offers – Premium and Quoting Convention. Bids and offers in U.S. dollar-settled FCOs on the Currencies must be made in terms of U.S. dollars per unit of the underlying foreign currency. The minimum increment for U.S. dollar-settled FCOs quoting under $ .0300 will be $ .0005 per unit of the foreign currency, expressed as .05 per unit of the foreign currency, which equals a $ 5.00 minimum increment per contract consisting of 10,000 Euros or 10,000 British pounds. The minimum increment for U.S. dollar-settled FCOs quoting at $ .0300 or higher would be $ .0010 per unit of the foreign currency, expressed as .10 per unit of the foreign currency, which equals a $ 10.00 minimum increment per contract consisting of 10,000 Euros or 10,000 British pounds. By way of example, if the spot price of the Euro is at $ 1.2550 and an investor purchases the December Euro $ 1.2500 (expressed as $ 125.00) Call at a premium of $ .0075 (expressed as $ .75) and then sells the December Euro $ 1.2500 Call at a premium of $ .0095 (expressed as $ .95), the investor's profit would be $ .0020 per Euro. The investor's total profit would be $ .0020 per Euro multiplied by 10,000 Euros (the size of the contract) for a total of $ 20.00.

Margin Requirements. The U.S. dollar-settled FCOs would have the same customer margin requirements as are provided for the existing FCOs. The Exchange calculates the margin requirements for each foreign currency underlying U.S. dollar-settled FCO separately, rather than determining one margin level for all foreign currencies based upon the historical pricing information for all foreign currencies together. The Exchange informs members and the public of the margin levels for each currency option immediately following quarterly reviews.

<u>Trading on Phlx XL</u>

The amended rules provide for the trading of U.S. dollar-settled FCOs on Phlx XL, the Exchange's electronic trading platform for options. The proposal amended a number of rules that currently govern the trading of equity and equity index options that trade as "Streaming Quote Options" on Phlx XL to extend the coverage of those rules to U.S. dollar-settled FCOs and to include U.S. dollar-settled FCOs as a product that may be traded on Phlx XL as a Streaming Quote Option. Exchange specialists, on-floor market makers known as Streaming Quote Traders ("SQTs"), and remote market makers known as Remote Streaming Quote Traders ("RSQTs") who stream their U.S. dollar-settled FCO quotes to the Exchange would be eligible to participate in the directed order flow program. Specialists in U.S. dollar-settled FCOs, like specialists in equity and index options, also would be eligible to participate in the Exchange's enhanced specialist participation programs.

Obligations and Restrictions. U.S. dollar-settled FCOs would trade in the same general manner as equity index options which are also U.S. dollar-settled products with certain exceptions. For example, the Auto-Quote system applies to equity and equity index options, but not to U.S. dollar-settled FCOs, and Phlx Rule 1014(c)(i)(B), which provides for a maximum option price change with exceptions based upon the price of the underlying security, would not apply to U.S. dollar-settled FCOs. The obligations and restrictions applicable to specialists and ROTs trading equity index options now generally will apply to specialists and ROTs in U.S. dollar-settled FCOs. In addition, under the amendments to Phlx Rule 1014, specialists and ROTs in U.S. dollar-settled FCOs, like specialists in physical delivery FCOs, would be subject to rules relating to bid/ask differentials and other affirmative market making obligations and restrictions but those rules with respect to U.S. dollar-settled FCOs would track rules currently applicable to equity options. Other amendments to Phlx Rule 1014 would make clear that current provisions on priority/parity and bid/ask differentials that apply to FCO contracts would be limited to physical delivery FCOs. Similarly, options Floor Procedure Advice F-17, relating to trades to be effected in the trading pit, is being amended so that it applies only to physical delivery FCOs, because U.S. dollar-settled FCOs will trade on Phlx XL. The Floor Broker Management System currently employed with respect to equity and equity index options would also be required to be used for U.S. dollar-settled FCOs.

Openings. Phlx Rule 1017, which governs the Exchange's fully automated opening system for options traded on Phlx XL, is amended to reflect that U.S. dollar-settled FCOs would be opened using the automated opening system, subject to certain adjustments to current processes because FCO openings, unlike openings of equity and index options, would not depend upon the opening of trading in an underlying cash market. Phlx XL will accept orders and quotes in U.S. dollar-settled FCOs beginning no later than one hour before market opening. The specialist assigned in the particular U.S. dollar-settled FCO must enter opening quotes not later than 30 seconds after market opening. Market opening, as with equity and index options, is normally at 9:30 a.m. Eastern Time. In certain circumstances an anticipated opening price will be calculated if the quotes of at least two Phlx XL participants have been submitted within two minutes of market opening (or such shorter time as determined by the FCO Committee and disseminated to membership via Exchange circular). The system will not open a series of U.S. dollar-settled FCOs if the opening price is not within an acceptable range (as determined by the FCO Committee and announced to Exchange members and member organizations by way of Exchange circular).

Block Trades. The block trade procedures in Phlx Rule 1016 will be limited to physical delivery FCOs and will not apply to U.S. dollar-settled FCOs.

Customized Foreign Currency Options. Phlx Rule 1069 is being amended to limit the applicability of the rule to physical delivery FCOs so that U.S. dollar-settled FCOs would not be eligible to trade on a customized basis.

Foreign Currency Options Committee. Phlx Rules 1014 and 1080 and Options Floor Procedure Advice A-13 are being amended to provide that the Foreign Currency Options Committee would have decision-making authority in certain instances with respect to U.S. dollar-settled FCOs (rather than the Options Committee, which oversees the trading of equity and equity index options on Phlx XL).

Customer Protection

Exchange rules designed to protect public customers trading in FCOs would apply to U.S. dollar-settled FCOs on the Currencies. Specifically, Phlx Rule 1024(b) prohibits members from accepting a customer order to purchase or write a U.S. dollar-settled FCO unless such customer's account has been specially approved in writing by a designated Foreign Currency Options Principal of the member for transactions in FCOs. Additionally, Phlx Rule 1026 is designed to ensure that options, including U.S. dollar-settled FCOs, are sold only to customers capable of evaluating and bearing the risks associated with trading in the instruments. Finally, under Phlx Rule 1027, members are permitted to exercise discretionary power with respect to trading U.S. dollar-settled FCOs in a customer's account only if the member has received prior written authorization from the customer and the account has been accepted in writing by a designated Foreign Currency Options Principal. In addition, the Foreign Currency Options Principal or a Registered Options Principal must approve and initial each discretionary U.S. dollar-settled FCO on the day the order is entered. Phlx Rule 1025 relating to the supervision of accounts, Phlx Rule 1028 relating to confirmations, and Phlx Rule 1029 relating to delivery of options disclosure documents also would apply to trading in U.S. dollar-settled FCOs.

Contacts For Additional Information

The foregoing description is a summary only. Interested persons are encouraged to review the entire proposed rule change, including the text of the proposed new and amended rules and the Commission’s approval order, on the Exchange’s website. Please contact Carla Behnfeldt, Legal Department, at (215) 496-5208, with any questions regarding the proposed rule change. Contact Dan Carrigan, Vice President – New Products, at (215) 496-5017 for further information concerning contract specifications or questions regarding trading U.S. dollar-settled FCO on Phlx XL.