

MEMORANDUM

TO: Members, Member Organizations, Participants, Participant Organizations

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

DATE: January 18, 2007

RE: SEC Approves New Exchange Rule 510
SQT and RSQT Monthly Performance Evaluation

As one element of a larger plan to conserve quote capacity by encouraging efficient quoting (in light of the imminent implementation of penny quoting and trading in options), and in order to address the costs required to process excess quoting, the Exchange filed a proposed rule change to adopt Exchange Rule 510, SQT and RSQT Performance Evaluation, to establish performance requirements for Streaming Quote Traders (“SQTs”)¹ and Remote Streaming Quote Traders (“RSQTs”).² The Securities and Exchange Commission (“SEC” or “Commission”) has **approved the new rules.**

New Rule 510: (1) establishes performance requirements for SQTs and RSQTs; (2) authorizes the Exchange to conduct performance evaluations periodically; and (3) authorizes the Exchange’s Options Allocation, Evaluation and Securities Committee (“OAESC”)³ to take corrective action where minimum requirements are not met.

¹ An SQT is an Exchange Registered Options Trader (“ROT”) who has received permission from the Exchange to generate and submit option quotations electronically through an electronic interface with AUTOM via an Exchange approved proprietary electronic quoting device in eligible options to which such SQT is assigned. See Phlx Rule 1014(b)(ii)(A). AUTOM is the Exchange's electronic order delivery, routing, execution and reporting system, which provides for the automatic entry and routing of equity option and index option orders to the Exchange trading floor. Orders delivered through AUTOM may be executed manually, or certain orders are eligible for AUTOM's automatic execution features, AUTO-X, Book Sweep and Book Match. AUTOM is today more commonly referred to as Phlx XL. See Securities Exchange Act Release No. 50100 (July 27, 2004), 69 FR 46612 (August 3, 2004) (SR-Phlx-2003-59) and Phlx Rule 1080.

² An RSQT is a participant in Phlx XL who has received permission from the Exchange to trade in options for his own account, and to generate and submit option quotations electronically from off the floor of the Exchange through AUTOM in eligible options to which such RSQT has been assigned. See Phlx Rule 1014(b)(ii)(B).

³ See Phlx By-Law Article X, Section 10-7. The Options Allocations Committee has jurisdiction over, among other things: the appointment of specialists on the options and foreign currency options trading floors; allocation, retention and transfer of privileges to deal in options on the trading floors; and administration of the 500 series of Phlx rules.

Rule 510 provides for monthly performance evaluations of 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.

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.

Monthly Evaluations - Criteria

New Rule 510 establishes **four (4) specific criteria** for each option assigned to an SQT or RSQT that will be regularly evaluated by the Exchange. First, the Exchange will evaluate the percentage of total quotes submitted by the SQT or RSQT that represent the NBBO. If the percentage of the total quotes that represent the NBBO is in the lowest quartile of all SQTs or RSQTs for two or more consecutive months, this may be considered sub-standard performance.

Second, the Exchange will evaluate the SQT or RSQT's adherence to the Exchange's established quoting requirements pursuant to Exchange Rule 1014.⁴ If an SQT or RSQT fails to meet the quoting requirements in the rule, this may be considered sub-standard performance.

Third, the Exchange will consider the number of requests for quote spread parameter relief.

Finally, to evaluate efficient quote submission to the Exchange, the Exchange will consider how an SQT or RSQT optimizes the submission of quotes through the Specialized Quote Feed ("SQF"), as defined in Rule 1080, by evaluating the number of individual quotes per quote "block" received by the Exchange.

A quote "block" is a component of the Exchange's SQF application that allows for delivery of a set of multiple quotations from the SQT or RSQT to the Exchange. Within a single "block," the SQT or RSQT can deliver quotes for any number of option

⁴ Exchange Rule 1014(b)(ii)(D)(1) provides that an SQT and an RSQT shall be responsible to quote continuous, two-sided markets in not less than 60% of the series in each option in which such SQT or RSQT is assigned, provided that, on any given day, a Directed SQT ("DSQT") or a Directed RSQT ("DRSQT") (as defined in Rule 1080(l)(i)(C)) shall be responsible to quote continuous, two-sided markets in not less than 99% of the series listed on the Exchange in at least 60% of the options in which such DSQT or DRSQT is assigned. Whenever a DSQT or DRSQT enters a quotation in an option in which such DSQT or DRSQT is assigned, such DSQT or DRSQT must maintain continuous quotations for not less than 99% of the series of the option listed on the Exchange until the close of that trading day.

series ranging from 1 to 99. The Exchange will evaluate the average number of quotes (1-99) submitted within the SQT or RSQT's quote blocks. The number of quotes delivered in each block will generally be a measure of the SQT or RSQT's quoting efficiency. For example, a member sending an average of 1 quote in each block may be considered inefficient while a member sending an average of 99 quotes in each block would be considered very efficient.

The Exchange believes that the regular monitoring of quoting efficiency in this fashion will result in more efficient quoting on the Exchange (*i.e.*, more quotes submitted per block), thus preserving and maximizing Exchange system capacity for handling quote traffic.

The text of the proposed rule is set forth below. Questions concerning the proposed rule may be addressed to Richard S. Rudolph, Vice President and Counsel, at (215) 496-5074, or to Walt Smith, Vice President, Listings and Projects, at (215) 496-5532.

Rule Text

Underlining indicates new text.

SQT and RSQT Performance Evaluation

Rule 510. (a) Performance Evaluation. The Exchange will periodically conduct an evaluation of member organizations who have Streaming Quote Traders ("SQTs") and Remote Streaming Quote Traders ("RSQTs"), as defined in Rule 1014, 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 among market makers, observance of ethical standards, and administrative factors.

(b) Committee Review of Minimum Performance Standards. The Committee may review the Performance Evaluations and in addition may consider any other relevant information including, but not limited to, trading data, regulatory history and such other factors and data as may be pertinent in the circumstances. If the Committee finds any failure by the SQTs and RSQTs to meet minimum performance standards, the Committee may take the following actions, after written notice and after opportunity for a hearing in accordance with Exchange By-Law Article XI, Section 11-1:

(i) restriction of assignments to additional options;

(ii) suspension, termination, or restriction of an assignment in one or more options; or

(iii) suspension, termination, or restriction of the SQT's and RSQT's registration in general.

(c) If an SQT's or RSQT's assignment in an option has been terminated pursuant to paragraph (b) above, the SQT or RSQT may not be re-appointed as a SQT or RSQT in that option for a period not to exceed six months.

Commentary:

.01 On a monthly basis, the Exchange will evaluate the following for each SQT and RSQT:

(a) Percentage of total quotes that represent the NBBO. If the percentage of the total quotes that represent the NBBO is in the lowest quartile of all SQTs or RSQTs for two or more consecutive months, this may be considered sub-standard performance.

(b) Quoting requirements pursuant to Rule 1014. If an SQT or RSQT fails to meet the quoting requirements as prescribed by the rule, this may be considered sub-standard performance.

(c) The number of requests for quote spread parameter relief will also be considered for the purposes of evaluating performance standards.

(d) To evaluate efficient quote submission to the Exchange, the Exchange will consider how a SQT or RSQT optimizes the submission of quotes through the Specialized Quote Feed, as defined in Rule 1080, by evaluating the number of individual quotes per quote block received by the Exchange.

.02. Upon implementation of this rule, the Exchange shall evaluate the first month's performance even if it is not a full calendar month.