

MEMORANDUM

TO: Members, Member Organizations, Participants, Participant Organizations

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

DATE: January 24, 2007

RE: SEC Approves Exchange's Penny 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 will 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")¹ 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 Friday, 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 with options overlying **Whole Foods Markets, Inc. (FMQ)**. The options included in the pilot are:

<u>Symbol</u>	<u>Underlying Security</u>
IWM	Ishares Russell 2000
QQQQ	QQQQ
SMH	SemiConductor Holders
GE	General Electric
AMD	Advanced Micro Devices
MSFT	Microsoft

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INTC	Intel
CAT	Caterpillar
WFMI	Whole Foods
TXN	Texas Instruments
A	Agilent Tech Inc.
FLEX	Flextronics International
SUNW	Sun Micro

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. Questions concerning the new 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.

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”)® 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 [\$.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