

Sanction is discretionary with Business Conduct Committee

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 Exchange 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 amend OFPA A-13 to include in the Exchange's minor rule violation enforcement and reporting plan ("Minor Rule Plan")⁴ violations for failure to receive approval to disengage the National Best Bid/Best Offer ("NBBO") Feature of the Exchange's Automated Options Market System ("AUTOM").⁵ The NBBO Feature automatically executes orders at the NBBO for certain options designated by the Phlx's Options Committee as eligible for the NBBO Feature ("automatic step-up options"), provided that the NBBO does not differ from the specialist's bid or offer by more than the "step up parameter."⁶ Currently, engagement and disengagement of the NBBO Feature

is governed solely by Phlx Rule 1080(c)(i), and violations are referred to the Business Conduct Committee ("BCC").

With regard to the manner in which a specialist must obtain approval to disengage the NBBO Feature, Phlx Rule 1080(c)(i) provides that the Chairman of the Options Committee or his designee (or if the Chairman of the Options Committee or his designee is unavailable, two Floor Officials) may determine to disengage the NBBO Feature for orders in certain automatic step-up options after notice to AUTOM users in certain situations set forth in the Rule. There is, however, no current corresponding OFPA providing a fine schedule for violations of the section of the Rule requiring approval to disengage the NBBO Feature. Thus, violations of Rule 1080(c)(i) currently are investigated by the Exchange's Market Surveillance Department ("Market Surveillance"), and referred by the Exchange's Enforcement Department ("Enforcement") to the BCC.

After receiving a referral from Enforcement, the BCC considers the matter and may determine to issue a statement of charges.⁷ This action is reportable on a member's Form U-4 or member organization's Form BD because it is a disciplinary action. By adopting a fine schedule under the Minor Rule Plan, the Exchange can issue fines for relatively minor infractions without the need for formal disciplinary action.

Accordingly, the Exchange proposes to amend OFPA A-13 to restate from Phlx Rule 1080(c)(i) the conditions for using the NBBO Feature, including the requirement to obtain approval to disengage the NBBO Feature, and to include a fine schedule for failure to obtain such approval. Specifically, the proposed fine schedule is as follows: first occurrence, \$250; second occurrence, \$500; third occurrence, \$1,000; fourth occurrence and thereafter, sanction discretionary with the BCC. The proposed fine schedule would be implemented on a one-year running basis. The BCC also would have discretion concerning sanctions for any violations should they be deemed egregious by Enforcement and referred directly to the BCC pursuant to Exchange Rule 960.2.

The Exchange believes it is appropriate to include in its Minor Rule Plan violations of the approval requirement for disengagement of the NBBO Feature. The Exchange's Minor

Rule Plan is designed to provide a prompt response to a violation of Exchange rules when a meaningful sanction is needed, but initiation of a disciplinary proceeding pursuant to Phlx Rule 960.2 is not suitable because such a proceeding would be more costly and time consuming than would be warranted given the nature of the violation.⁸ Therefore, inclusion in the Minor Rule Plan of violations of the NBBO Feature disengagement approval requirement should make the Exchange's disciplinary system more efficient. If the Exchange determines that a violation of Phlx Rule 1080(c)(i) or OFPA A-13, as amended, is not minor in nature, the Exchange may initiate full disciplinary proceedings in accordance with Phlx Rule 960.2.

2. Statutory Basis

The Phlx believes the proposed rule change is consistent with section 6 of the Act,⁹ in general, and with section 6(b)(5) of the Act,¹⁰ in particular, in that it is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system, and to protect investors and the public interest, by including violations of the approval requirement for disengagement of the NBBO Feature in its Minor Rule Plan, thus providing for the more efficient operation of its disciplinary system. In addition, the Exchange believes the proposal is consistent with section 6(b)(6) of the Act,¹¹ which requires that the rules of an exchange provide that its members be appropriately disciplined for violation of exchange rules, the Act, and the rules and regulations thereunder, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Phlx does not believe that the proposed rule change will impose any inappropriate burden on competition.

⁴ The Exchange's Minor Rule Plan, codified in Exchange Rule 970, includes Floor Procedure Advises with accompanying fine schedules. Rule 19d-1(c)(2) under the Act authorizes National Securities Exchanges to adopt minor rule violation plans for summary discipline and abbreviated reporting. 17 CFR 240.19d-1(c)(2). Rule 19d-1(c)(2) requires prompt filing with the Commission of any final disciplinary action. However, fines for minor rule violations not exceeding \$2,500 are deemed not final, thereby permitting periodic, as opposed to immediate, reporting.

⁵ 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 feature, AUTO-X. Equity option and index option specialists are required by the Exchange to participate in AUTOM and its features and enhancements. Option orders entered by Exchange members into AUTOM are routed to the appropriate specialist unit on the Exchange trading floor.

⁶ For a complete description of the NBBO Feature, see Securities Exchange Act Release No. 43684 (December 6, 2000), 65 FR 78237 (December 14, 2000) (order partially approving SR-Phlx-00-93).

⁷ See Phlx Rule 960.3. The BCC could also determine that a less formal sanction, such as a letter of caution, is appropriate.

⁸ Phlx Rule 960.2 governs the initiation of disciplinary proceedings by the Exchange for violations within the disciplinary jurisdiction of the Exchange.

⁹ 15 U.S.C. 78f.

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ 15 U.S.C. 78f(b)(6).