

*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 extend the pilot for an additional six-month period. The pilot was originally approved on a six-month basis for a limited number of eligible options<sup>7</sup> and extended for an additional six-month period.<sup>8</sup> Subsequently, the number of options eligible for the pilot was expanded to include all Phlx-traded options.<sup>9</sup> In December 2001, the pilot was extended again for an additional six-month period;<sup>10</sup> and extended again in May 2002.<sup>11</sup> The current pilot was extended in November 2002, and is scheduled to expire on May 31, 2003.<sup>12</sup>

The pilot currently includes the following features:

- Once an automatic execution occurs via AUTO-X in an option, the system begins a "counting" program, which counts the number of contracts executed automatically for that option up to a certain size,<sup>13</sup> which causes AUTO-X to become disengaged for that option.

- When the number of contracts executed automatically for that option exhausts the maximum guaranteed AUTO-X size for the specific option

within a 15 second time frame, the system ceases to automatically execute for that option, and drops all AUTO-X eligible orders in that option for manual handling by the specialist for a period of 30 seconds in order to enable the specialist to refresh quotes in that option.

- Upon the expiration of 30 seconds, automatic executions resume, the "counting" program is set to zero and it begins counting the number of contracts executed automatically within a 15 second time frame again, up to the specified disengagement size.

- Again, when the number of contracts automatically exceeds the specified disengagement size within a 15 second time frame, the system drops all subsequent AUTO-X eligible orders for manual handling by the specialist for a period of 30 seconds. The system then continues to reset the "counting" program and drop to manual, etc.

Since the most recent extension of the pilot, the Exchange has undertaken to provide automatic executions for eligible inbound orders (for the account(s) of both customers and broker-dealers) at the Exchange's disseminated price, up to the disseminated size, subject to a maximum guaranteed AUTO-X size of 250 contracts.<sup>14</sup> Thus, the current AUTO-X guarantee for eligible orders on the Exchange is the disseminated size for the given series, instead of a pre-determined "maximum guaranteed AUTO-X size" for the given option. The "maximum guaranteed AUTO-X size" is no longer the appropriate term, because the Exchange's current guaranteed AUTO-X size for eligible orders is equal to the disseminated size, which may be for a different number of contracts each time the quote in a given series is revised; there is no longer a pre-determined "maximum guaranteed AUTO-X size" (other than the Exchange's maximum allowable AUTO-X size of 250 contracts for all options other than options on the Nasdaq-100 Index Tracking Stock ("QQQ" SM)).<sup>15</sup>

which have a maximum guaranteed AUTO-X size of 2,000 contracts in the first two near term expiration months, and 1,000 contracts for all other expiration months).<sup>16</sup>

Accordingly, the Exchange has filed this proposed rule change to accommodate intervening changes in the function of AUTO-X; the pilot has not been changed, only the terminology used to describe the number of contracts executed within 15 seconds that would result in the temporary disengagement of AUTO-X.

In order to account for the recent changes to the AUTO-X function (*i.e.*, automatic executions up to the Exchange's disseminated size, rather than up to a pre-set maximum guaranteed size determined by the specialist), the instant pilot renewal includes the term "specified disengagement size."<sup>17</sup> The specified disengagement size shall not be for a number of contracts that is fewer than the highest quotation size for any series in the given option.<sup>18</sup>

One significant purpose of the pilot is to enable the Exchange to continue to move towards the dissemination of options quotations with actual size.<sup>19</sup> As discussed above, the "counting" feature of the pilot functions to disengage AUTO-X for a period of 30 seconds in

determining, comprising, or calculating the Index in the future.

<sup>16</sup> See Securities Exchange Act Release No. 46531 (September 23, 2002), 67 FR 61370 (September 30, 2002) (SR-Phlx-2002-47).

<sup>17</sup> See Amendment No. 2, note 4 *supra*.

<sup>18</sup> *Id.*

<sup>19</sup> In August 2002, the Commission approved amendments to the Exchange's definition of "disseminated size" to mean, with respect to the disseminated price for any quoted options series: (a) respecting options subject to the Auto-Quote technology operating as of May, 2002 ("current Auto-Quote") and scheduled to be phased-out by September 2002, the AUTO-X guarantee for the quoted option, except that the disseminated size of limit orders on the book shall be ten (10) contracts; or (b) respecting options subject to the Auto-Quote technology implemented after the effective date of this provision ("new Auto-Quote") and options subject to a proprietary quoting system provided for in Rule 1080.02 ("Specialized Quote Feed"), at least the sum of limit orders. The specialist and crowd may determine to disseminate a size greater than the sum of limit orders. See Securities Exchange Act Release No. 463425 (August 8, 2002), 67 FR 53376 (August 15, 2002) (SR-Phlx-2002-15) (Order approving amendments to Exchange Rule 1082(a)(ii) and Option Floor Procedure Advice F-7). The "current Auto-Quote" described in that Order has been phased out as of the time of the instant proposal. The "new Auto-Quote" is currently fully deployed. The Exchange recently filed a proposed rule change amending the rule to (i) reflect the full deployment of the "new Auto-Quote" and (ii) to add the specialist's size to the sum of the size of limit orders at the disseminated price to the Exchange's definition of "disseminated size" in Exchange Rule 1082. See SR-Phlx-2003-23. The Exchange expects to continue to amend its definition of "disseminated size" to reflect actual size as supporting systems become available.

<sup>7</sup> See Securities Exchange Act Release No. 43652 (December 1, 2000), 65 FR 77059 (December 8, 2000) (SR-Phlx-00-96).

<sup>8</sup> See Securities Exchange Act Release No. 44362 (May 29, 2001), 66 FR 30037 (June 4, 2001) (SR-Phlx-2001-56).

<sup>9</sup> See Securities Exchange Act Release No. 44760 (August 31, 2001), 66 FR 47253 (September 11, 2001) (SR-Phlx-2001-79).

<sup>10</sup> See Securities Exchange Act Release No. 45090 (November 21, 2001), 66 FR 59834 (November 30, 2001) (SR-Phlx-2001-100).

<sup>11</sup> See Securities Exchange Act Release No. 45862 (May 1, 2002), 67 FR 30990 (May 8, 2002) (SR-Phlx-2002-22).

<sup>12</sup> See Securities Exchange Act Release No. 46840 (November 15, 2002), 67 FR 70473 (November 22, 2002) (SR-Phlx-2002-59) ("Previous Pilot Extension").

<sup>13</sup> Currently, the rule refers to this size as the "AUTO-X guarantee." Under this proposal, the size would be referred to as the "specified disengagement size." In November 2002, the Commission approved amendments to Exchange Rule 1080(c) to provide automatic executions for eligible orders at the Exchange's disseminated size, subject to a minimum and maximum AUTO-X eligible size range, on an issue-by-issue basis. See Securities Exchange Act Release No. 46886 (November 22, 2002), 67 FR 72015 (December 3, 2002) (SR-Phlx-2002-39). That proposal provided that the maximum guaranteed AUTO-X size may be for a different number of contracts for customer orders than for broker-dealer orders. The previous pilot extension set forth that when the maximum guaranteed AUTO-X size in an option is for a different number of contracts for customer orders than for broker-dealer orders, AUTO-X would be disengaged when the larger of the two maximum guaranteed AUTO-X sizes for the particular option is exhausted.

<sup>14</sup> See Securities Exchange Act Release No. 47646 (April 8, 2003), 68 FR 17976 (April 14, 2003) (SR-Phlx-2003-18).

<sup>15</sup> The Nasdaq-100®<sup>SM</sup>, Nasdaq-100 Index®, Nasdaq®, The Nasdaq Stock Market®, Nasdaq-100 Shares<sup>SM</sup>, Nasdaq-100 Trust<sup>SM</sup>, Nasdaq-100 Index Tracking Stock<sup>SM</sup>, and QQQ<sup>SM</sup> are trademarks or service marks of The Nasdaq Stock Market, Inc. ("Nasdaq") and have been licensed for use for certain purposes by the Exchange pursuant to a License Agreement with Nasdaq. The Nasdaq-100 Index® (the "Index" is determined, composed, and calculated by Nasdaq without regard to the Licensee, the Nasdaq-100 Trust<sup>SM</sup>, or the beneficial owners of Nasdaq-100 Shares<sup>SM</sup>. Nasdaq has complete control and sole discretion in determining, comprising, or calculating the Index or in modifying in any way its method for