

“hinders the public’s access to the Exchange and serves only to protect those market participants who have not invested the proper time and capital to ensure that their trading systems are sufficiently robust and advanced.” IB also expressed the view that the Rule is difficult and expensive to enforce, and encourages traders to insert manual steps in their trading processes that increase the chance of error. IB concluded that removal of the Rule will enable customers to post competitive limit orders more quickly; force specialists to upgrade their operations and update prices faster; and thus improve the quality of the options National Best Bid and Offer (“NBBO”) and enhance the linkage system.

## 2. SIG Letter

In its letter opposing the proposal, SIG stated that the concerns and conditions that prompted adoption of the Rule have not changed. SIG contended that removal of the Rule will “unfairly place specialists at a competitive disadvantage [vis-a-vis] professional customers and broker-dealers who generate and send orders electronically.” Further, SIG expressed the view that adoption of the proposal will discourage liquidity providers from quoting deep markets, “as occasional errors or delays in quote updates will be instantaneously met with economic loss from electronic pick-off orders of professionals.”

SIG stated that the likelihood that Phlx will adopt a hybrid trading system will further compound the problems arising from electronically generated orders. Specifically, SIG believes that increased quoting by market makers in a hybrid system will create more instances of quote errors and anomalies, which will increase the opportunities for professional traders to pick off liquidity providers. Accordingly, SIG believes that any withdrawal of the Rule should be accompanied by adoption of an effective decrementation feature or other means to address quote clogging once a hybrid system is introduced.

In addition, SIG believes that recent enhancements to Phlx’s AUTOM and AUTO-X systems—such as a change to Auto-Quote that enables Phlx to disseminate a firm quote size of at least the sum of limit orders at Phlx’s disseminated price—do not warrant removal of the Rule. Rather, SIG stated that the enhancements exacerbate the disadvantages to specialists and market makers from electronically generated orders.

Finally, SIG argued that the Rule should be bolstered rather than eliminated. Specifically, SIG believes

that regulators should enforce the human intervention requirement of the Rule by categorizing “queue-trading” (which occurs when an off-floor system is programmed to identify a quoting error or quote delay and then queues an order on the screen to be sent to the exchange with the stroke of a key) as electronically generated.

## 3. Phlx Response to SIG Letter

In its response to the SIG Letter, the Phlx reiterated its belief that the systems changes it has made to AUTOM and AUTO-X have “narrowed the gap with respect to any actual or perceived advantage an off-floor customer or broker-dealer could have over a specialist \* \* \*.” The Exchange also noted that it has developed and deployed new electronic technology that provides for the automatic execution of eligible inbound customer and off-floor broker-dealer limit orders against booked customer limit orders at the Exchange’s disseminated price (called “Book Match”), and a new component of AUTOM, “Book Sweep,” designed to automatically execute limit orders on the book when the Exchange’s electronic options pricing system, Auto-Quote, or a specialist’s quote sent to the Exchange via specialized quote feed locks or crosses a limit order on the book. Phlx stated that as a result of its technology changes and as a competitive initiative, it proposed to delete the Rule. However, the Exchange also stated that it will continue to surveil for, and enforce, compliance with Exchange rules that help specialists and ROTs in managing their risk while making markets on the Exchange. In addition, the Exchange represented that it expects to monitor the effects of the deletion of this prohibition in order to readily ascertain its effects on the risk management activities of on-floor members and member organizations. If the Exchange determines that such effects are detrimental to the risk management activities of on-floor members and member organizations, the Exchange expects to take appropriate action, including the filing of appropriate rules and/or systems changes, to address such a situation.

## IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>12</sup> Specifically, the

<sup>12</sup> In approving this proposal, the Commission has considered the proposed rule’s impact on

Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,<sup>13</sup> which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest. Specifically, the Commission believes that the proposal should permit faster entry and execution of orders on the Exchange, thereby providing investors with improved services. The Commission also believes the proposal should facilitate the entry by traders of competitive limit orders on the Exchange, which should narrow spreads and improve the quality of the NBBO. Finally, the Commission notes that the Exchange has addressed the possible risk exposure issue of specialists and ROTs by representing that it will surveil for and enforce Exchange rules designed to help specialists and ROTs manage risk.<sup>14</sup> The Commission expects the Exchange to monitor the effects of the proposal on the risk management activities of on-floor members and member organizations, and take appropriate action if necessary.

## V. Conclusion

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act<sup>15</sup>, that the proposed rule change (SR-Phlx-2003-37), be, and hereby is, approved.

efficiency, competition, and capital formation. 15 U.S.C. 78(c)(f).

<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> For example, the Exchange committed to continue to surveil for, and enforce, compliance with Phlx Rule 1080(c)(ii), which sets forth the obligations of an Exchange Order Entry Firm, defined as a member organization of the Exchange that is able to route orders to AUTOM, and a User, defined as any person or firm that obtains access to AUTO-X through an Order Entry Firm. Specifically, the rule requires Order Entry Firms to comply with all applicable Exchange options trading rules and procedures; provide written notice to all Users regarding the proper use of AUTO-X; and neither enter nor permit the entry of multiple orders in call options and/or put options in the same option issue within any 15-second period for an account or accounts of the same beneficial owner.

<sup>15</sup> *Id.*