

the exercise or non-exercise of expiring options.

.03 In the event of "unusual circumstances," Rule 1042(h)(i) provides that the Exchange may extend the cut-off times for exercise instructions and the submission of a CEA beyond the normal time frames specified in Rule 1042(c). For purposes of subparagraph (h)(i), an "unusual circumstance" includes, but is not limited to, increased market volatility; significant order imbalances; significant volume surges and/or systems capacity constraints; significant spreads between the bid and offer in underlying securities; internal system malfunctions affecting the ability to disseminate or update market quotes and/or deliver orders; or other similar occurrences. Rule 1042 (h)(ii) provides that the Exchange may also reduce such cut-off times for "unusual circumstances." For purposes of subparagraph (h)(ii), an "unusual circumstance" includes, but is not limited to, a significant news announcement concerning the underlying security of an option contract that is scheduled to be released just after the close on the business day immediately prior to expiration.

.04 Although the deadline for options holders to make a final decision to exercise or not exercise is 5:30 p.m. (EST), the deadline for the submission of the CEA in the case of non-customer accounts will depend on the manner of the decision to exercise or not exercise as set forth below.

(i) For electronic submissions of CEAs by non-customer option holders with an electronic timestamp indicating receipt of exercise instructions on or before 5:30 p.m. (EST), members and member organizations must submit CEAs to the Exchange by 6:30 p.m. (EST).

(ii) For non-electronic submissions of CEAs by non-customer option holders, members and member organizations must submit CEAs to the Exchange via the Contrary Exercise Advice Box by 5:30 p.m. (EST).

.05 Each member organization shall establish fixed procedures to insure secure time stamps in connection with their electronic systems employed for the recording of submissions to exercise or not exercise expiring options.

[.02].06 It is contemplated by this rule that effecting an exercise decision in an expiring option on the basis of material information obtained after the exercise cut-off time is activity inconsistent with just and equitable principles of trade.

[.03].07 The exercise cut-off requirements contained in this rule do not apply to any foreign currency or

index option products listed on the Exchange.

.08 Each Member Organization shall prepare a memorandum of every exercise instruction received showing the time when such instruction was so received. Such memoranda will be subject to the requirements of SEC Rule 17a-4(b).

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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 and is 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 Phlx Rule 1042 to simplify how CEAs are submitted to the Exchange in light of the Options Clearing Corporation's ("OCC") Exercise-by-Exception ("Ex-by-Ex") procedure and to provide additional time for members and member organizations to submit CEAs for certain accounts to the Exchange. The purpose is also to provide the Exchange with flexibility to modify the time to close options trading prior to expiration and the time by which decisions whether to exercise must be made. The proposal provides guidance to those member organizations that indicate final exercise decisions on behalf of others. Additionally, the proposal conforms the language of the various parts of the rule in light of the changes.

The OCC, issuer of all Phlx and other exchange-traded options contracts, has an established procedure pursuant to OCC Rule 805 for options holders wishing to exercise in-the-money options before they expire. Known as Ex-by-Ex, the procedure provides for the automatic exercise at expiration of any equity option contract that has an exercise price below (in the case of a call) or above (in the case of a put) the closing price of the underlying security by: "of a point (\$.75) or more if the option contract is carried in a customer

account,"⁵ or ¼ of a point (\$.25) or more if the option is carried in any other account. Options holders who wish to have their options contracts exercised in accordance with the Ex-by-Ex procedure need to take no further action. Those contracts that are in-the-money by the appropriate amount will be automatically exercised. Options holders who do not wish to have their options automatically exercised, or wish their options to be exercised under different parameters than the Ex-by-Ex procedure, must file a CEA with the Exchange pursuant to Phlx Rule 1042, and thereby instruct OCC of their "contrary intention".⁶ Members and member organizations can satisfy the filing requirement by manually submitting a CEA to the Exchange or by electronically submitting the CEA through OCC's clearing system (ENCORE). Phlx Rule 1042 is designed to, among other things, deter individuals from taking improper advantage of late-breaking news by requiring evidence of an option holder's intention regarding whether to exercise expiring equity options via the submission of a CEA.

On occasion, OCC has had to waive or suspend its Ex-by-Ex procedure, such as when trading in the underlying stock has been halted, or where no accurate price was available to be used in the determination of the closing price. When this occurs and there is no automatic exercise per OCC Rule 805, all options holders must send exercise instructions to OCC if they wish to exercise an option regardless of whether the option is in or out-of-the-money. Currently, when OCC suspends its Ex-by-Ex procedure for an option class, Phlx Rule 1042 requires the submission of a CEA. Thus, when OCC has waived the Ex-by-Ex procedure, option holders must determine what price would have been used, even though the only available price might be a "stale" last sale price, and then determine whether a CEA needs to be submitted to the Exchange to indicate the option holder's intention to exercise or not exercise. Option holders and options exchanges have long viewed this process as cumbersome and confusing.

⁵ A "customer account" is defined in OCC By-Laws as an account of a Clearing Member which is confined to Exchange transactions cleared and positions carried by the Clearing Member on behalf of its securities customers, other than those transactions of market-makers which are cleared through a market maker's account. See OCC By-Laws Article (I)(C)(28).

⁶ A CEA may be cancelled by filing an Advice Cancel with the Exchange at any time up to the submission cut-off deadline specified in proposed Phlx Rule 1042(c).