

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b)<sup>17</sup> of the Act in general, and furthers the objectives of Sections 6(b)(6)<sup>18</sup> and 6(b)(7)<sup>19</sup> of the Act in particular, in that it is designed to ensure that Exchange members, and persons associated with members, are appropriately disciplined for violations of the provisions of the Act, the rules and regulations thereunder, or the rules of the Exchange, as well as providing a fair procedure for the disciplining of Exchange members, and persons associated with members, by fostering a prompt, efficient disciplinary process.

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

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

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others*

The Exchange has neither solicited nor received written comments on the proposed rule change.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the

Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Phlx. All submissions should refer to File No. SR-Phlx-00-13 and should be submitted by January 18, 2001.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43747; File No. SR-Phlx-00-62]

### **Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Mandatory Auto-Quote Settings to Update Quotations Based on a Certain Minimum Movement in the Underlying Security**

December 19, 2000.

#### **I. Introduction**

On August 1, 2000, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4<sup>2</sup> thereunder, a proposal to grant the Chairman of the Exchange's Board of Governors (or his designee) the authority to mandate that the Exchange's Auto-Quote System ("Auto-Quote") be set to update options quotations based on a certain minimum movement in the underlying security. On September 14, 2000, the Commission published the proposed rule change in the **Federal Register**.<sup>3</sup> The Commission received no comments on the proposal. This order approves the proposed rule change.

<sup>20</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 43254 (September 6, 2000), 65 FR 55663.

## II. Description of the Proposal

Phlx has proposed to amend Commentary .01 to Exchange Rule 1080, "Philadelphia Stock Exchange Automated Options Market (AUTOM) and Automatic Execution System (AUTO-X)," to allow the Chairman of the Exchange's Board of Governors (or his designee) ("Chairman") to increase the increment by which the price of the underlying security would have to change before Auto-Quote<sup>4</sup> would generate new quotes for the overlying options.

Outbound options quotations are forwarded electronically by the Exchange to the Options Price Reporting Authority ("OPRA"), which, in turn, disseminates them to vendors. Recently, due to increased overall options volume and significant increases in the number of quotations generated, OPRA has, at times, been unable to disseminate quotation traffic on a timely basis. To address the capacity constraints, the Commission recently adopted a formula to allocate among the options exchanges a specific allotment of bandwidth capacity for messages transmitted to, and received from, OPRA during peak usage periods.<sup>5</sup>

The proposed rule is intended to enhance the Exchange's ability to manage quote traffic while various solutions to quote capacity issues are being implemented. Currently, one long-standing method the Exchange has used to manage quote traffic is "throttling," or capping outbound quote message traffic to OPRA. For many years, the Exchange's options trading systems have had the ability to throttle outbound message traffic to OPRA by limiting the amount of messages sent to OPRA in a given second. This is accomplished by withholding some Auto-Quote generated messages from dissemination each second until the next second. Throttling may result in some quotations being overridden by subsequent quotations and, thus, prevent older quotations-in-waiting from ever being disseminated.

The proposed rule will allow the Chairman, if the Exchange's options trading systems throttle quotations for at least three minutes, to mandate that Auto-Quote be set to update quotations based on a certain minimum movement

<sup>4</sup> Auto-Quote is the Exchange's electronic options pricing system that enables specialists to automatically monitor and instantly update quotations, based on incremental changes in the price of the security underlying the option.

<sup>5</sup> See Securities Exchange Act Release No. 43621 (November 27, 2000), 65 FR 75564 (December 1, 2000) ("Capacity Allocation Formula Release").

<sup>17</sup> 15 U.S.C. 78f(b).

<sup>18</sup> 15 U.S.C. 78f(b)(6).

<sup>19</sup> 15 U.S.C. 78f(b)(7).

in the underlying security.<sup>6</sup> For example, Auto-Quote may be set to update options quotations based on a price change in the underlying security of an eighth of \$1.00. Thus, each time the price of the underlying security increased or decreased by an eighth or more, Auto-Quote would update the quotation on the overlying option to reflect such a change.<sup>7</sup> The proposed rule will allow the Chairman to mandate that Auto-Quote be set to update options quotations based on, for example, a price change of a quarter of \$1.00 in the underlying security, meaning that Auto-Quote would not update quotations on the overlying option until the price of the underlying security increases or decreases by a quarter.<sup>8</sup> Increasing the incremental price change in the underlying security required for an Auto-Quote update would result in fewer quotes generated and, thus, fewer messages queuing to be sent to OPRA.

The Chairman could exercise the authority described in the proposed rule change with respect to certain securities but not others, or cause Auto-Quote to raise the threshold to different amounts for different underlying securities (e.g., one quarter for Stock A and one half for Stock B).<sup>9</sup>

### III. Discussion

The Commission has determined that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a

<sup>6</sup> Under the proposal, the restrictions to Auto-Quote could continue for a period of 15 minutes and could be continued every 15 minutes thereafter, provided that the Exchange's options trading systems were throttling quotations at the end of each such 15-minute period.

<sup>7</sup> Auto-Quote will aggregate consecutive changes in price for purposes of the proposed rule. Thus, two consecutive increases of one sixteenth in the price of the underlying security would be considered an increase of an eighth. Telephone conversation between Richard S. Rudolph, Counsel, Phlx, and Michael Gaw, Attorney-Adviser, Division of Market Regulation ("Division"), Commission, on December 18, 2000.

<sup>8</sup> In practice, a threshold below which a price change in the underlying security would not result in a new price generated by Auto-Quote for the overlying option already exists, because the Exchange has set a minimum trading increment of an eighth for options contracts trading at \$3.00 per share per option or higher and one sixteenth in option contracts trading under \$3.00 per share per option. See Phlx Rule 1034(i). Thus, a price change in the underlying security would not result in a shift in the spread for the overlying option unless that price change triggered a shift in that option's spread of one eighth or greater (assuming the option was trading over \$3.00). The proposed rule will merely give the Chairman the authority to raise the threshold.

<sup>9</sup> Telephone conversation between Richard S. Rudolph, Counsel, Phlx, and Michael Gaw, Attorney-Adviser, Division, Commission, on December 18, 2000.

national securities exchange.<sup>10</sup> In particular, the Commission believes that the proposal is consistent with Sections 6(b)(5) and 6(b)(8) of the Act.<sup>11</sup> Section 6(b)(5) requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to facilitate transactions in securities, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that those rules not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Finally, Section 6(b)(8) of the Act requires that the rules of an exchange not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

As the Commission has previously noted,<sup>12</sup> the amount of market data generated by the options markets has, at times, exceeded OPRA's capacity to disseminate it publicly on a real-time basis. When this occurs, the only market participants with up-to-date quote and trade information are those present on the floor of an exchange. Market participants not physically present on the floor are at an informational disadvantage, which reduces market transparency, impedes efficient price discovery, and is inconsistent with the goal of fair competition.

As discussed above, because OPRA has not been able to increase its systems capacity in the short-term sufficiently and because the participants in OPRA have not been able to agree how to allocate existing capacity amongst themselves, the Commission recently adopted certain amendments to the OPRA Plan to allocate among the options exchanges OPRA's peak-period message handling capacity.<sup>13</sup> In its Order, the Commission asserted its expectation that the options exchanges

<sup>10</sup> In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78f(b)(5) and 78f(8).

<sup>12</sup> See Capacity Allocation Formula Release, *supra* note 5, at 75564.

<sup>13</sup> See Capacity Allocation Formula Release, *supra* note 5. The Commission intended for the capacity allocation formula to be a short-term solution to OPRA capacity shortages. As a more permanent solution, as part of their settlement of an enforcement action with the Commission, the American Stock Exchange, the Chicago Board Options Exchange, the Pacific Exchange, and the Phlx have consented, among other things, to modify the organization structure and operation of OPRA so that each exchange will independently determine the amount of capacity it will obtain. See Securities Exchange Act Release No. 43268 (September 11, 2000).

would continue to "consider and implement other quote message mitigation strategies as both long-term and short-term solutions."<sup>14</sup> The Commission also noted that "the allocation formula should encourage each individual exchange to establish and utilize quote reduction methods based on the amount of message capacity it has been allocated, thereby promoting efficiency of the market data dissemination process."<sup>15</sup>

Phlx's proposed rule change is one such quote reduction method. Upon implementation of the new rule, the Chairman of the Exchange's Board of Directors (or his designee) could require Auto-Quote to be set to update options quotations only if the price of the underlying security were to move more than a designated amount. If Auto-Quote were set in this manner, the options prices determined by Auto-Quote would remain static if the price of the underlying security moved by less than the designated increment. The result of Auto-Quote's reduced sensitivity to changes in the price of the underlying security would be fewer new quotations generated by Auto-Quote and, consequently, fewer quote messages to be sent to OPRA.

The Commission recognizes that the proposal could affect price competition because, as a result of the restrictions to Auto-Quote, the options prices generated may not reflect the price that otherwise would be dictated by the pricing model used by a Phlx specialist or a specialist or market-maker on another options exchange. As a result, the proposed rule change may increase the likelihood that the prices offered by Phlx specialists—as displayed on OPRA—will differ from those displayed on other options exchanges. These disparities could result in an increased occurrence of locked and crossed markets across the options markets.

However, the Commission believes that this minimal impact on competition is necessary and appropriate in furtherance of the purposes of the Act and, thus, is consistent with Section 6(b)(8) of the Act.<sup>16</sup> Given that the Exchange is allocated only a defined percentage of OPRA's capacity during peak usage periods, it must take steps to ensure that the message traffic it generates does not exceed that allocation.<sup>17</sup> To address this problem,

<sup>14</sup> Capacity Allocation Formula Release, *supra* note 5, at 75565.

<sup>15</sup> *Id.* at 75574.

<sup>16</sup> 15 U.S.C. 78f(b)(8).

<sup>17</sup> See Capacity Allocation Formula Release, *supra* note 5, at 75573 ("The Commission recognizes that there are always costs associated with allocating a finite resource among users").

the Exchange for many years has had the ability to “throttle” outgoing message traffic by preventing the dissemination to OPRA of certain quotes that have been generated by Auto-Quote. The current proposal takes a slightly different tack by restricting the generation of new quotes rather than “throttling” the transmission to OPRA of new quotes that have been generated. On the whole, the Commission believes that both are reasonable means by which to address the problem of the limited capacity of the OPRA system and, as such, are consistent with the Act.

The Commission believes, though, that the proposed rule change may offer a more effective tool to restrain message traffic than throttling and, thus, may have a more minimal effect on competition. Presently, the throttling function is applied indiscriminately to all quotes generated by Auto-Quote. The approach described in the proposed rule change, however, may be used selectively. Thus, Phlx could choose to continue updating quotes for certain options classes continuously while restraining the generation of new quotes in other options classes. As a result, Phlx would be able to determine—based on competitive factors—which options classes should have a greater share during peak usage periods of the bandwidth allocated to it by OPRA. Therefore, the Commission believes the proposal promotes just and equitable principles of trade, facilitates transactions in securities, and removes certain impediments to a free and open market, consistent with Section 6(b)(5) of the Act.<sup>18</sup>

#### IV. Conclusion

*It Is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act,<sup>19</sup> that the proposed rule change (SR-Phlx-00-62) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 43740; File No. SR-Phlx-00-48]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Telephone Use on the Options Floor

December 19, 2000.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) <sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 16, 2000, the Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change described in Items I, II, and III below, which Items have been prepared by the Exchange. The Exchange filed Amendment No. 1 to the proposed rule change on December 1, 2000.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Phlx proposes to amend Exchange Rule 606 and to create new Options Floor Procedure Advice (“OFPA”) F-31 to establish rules and procedures for telephone use on the Phlx's options floor. The text of the proposed rule change is set forth below. All text is being added.

#### Wire and Other Connections

##### *Communications and Equipment*

#### Rule 606

(e)(1) *Registration.* Members and member organizations must register, prior to use, any new telephone to be used on the Options Floor. Each phone registered with the Exchange must be registered by category of user. If there is a change in the category of any user, the phone must be re-registered with the Exchange. At the time of registration, members and member firm representatives must sign a statement that they are aware of and understand the rules

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The Exchange submitted a new Form 19b-4, which replaces and supersedes the original filing (“Amendment No. 1”). Amendment No. 1 amends the purpose section of the proposed rule change to provide a description of provisions governing floor brokers, registered options traders, general access phones, and exchange liability. Amendment No. 1 also clarifies that registration and maintenance of registration records is handled through the Exchange's Membership Services Department. Finally Amendment No. 1 amends proposed Phlx Rule 606(e)(3) to include specialists.

and procedures governing the use of telephones on the Options Floor.

(2) *Capacity and Functionality.* No wireless telephone used on the Options Floor may have an output greater than one watt. No person on the Options Floor may use any device for the purpose of maintaining an open line of continuous communication whereby a person not located in the trading crowd may continuously monitor the activities in the trading crowd. This prohibition covers intercoms, walkie-talkies and any similar devices. Speed-dialing features are permitted on any member telephone.

(3) *Specialist and Registered Options Traders.*

(a) Specialists and Registered Options Traders (“ROT's”) may use their own cellular and cordless phones to place calls to any person at any location (whether on or off the Options Floor).

(b) ROT's located off the Options Floor may not place an order by calling a Floor Broker who is present in a trading crowd. ROT's located off the Options Floor may not otherwise place an order by calling the specialist phone in the trading crowd. Any telephonic order entered from off the Options Floor must be placed with a person located in a member firm booth.

(4) *Floor Brokers.*

(a) Floor Brokers may use cellular and cordless telephones, but only to communicate with persons located on the Options Floor. These telephones may not include a call forwarding feature. Headsets are permitted for Floor Brokers, but if the Exchange determines that a Floor Broker is maintaining a continuous open line through the use of a headset, the Floor Broker will be prohibited from future use of any headset for a length of time to be determined by the Exchange.

(b) All orders phoned to the Floor Brokers must be received initially at the Floor Broker's booth. Floor Brokers may not receive telephonic orders while in the trading crowd except from their booth. Any telephonic order entered from off the Options Floor must be placed with a person located in a member firm booth.

(5) *Clerks.*

(a) Floor Broker clerks are subject to the same terms and conditions on telephone use as Floor Brokers.

(b) Stock Execution clerks are subject to the same terms and conditions on telephone use as Floor Brokers.

(c) The Options Committee reserves the right to prohibit clerks from using cellular or cordless phones on the floor at any time that it is necessary due to electronic interference problems or capacity problems resulting from the number of such phones then in use on the Options Floor. In such circumstances, the Committee will first consider restricting the use of such phones by Stock Execution Clerks, and then by Floor Broker Clerks.

(6) *General Access In-House Phones.* The general access in-house telephones located outside of the trading post areas may be used by any member, clerk or floor broker to communicate with persons located on the Options Floor or within the Exchange complex.

<sup>18</sup> 15 U.S.C. 78f(b)(5).

<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</sup> 17 CFR 200.30-3(a)(12).