

*Required fields are shown with yellow backgrounds and asterisks.*

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
Form 19b-4

File No.\* SR - 2012 - \* 18

Amendment No. (req. for Amendments \*)

Proposed Rule Change by NASDAQ OMX PHLX LLC.

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * <input checked="" type="checkbox"/>	Amendment * <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) * <input checked="" type="checkbox"/>	Section 19(b)(3)(A) * <input type="checkbox"/>	Section 19(b)(3)(B) * <input type="checkbox"/>
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Rule

Pilot <input type="checkbox"/>	Extension of Time Period for Commission Action * <input type="checkbox"/>	Date Expires * <input type="text"/>
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<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)
<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)
<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)

Exhibit 2 Sent As Paper Document Exhibit 3 Sent As Paper Document **Description**

Provide a brief description of the proposed rule change (limit 250 characters, required when Initial is checked \*).

Relating to FLEX Trading

**Contact Information**

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name *	Jurij	Last Name *	Trypupenko
Title *	Associate General Counsel		
E-mail *	Jurij.trypupenko@nasdaqomx.com		
Telephone *	(301) 978-8132	Fax	

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date 02/10/2012

By Edward S. Knight  
(Name \*)Executive Vice President and General Counsel  
(Title \*)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Edward S Knight,

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

**Form 19b-4 Information (required)**

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change (required)**

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> NASDAQ OMX PHLX LLC (“Phlx” or “Exchange”) is filing with the Securities and Exchange Commission (“Commission”) a proposal to amend Phlx Rule 1079 (FLEX Index, Equity and Currency Options) to enhance, clarify, and streamline FLEX option rules and procedures and eliminate unnecessary and obsolete language.<sup>3</sup> The proposal would also amend Rule 1034 (Minimum Increments) regarding FLEX option trading increments. Additionally, the proposal would amend Options Floor Procedure Advice F-28 (Trading FLEX Index, Equity and Currency Options)<sup>4</sup> to conform it to the proposed Rule 1079 amendments.

A notice of the proposed rule change for publication in the Federal Register is attached hereto as Exhibit 1 and the text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

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

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

<sup>3</sup> FLEX options are flexible exchange-traded index, equity, or currency option contracts that provide investors the ability to customize basic option features including size, expiration date, exercise style, and certain exercise prices. FLEX options may have expiration dates within five years. See Phlx Rule 1079. FLEX currency option contracts traded on the Exchange are also known as FLEX World Currency Options (“WCO”) or Foreign Currency Options (“FCO”) contracts.

<sup>4</sup> Options Floor Procedure Advices (“OFPAs” or “Advices”), which may correspond to Exchange rules, contain the Exchange’s minor rule plan (“MRP” or “Minor Rule Plan”) in respect of options trading. The Minor Rule Plan consists of Advices pursuant to Rule 19d-1(c) under the Act. 17 CFR 240.19d-1(c). OFPA F-28 corresponds to Rule 1079.

2. Procedures of the Self-Regulatory Organization

The Board of Directors of the Exchange (“Board”) approved the submission of this proposed rule change, by unanimous written consent on March 16, 2010. No other action by the Exchange is necessary for the filing of the rule change.

Questions and comments on the proposed rule change may be directed to Jurij Trypupenko, Associate General Counsel, NASDAQ OMX, at (301) 978-8132.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

a. Purpose

The purpose of this proposal is to amend Rule 1079 to enhance, clarify, and streamline FLEX option rules and procedures and eliminate unnecessary and obsolete language. The proposal amends Rule 1079 regarding FLEX provisions that include: what FLEX products may be traded, minimum increment, settlement value and computation, time to expiration, response time, BBO improvement interval, assignment of certain market makers to FLEX options, and fair split. The purpose of the proposal is also to amend Rules 1079 and 1034 regarding a \$.01 minimum trading increment for FLEX options. Additionally, the proposal would amend Options Floor Procedure Advice F-28 to conform it to proposed Rule 1079.

Background

Unlike other options, FLEX options are not continuously quoted and series are not pre-established; the variable terms of FLEX options are established through the

processes described in Rule 1079 regarding equity, index, and foreign currency FLEX options.<sup>5</sup>

Rule 1079 deals with the process of listing and trading FLEX options on the Exchange. Rule 1079 states that the term "FLEX option" means a FLEX option contract that is traded subject to this rule. Rule 1079(a)(1) permits trading FLEX options on the Exchange on the following: any index upon which options currently trade on the Exchange; any security which is options-eligible pursuant to Rule 1009; or any foreign currency which is options-eligible pursuant to Rule 1009 and which underlies non-FLEX U.S. dollar-settled foreign currency options that are trading on the Exchange.<sup>6</sup> Rule 1079 discusses, among other things: opening FLEX options trading through the Request-for-Quote ("RFQ") process; quotes responsive to RFQs; trading parameters and procedures; and position and exercise limits for FLEX options. The rule also discusses the characteristics of FLEX options in terms of underlying interest, exercise price and style, quote format, expiration and settlement; and who may trade FLEX options; and in subsection (b) sets forth the procedures for quoting and trading FLEX options.

For various reasons, exchange traded options are not listed on every National Market System ("NMS") stock, index or other products approved for options trading; and

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<sup>5</sup> However, all FLEX transactions must be in compliance with Section 11 of the Act and the rules promulgated thereunder. 15 U.S.C. 78k. This includes, for example, yielding priority to customer orders.

<sup>6</sup> Rule 1079(a)(1) is more restrictive in respect of index options than the rules of other markets that trade FLEX products and allow FLEX index options to trade even if such exchange does not list and trade the non-FLEX options. See CBOE Rule 24A.4(b)(1).

even when listed may not be listed in every available series.<sup>7</sup> The Exchange recognizes that market participants may want access to options on such securities. In addition, market participants may want the certainty and safeguards of a regulated and standardized marketplace for listing and trading standardized option products that are cleared on behalf of option exchanges and market participants by The Options Clearing Corporation (“OCC”). The OCC does not, however, engage in the clearing of options (or other derivative products) on behalf of the over the counter (“OTC”) marketplace.<sup>8</sup> The OCC clearing function is one of the fundamental and essential distinctions between exchange-listed options contracts and OTC options (derivatives) contracts; whereas the ability to exercise OTC options contracts is dependent on the willingness and ability of the contra-party to meet its obligation. The Exchange is, like all other option exchanges, a self-regulatory organization (“SRO”) with fundamental regulatory responsibilities in respect of the Phlx listed options marketplace; there is no similar regulatory structure for the OTC options marketplace. For these and other reasons, exchange listed options are viewed as a viable, liquid alternative to OTC options, because exchange listed options do not possess the negative characteristics associated with non-exchange listed (OTC)

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<sup>7</sup> Moreover, certain products such as, for example, the Exchange’s Foreign Currency Options (also known as World Currency Options) are not fungible with foreign currency options that may be listed and traded on other exchanges (e.g. the International Stock Exchange LLC (“ISE”)).

<sup>8</sup> In the fall of 2010, OCC announced that it entered into an agreement marking its first step into OTC equity derivatives clearing of OTC options based on the Standard and Poor’s (S&P) 500. And in April 2011, OCC announced that it entered into an agreement establishing MarkitSERV as a trade source and middleware provider for OTC equity derivative trades to be cleared by OCC. See <http://www.markitserv.com/ms-en/media-centre/press-releases/detail.page?dcr=/markit/PressRelease/data/ms-en/2011/April-11/13>.

options, namely: lack of transparency, insufficient collateral requirements, inefficient trade processing, insufficient clearing arrangements, insufficient regulation, and counterparty risk.<sup>9</sup>

As an alternative to the OTC marketplace, the Exchange has been offering market participants the ability to trade customized flexible option (FLEX) products in a regulated and centrally cleared trading environment continuously for about thirteen years.<sup>10</sup> With the onset of the current financial crisis, some Exchange customers have been seeking a means by which they could shift OTC options trading to the Exchange in order to minimize the risks inherent in OTC trading. The Exchange believes that this desire to trade options on regulated exchanges, as opposed to un-regulated OTC transactions, will continue and likely increase.

#### The Proposal

The goal of the Exchange is to make FLEX options more accessible, flexible, and usable trading and hedging vehicles. The Exchange believes that the changes proposed in this rule filing should afford additional trading opportunities and provide market participants and investors with significantly enhanced means to manage their risk exposures and carry out their investment objectives with exchange-traded products.

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<sup>9</sup> The Exchange/OTC market distinction and the safeguards of central clearing and SRO regulation have become particularly evident and significant in the economic downturn of the last two years.

<sup>10</sup> See Securities Exchange Act Release No. 39549 (January 14, 1998), 63 FR 3601 (January 23, 1998)(SR-Phlx-96-38)(order approving addition of Rule 1079 regarding FLEX options). FLEX options have also been traded on CBOE for about eighteen years. See also Securities Exchange Act Release No. 31920 (February 24, 1993), 58 FR 12280 (March 3, 1993)(SR-CBOE-92-17)(order approving FLEX trading on CBOE).

### What FLEX Products May Be Traded

Currently, Rule 1079(a)(1) permits trading FLEX index options and FLEX foreign currency options on the Exchange if the associated non-FLEX options are trading on the Exchange. Unlike index options and currency options, however, the rules allow FLEX options to be traded on any securities that are options-eligible pursuant to Rule 1009. The Exchange now proposes to make FLEX trading eligibility the same for all FLEX products.

The Exchange proposes to amend its FLEX rules to state that FLEX products may be traded only if the non-FLEX products are trading on the Exchange. Specifically, the Exchange is modifying its Rule 1079(a)(1)(B) to state that FLEX options can be traded on any security which is options-eligible pursuant to Rule 1009 and in addition is trading on the Exchange.

The Exchange also proposes to add to the opening paragraph of Rule 1079 a statement that a new series of FLEX options may be established on any business day prior to the expiration date as provided for in this rule. The proposed change serves to codify current practice regarding the addition of new series of FLEX options.<sup>11</sup>

The Exchange believes that these proposed amendments should add clarity to its FLEX rules and procedures. Traders that want to trade FLEX products would be able to ascertain whether they could trade FLEX products simply by seeing if the Exchange trades the associated non-FLEX options, and may trade newly added FLEX series any time until expiration.

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<sup>11</sup> Equity options and index options, on the other hand, have certain restrictions prohibiting addition of new options series within five days of expiration. Rules 1012(a)(i)(B) and 1101A(b)(i).

### Minimum Increment

Minimum increments for options on stocks, index options, and exchange traded options are established in Rule 1034 as follows: options quoting in decimals at \$3.00 or higher have a minimum increment of \$.10, and options on stocks and index options quoting in decimals under \$3.00 have a minimum increment of \$.05. Rule 1034 has provisions for other trading increments. For example, Rule 1034(a)(i)(B) establishes a Penny Pilot Program for certain high trading volume options overlying the PowerShares QQQ™ Trust ("QQQQ"), SPDR S&P 500® Exchange Traded Funds ("SPY"), and iShares Russell 2000® Index Funds ("IWM"). Rule 1034(a)(ii) establishes that all options on foreign currencies where the underlying foreign currency is not the U.S. dollar have a minimum increment of \$.01. Rule 1034(a)(iii) establishes that all options on Alpha Indexes shall have a minimum increment of \$.01 if options on either component of the index have a minimum increment of \$.01. The Exchange proposes, as discussed below, a similar \$.01 increment for FLEX options in new Rule 1034(a)(iv).

Rule 1079(a) currently sets forth exercise price methodologies for equity, index, and currency FLEX options. The exercise price methodologies are unique to each option type. With respect to FLEX equity options, Rule 1079(a)(3)(B) states that the exercise price may be specified in terms of a specific dollar amount rounded to the nearest \$.10 or a percentage of the underlying security rounded to the nearest minimum increment. With respect to FLEX index options, Rule 1079(a)(3)(A) states that the exercise price may be specified in terms of a specific index value number, a percentage of the index value calculated as of the open or close of trading on the Exchange on the trade date, or a method for fixing such number. With respect to FLEX currency options, Rule 1079

(a)(3)(C) states that exercise price may be specified in terms of a specific dollar amount rounded to the nearest hundredth of a dollar.

With respect to quote format for FLEX index options and equity options, Rule 1079(a)(4)(A) states that a bid and/or offer may be specified in the form of a decimal price (e.g. .10 or .25), pursuant to Rule 1034, a specific dollar amount, or a percentage of the underlying equivalent value, in the case of FLEX index options, or security, in the case of FLEX equity options, rounded to the nearest minimum increment. With respect to quote format for FLEX currency options, Rule 1079(a)(4)(B) states that a bid and/or offer may be specified in the form of dollars per unit of underlying foreign currency in the minimum increments set forth for U.S. dollar settled foreign currency options in Rule 1034(a).

The Exchange proposes to clarify subsections (a)(4)(A) and (a)(3)(B) of Rule 1079 to state that the minimum increment will be as specified in proposed amended Rule 1034 (\$.01). The Exchange also proposes to state in subsection (a)(3)(B) that the exercise price for FLEX equity options may be specified in a dollar amount that is rounded to the nearest \$.01.<sup>12</sup> The Exchange simultaneously proposes new Rule 1034(a)(iv) stating that all FLEX options shall have a minimum increment for quoting, trading and exercise purposes that may not be smaller than \$.01.<sup>13</sup> This allows maximum

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<sup>12</sup> In the alternative, the exercise price may be a percentage of the underlying security rounded to the nearest minimum increment. Subsection (a)(3)(B) to Rule 1079.

<sup>13</sup> The Exchange proposes additional non-substantive changes to Rule 1034 clarifying that exceptions to the general minimum increments provision of Rule 1034 may be located throughout the rule and in proposed subsection 1034(a)(v) indicating that reference is to minimum increments.

flexibility for FLEX options to trade at any increment that is authorized for trading on the Exchange. The Exchange notes that its minimum increment proposal is similar in nature to what is available on other options markets.<sup>14</sup>

FLEX options are, similarly to options on foreign currencies, unique products that require upmost flexibility to allow investors the ability to precisely establish the parameters of the products. The minimum increment proposal will increase the flexibility of FLEX products in relation to OTC products and will enhance the ability to customize FLEX products for trading and hedging purposes.<sup>15</sup> The Exchange believes that allowing FLEX options a similar price improvement opportunity of not less than the minimum increment of one cent would encourage price improvement to the benefit of FLEX trading participants and significantly increase the flexibility of FLEX products.

#### Settlement

Rule 1079(a)(9) currently states that, respecting FLEX index options,<sup>16</sup> the settlement value may be specified as the index value reported at the close (P.M.-settled),

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<sup>14</sup> As an example, CBOE provides in its Rule 24A.4(c)(2) that there may be a \$.01 minimum increment provision for exercise prices of its FLEX equity options, and that exercise prices may be rounded to the nearest decimal increment determined by CBOE on a class-by-class basis that may not be smaller than \$0.01. CBOE also provides in its Rule 24A.5(f) that bids and offers for specified FLEX Index Options may be in \$.01 increments, and that changes in decimal bids and offers for FLEX equity options shall be determined by the CBOE on a class-by-class basis, but may not be smaller than \$.01.

<sup>15</sup> Currently, FLEX options trade in the same increments as non-FLEX options.

<sup>16</sup> Respecting currency FLEX options (WCOs or FCOs), Rule 1079(a)(9) states that the settlement value for such options will be the Exchange Spot Price at 12:00:00 Eastern Time (noon) on expiration day, unless the Exchange determines to apply an alternative closing settlement value as a result of extraordinary circumstances. FLEX currency options are settled in U.S. dollars. FLEX currency options will cease trading at 10:15 a.m. eastern time on their designated expiration date.

opening of trading on the Exchange (A.M.-settled),<sup>17</sup> or as an average over a specified period of time within parameters established by the Exchange.<sup>18</sup> The Exchange has found that while average settlement may have appeared historically to be a viable alternative, this type of settlement is no longer used as a FLEX settlement alternative. As such, the Exchange proposes to delete average settlement from subsection (a)(9), while leaving as settlement values the index value reported at the close or at the opening of trading on the Exchange. The Exchange believes that this proposal is conducive to the goal of streamlining FLEX trading procedures.

#### Expiration

Rule 1079(a)(6)(B) currently states that FLEX equity options effectively have to expire within five years. Specifically, the rule states that a FLEX equity option may expire any month, business day and year within three years, provided, however, that a FLEX Requesting Member<sup>19</sup> may request a longer term to a maximum of five years, and

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<sup>17</sup> The restriction that FLEX options could not expire on any business day that falls on, or within two business days of an expiration day for any non-FLEX option on the same underlying security was recently removed. However, in the case of FLEX index options only, FLEX index options expiring on or within two business days of an Expiration Friday may not have an exercise settlement value on the expiration date determined by reference to the closing price of the index or specified averages; the exercise settlement value on such expiration dates may only be determined by a.m. settlement values. See Securities Exchange Act Release No. 60679 (September 16, 2009), 74 FR 48619 (September 23, 2009)(SR-Phlx-2011-81)(notice of filing and immediate effectiveness). FLEX options may now expire on any given business day (and settle thereafter).

<sup>18</sup> FLEX American style index options and FLEX foreign currency options settle pursuant to alternate parameters. See Rule 1079(a)(9)(A) and (B), respectively.

<sup>19</sup> A Requesting Member is an Exchange member that requests to do a FLEX option trade through an RFQ and obtains quotes and executes trades in certain non-listed FLEX options at the specialist post of the non-FLEX option on the Exchange. See introductory paragraph and subsection (a)(10) of Rule 1079.

upon the assessment of the regulatory staff (Exchange employee) that sufficient liquidity exists among FLEX equity participants, such request may be granted. The Exchange now proposes to amend subsection (a)(6)(B) to clarify that all FLEX equity options may expire within five years.

The Exchange believes that there is no reason to delay the FLEX trading (RFQ) process by requiring Exchange staff involvement where a Requesting Member wants to trade an equity FLEX option that is between three years and one day and five years long. The Exchange believes that there is no qualitative difference between a FLEX equity option that is more than, as opposed to less than, three years in length (e.g. three years less one day as opposed to three years plus one day in length) that of necessity requires staff involvement; and therefore no reason to mandate Exchange involvement to make a liquidity finding for FLEX products between three and five years in length.<sup>20</sup>

#### Registered Options Traders and Specialists

Rule 1079(c) currently indicates that a Registered Options Trader (“ROT”)<sup>21</sup> or Specialist may apply on a form prescribed by the Exchange to be assigned in FLEX options. Subsection (c) provides further that at least two members shall be assigned to

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<sup>20</sup> Other options exchanges that allow FLEX options trading do not have an exchange staff liquidity assessment requirement, while allowing trading of FLEX options products with significantly longer expirations (e.g. fifteen year FLEX options). See CBOE Rule 24A.4(a)(4).

<sup>21</sup> An ROT is a regular member or a foreign currency options participant of the Exchange located on the trading floor who has received permission from the Exchange to trade in options for his own account. See Rule 1014 (b)(i). For discussion regarding other market makers on the Exchange such as, for example, Specialists, see Rule 1020 regarding registration and functions of specialists and Rule 1014(b)(ii)(D)(2) regarding quote obligations.

each FLEX option, and that only the Specialist in the non-FLEX option may be the assigned Specialist in that FLEX option. The Exchange proposes to simplify this by eliminating the form application procedure and providing for automatic assignment of FLEX options market makers. The result would be that there will be at least one liquidity provider (specialist) available for each FLEX option.

Specifically, the Exchange proposes in Rule 1079(c)(1) that a Specialist or ROT, including an SQT<sup>22</sup> or RSQT<sup>23</sup> as defined in Rule 1014, that is assigned (allocated) in a non-FLEX option is deemed to be assigned in the related FLEX option.<sup>24</sup> This is consistent with the current Rule 1079 specialist assignment process, which indicates that only the specialist in the non-FLEX options may be the specialist in the FLEX options, but makes the process automatic. The Exchange believes that the deemed assignment process whereby a Specialist or ROT is assigned to a non-FLEX option is similar to other Exchange automatic assignment processes that assign related options to specialists that

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<sup>22</sup> An SQT is an ROT who has received permission from the Exchange to generate and submit option quotations electronically in eligible options to which such SQT is assigned. An SQT may only submit such quotations while such SQT is physically present on the floor of the Exchange. See Rule 1014(b)(ii)(A).

<sup>23</sup> An RSQT is an ROT that is a member or member organization with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically in eligible options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. See Exchange Rule 1014(b)(ii)(B).

<sup>24</sup> The rules now provide that Specialists (including Remote Specialists) are allocated non-FLEX options pursuant to Rules 501, 505, and 506; and RSQTs and SQTs are assigned options pursuant to Rule 507. These rules are applicable to the specialists that are automatically assigned in FLEX options. For ease of discussion in this proposal, reference may be made to assignment to FLEX options for both Specialists and RSQTs/SQTs.

are already assigned in underlying options.<sup>25</sup> Moreover, the Exchange believes that in light of the proposed automatic FLEX allocation process the requirement to have at least two members assigned to each FLEX option is simply not necessary.<sup>26</sup> The Exchange is thereby eliminating the two member requirement and replacing it with a requirement that at least one member shall be assigned to each FLEX option to provide liquidity. This is wholly consistent with the Exchange's specialist system, which requires (and allows for) one specialist per option issue.<sup>27</sup>

The Exchange does not propose to change any of the fundamental quoting (market making) obligations in Rules 1014 and 1079. Thus, Rule 1079(c) continues to require that the provisions of Rule 1014(c) regarding market making obligations shall be applicable to assigned FLEX Specialists (and assigned ROTs), such that a market must be

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<sup>25</sup> See Securities Exchange Act Release No. 60455 (August 6, 2009), 74 FR 40857 (August 13, 2009)(SR-Phlx-2009-62)(notice of filing and immediate effectiveness regarding automatic allocation of related options emanating from mergers and acquisitions and spin-offs).

<sup>26</sup> Because FLEX options would be traded only in classes listed on the Exchange (which would have specialists), the automatic allocation process would essentially result in a FLEX specialist for each FLEX option.

<sup>27</sup> Moreover, as noted in a comment letter in respect of SR-NASDAQ-2007-004 and NASDQ-2007-080, the Exchange believes that there is no requirement in the Act or rules thereunder for a specialist-based exchange to have more than one specialist per option issue; nor for a non-specialist based exchange to have more than one market maker per option issue. See note 89 and related text in Securities Exchange Act Release No. 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008)(SR-NASDAQ-2007-004 and NASDQ-2007-080)(approval order). See also note 92 and related text in the cited filing, wherein the Commission discusses that although market makers could be an important source of liquidity, the Act does not require an exchange to have market makers.

provided in any FLEX option when requested by an Options Exchange Official.<sup>28</sup> And Rule 1079(b)(2) continues to require that during the response time following an RFQ announcement, each assigned Specialist and assigned ROT who responds is required to respond with a market of minimum size but is not required to provide continuous quotes or a minimum bid-offer differential.

#### Response Time

Section 1079(b)(2) currently indicates that following the RFQ announcement, a preset response time will begin, during which members may provide responsive quotes. The response time, between two and 15 minutes, will be determined by the Exchange (the “response time”). During the response time, members may provide responsive quotes to the RFQ, which may be entered, modified or withdrawn. Each assigned ROT and assigned Specialist who responds is required to respond with a market of the minimum size, but is not required to provide continuous quotes or a minimum bid-offer differential (quotation spread parameters). The Exchange proposes to modify the response time.

Specifically, the Exchange proposes to reduce the lower range of the subsection (b)(2) response time from two minutes to fifteen seconds; as a result, the Exchange would be able to determine a response time between fifteen seconds and 15 minutes. The Exchange believes that the current fast-paced trading environment, driven, in part, by sophisticated on-floor computers and risk management systems that are employed by floor traders, no longer requires several minutes of FLEX response time, unlike when the FLEX program was initiated about a decade ago. The Exchange has noted that as the

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<sup>28</sup> Rule 1014 also indicates under what circumstances certain market makers are not deemed to be assigned in certain products, and do not have market making obligations. See, e.g., Rule 1014(b)(ii)(D)(4) (regarding SQTs and RSQTs not assigned in Quarterly Option Series and adjusted options series).

FLEX program has matured, FLEX responses times have been significantly diminished and are often now measured in seconds. Moreover, the Exchange proposes to make the response time even more transparent to all that want to participate in a FLEX RFQ by specifically adding a provision that the response time will be announced to the Exchange's membership via Options Trading Alert ("OTA") and posted on the Exchange's website. The Exchange believes that the reduction of response time, and publication on the web, should make FLEX options a more attractive trading and hedging vehicle for the investing public. The Exchange proposes to similarly reduce the best bid or offer improvement interval to fifteen seconds.

#### Best Bid or Offer Improvement Interval

FLEX best bid or offer ("BBO") procedures are set forth in Rule 1079. Rule 1079(b)(3) states that at the end of the response time, the assigned Specialist, or if none, the Requesting Member shall determine the best bid and offer based on price, but not time or size. However, where two or more bids/offers are at parity, bids/offers submitted by an assigned Specialist, assigned ROT or customer will have priority over bids/offers submitted by non-assigned ROTs and by controlled accounts as defined in Rule 1014(g)(i). The BBO shall be disseminated with reference to the corresponding RFQ. Additionally, Rule 1079(b)(4) currently states that if the Requesting Member rejects the BBO or the BBO is for less than the entire size requested, the BBO improvement interval provides a two minute time period during which the BBO may be matched or improved (the "improvement interval"). An assigned ROT or assigned Specialist who responded with a market during the response time may immediately join any new BBO. The new BBO shall be determined and disseminated with reference to the corresponding RFQ.

The Exchange proposes to reduce the improvement interval in subsection (b)(4) to fifteen seconds. As the Exchange noted previously, the Exchange believes that the current fast-paced trading environment, driven, in part, by sophisticated computers and risk management systems that are employed by floor traders, no longer requires several minutes for the improvement interval. The Exchange has noted that as the FLEX program has matured, BBO improvement intervals, like FLEX response times in general, have been significantly diminished and are often now measured in seconds. Moreover, most FLEX option trades are priced at the BBO, and the improvement interval is rarely, if ever, employed in the modern age of floor trading with rapid electronically computed, and verbally announced, bids and offers. As such, the current lengthy two minute improvement interval procedure is no longer necessary and, the Exchange believes, is counter-productive to the Exchange's goal of streamlining the trading of FLEX options so that they are efficient and superior trading and hedging vehicles, particularly when compared to OTC options.<sup>29</sup>

#### Fair Split

Rule 1079(b)(6) states that whenever a Requesting Member intends to cross a FLEX option after the BBO is determined, the Requesting Member, having announced an intention to cross, must bid and offer at or better than the BBO. The rule further provides that if the Requesting Member's bid/offer is at the BBO (subsection (b)(6)(A)) or improves the existing BBO (subsection (b)(6)(B)), the Requesting Member may execute 25% or a fair split, whichever is greater, of the contra-side of the order that is the subject

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<sup>29</sup> Moreover, the Exchange notes that the BBO concept, which applies to and is used extensively in FLEX options trading, is not mandated for OTC trading.

of the RFQ. The Exchange proposes to increase the execution percentage to 40%. The Exchange believes that the split percentage increase is consistent with its goals for this filing in that this proposal should help to incentivize the use of FLEX options.<sup>30</sup>

#### Option Floor Procedure Advice

The Exchange proposes to amend OFPA F-28 so the language of the Advice conforms to the proposed rule changes. Specifically, using the same language changes as proposed in Rule 1079 the Exchange proposes the following conforming language changes in OFPA F-28: in the opening paragraph of the Advice to indicate that a new series of FLEX options may be established on any business day prior to the expiration date; in subsection (2) of the Advice to indicate that the response time will be between 15 seconds and 15 minutes and that the response time will be announced to the Exchange's membership; in subsection (3) of the Advice to reflect the process of automatically assigning a FLEX Specialist; in subsection (4) of the Advice to indicate that the BBO improvement interval will be 15 seconds; and in subsection (6) of the Advice to indicate that the Requesting Member may execute 40% or a fair split.

In terms of housekeeping changes, the Exchange proposes to add the word "certain" in the opening sentence of OFPA F-28 to more accurately track the corresponding opening sentence of Rule 1079.

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<sup>30</sup> CBOE indicates in its rules that it may determine on a class-by-class basis whether to establish a crossing participation entitlement for facilitations and/or solicitations and the applicable crossing participation entitlement percentage, which shall not exceed 40% of the trade. See CBOE Rule 24A.5(e)(iii). The proposed 40% standard may also be found in current Exchange rules in respect of enhanced participation, such that options specialists may get a 40% to 60% participation in respect of controlled accounts. See Rule 1014(g)(ii).

### Discussion of Proposal

The Exchange believes that its proposals to amend Rule 1079 (with corresponding changes to OFPA F-28 and Rule 1034) are important and necessary to the Exchange's efforts to create a product and market that provides members and investors interested in FLEX-type options with an improved and superior alternative to the over the counter (OTC) market in customized options, which can take on contract characteristics similar to FLEX options but are not subject to the same restrictions. The proposed changes should afford all market participants, including public customers and investment banks, greater flexibility in determining whether to execute their customized options in an exchange environment or in an un-regulated OTC market. The Exchange believes that market participants would benefit from being able to trade these customized FLEX options in an exchange environment in several ways, including, but not limited to, the following: (1) enhanced efficiency in initiating and closing out positions; (2) increased market transparency; and (3) heightened contra-party creditworthiness due to the role of The Options Clearing Corporation (OCC) as issuer and guarantor of FLEX options.

The Exchange notes that when the FLEX option rules were initially proposed and approved about thirteen years ago, there was uncertainty regarding what market impacts, if any, excessive FLEX positions would have on the market or on firms.<sup>31</sup> To minimize the risk of adverse market effects, at the time the FLEX rules were first introduced the

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<sup>31</sup> See Securities Exchange Act Release No. 39549 (January 14, 1998), 63 FR 3601 (January 23, 1998)(SR-Phlx-98-38)(order approving). The trading of FLEX options since the initial FLEX proposal appears to indicate there is limited secondary trading in any FLEX option series having a particular expiration date due to the diversity inherent in FLEX options, and that extensive FLEX expiration concentrations are rare.

Exchange put in place numerous FLEX trading boundaries some of which, such as for example position limits, have been modified over time. Based on the Exchange's experience in trading FLEX options to date -- specifically with respect to the diversity in FLEX option trading, the relatively small percentage of FLEX options traded compared to overall trading on the Exchange, and the lack of market disruptions or problems caused by or on existing FLEX option expirations -- the Exchange believes that many of these restrictions and requirements are no longer necessary. To the contrary, the Exchange believes that the restrictions (procedures) that it proposes to eliminate in this filing actually place the Exchange at a competitive disadvantage to its OTC counterparts in the market for customized options, and unnecessarily limit market participants' ability to trade in an exchange environment that offers the added benefits of transparency, price discovery, liquidity, and financial stability.

The Exchange also notes that position limit, aggregation and exercise limit requirements would continue to be applicable to FLEX options in accordance with Rule 1079.<sup>32</sup> Additionally, FLEX options would remain subject to the reporting requirements.<sup>33</sup> Moreover, member organizations would remain subject to the margin requirements of Rule 721. The Exchange believes these existing safeguards serve sufficiently to help monitor open interest in FLEX option series and significantly reduce potential FLEX trading risk. In addition, the Exchange notes that FLEX options are

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<sup>32</sup> See Rule 1079(d) and (e). For non-FLEX position and exercise procedures generally, see Rules 1001, 1002, 1001A, and 1002A.

<sup>33</sup> See Rule 1079(b)(7).

subject to the options disclosure document ("ODD") requirements of Rule 9b-1<sup>34</sup> under the Act.<sup>35</sup> No broker or dealer can accept an order from a customer to purchase or sell an option contract relating to an options class that is the subject of a definitive ODD (including FLEX options), or approve the customer's account for the trading of such an option, unless the broker or dealer furnishes or has furnished to the customer a copy of the definitive ODD. The ODD contains a description, special features, and special risks of FLEX options. Lastly, similar to any other options, FLEX options are subject to member firm supervision and suitability requirements.<sup>36</sup>

The Exchange believes that the proposed changes to the FLEX rules are appropriate in light of the concerns that have been expressed at the highest levels by regulators of the U.S. financial system. The Commission noted in its 2010 concept release ("Concept Release") that concerns were raised and sought input regarding, among other things, equity market structure about off-exchange, as opposed to on-exchange, trading (for example, over the counter or OTC trading); and recognized the strong policy preference under the Act in favor of price transparency and displayed markets (which OTC are not). The Commission indicated that the Concept Release was being published to invite public comment on a wide range of market structure issues, including OTC (off-exchange) trading, un-displayed (or "dark") liquidity, and high frequency trading.<sup>37</sup>

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<sup>34</sup> 17 CFR 240.9b-1.

<sup>35</sup> 15 U.S.C. 78a et seq.

<sup>36</sup> See Rule 763. See also Rule 748.

<sup>37</sup> See Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010)(Concept Release on Equity Market Structure). The Commission noted in the Concept Release that it appears that a significant

More recently, Congress passed, and the president in July 2010 signed into law, extensive financial reforms that include provisions regarding the regulation of certain OTC derivatives (swaps) markets to make them regulated and transparent (the “Dodd-Frank Act”). To achieve these goals, the Dodd-Frank Act requires that, among other things, these derivatives markets have, like current equity and options markets, participant registration requirements, central clearing, position limits, capital and margin requirements, and recordkeeping and recording responsibilities pursuant to the Act.<sup>38</sup>

The Exchange believes that the proposed changes to the FLEX rules are wholly consistent with the noted concerns and may, in fact, be helpful to ameliorate them. The Exchange believes the proposed changes are appropriate and reasonable and would provide market participants with more opportunities to execute their customized options on a regulated national securities exchange. The Exchange believes that the proposed

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percentage of the orders of individual investors are executed at OTC market makers and that a significant percentage of the orders of institutional investors are executed in dark pools; and indicated that a review of the order routing disclosures required by Rule 606 of Regulation NMS of eight broker-dealers with significant retail customer accounts revealed that nearly 100% of their customer market orders are routed to OTC market makers. The Chairperson of the Commission, Mary L. Shapiro, referenced the Concept Release, stating that “today, nearly 30 percent of volume in U.S.-listed equities is executed in venues that do not display their liquidity or make it generally available to the public. The percentage executed by these dark, non-public markets is increasing nearly every month.” See Mary L. Schapiro, Strengthening Our Equity Market Structure (Speech at the Economic Club of New York, Sept. 7, 2010) (“Schapiro Speech,” available on the Commission website). Regarding the recent effort of another exchange to bring additional targeted liquidity onto a regulated and lit (displayed) options market, see Securities Exchange Act Release No. 63270 (November 8, 2010), 75 FR 69489 (November 12, 2010)(NASDAQ-2010-141)(notice of filing and immediate effectiveness regarding Investor Support Program).

<sup>38</sup> See H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

revisions would promote just and equitable principles of trade, and would facilitate transactions in securities while continuing to foster the public interest and greatly enhanced investor protection.

b. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act<sup>39</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>40</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanisms of a free and open market and a national market system.

The Exchange is proposing to enhance, clarify, and streamline Rule 1079 regarding FLEX provisions to include: what FLEX products may be traded, minimum increment, settlement value and computation, time to expiration, response time, BBO improvement interval, automatic assignment of market makers to FLEX options, and fair split. The Exchange believes that these proposals will promote the goals of the Act, and in particular will remove impediments to and perfect the mechanisms of a free and open market and a national market system by making FLEX options that are traded on the regulated Exchange more accessible, flexible, and usable trading and hedging vehicles that are a desirable alternative to over the counter trading.

In addition to enhancing competition among lit markets and OTC markets, the Exchange believes that its proposal would enhance competition among options

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<sup>39</sup> 15 U.S.C. 78f(b).

<sup>40</sup> 15 U.S.C. 78f(b)(5).

exchanges; provide additional, sought after opportunities to manage risk and trade customized FLEX options on an accessible, regulated, and transparent platform, namely the Exchange; provide benefits to all manner of FLEX option participants including institutional and large traders, retail investors, and retail and public investors; and significantly expand trading, investing, and hedging opportunities in a volatile economic environment.

The Exchange also believes that its proposal is consistent with investor protection and the public interest in that it is limited to FLEX options on securities that have non-FLEX options listed on them. The criteria for listing such underlying securities (e.g. securities with sufficient trading volume and shareholders) has been carefully crafted over the years to ensure that only appropriate securities have standardized options listed on them to the benefit of investors and the public.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. To the contrary, the Exchange feels that the proposal would enhance competition among options exchanges; provide additional, sought after opportunities to manage risk and trade customized FLEX options on an accessible, regulated, and transparent platform, namely the Exchange; provide benefits to all manner of FLEX option participants including institutional and large traders, retail investors, and retail and public investors; and significantly expand trading, investing, and hedging opportunities in a volatile economic environment.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

6. Extension of Time Period for Commission Action

The Exchange does not consent to an extension of the time period for Commission action.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Notice of proposed rule for publication in the Federal Register.

5. Proposed Rule text.

Exhibit 1

SECURITIES AND EXCHANGE COMMISSION  
(Release No. \_\_\_\_\_ ; File No. SR-Phlx-2012-18)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by NASDAQ  
OMX PHLX LLC Relating to FLEX Trading

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, notice is hereby given that on February 10, 2012, NASDAQ OMX PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III, below, which Items have been prepared by the Exchange. 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 Exchange, pursuant to Section 19(b)(1) of the Act<sup>3</sup> and Rule 19b-4 thereunder,<sup>4</sup> proposes to amend Phlx Rule 1079 (FLEX Index, Equity and Currency Options) to enhance, clarify, and streamline FLEX option rules and procedures and eliminate unnecessary and obsolete language.<sup>5</sup> The proposal would also amend Rule

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

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

<sup>3</sup> 15 U.S.C. 78s(b)(1).

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

<sup>5</sup> FLEX options are flexible exchange-traded index, equity, or currency option contracts that provide investors the ability to customize basic option features

1034 (Minimum Increments) regarding FLEX option trading increments. Additionally, the proposal would amend Options Floor Procedure Advice F-28 (Trading FLEX Index, Equity and Currency Options)<sup>6</sup> to conform it to the proposed Rule 1079 amendments.

The text of the proposed rule change is available on the Exchange's Website at <http://www.nasdaqtrader.com/micro.aspx?id=PHLXRulefilings>, at the principal office of the Exchange, and at the Commission's Public Reference Room.

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 Exchange 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 this proposal is to amend Rule 1079 to enhance, clarify, and streamline FLEX option rules and procedures and eliminate unnecessary and obsolete

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including size, expiration date, exercise style, and certain exercise prices. FLEX options may have expiration dates within five years. See Phlx Rule 1079. FLEX currency option contracts traded on the Exchange are also known as FLEX World Currency Options ("WCO") or Foreign Currency Options ("FCO") contracts.

<sup>6</sup> Options Floor Procedure Advices ("OFPAs" or "Advices"), which may correspond to Exchange rules, contain the Exchange's minor rule plan ("MRP" or "Minor Rule Plan") in respect of options trading. The Minor Rule Plan consists of Advices pursuant to Rule 19d-1(c) under the Act. 17 CFR 240.19d-1(c). OFPA F-28 corresponds to Rule 1079.

language. The proposal amends Rule 1079 regarding FLEX provisions that include: what FLEX products may be traded, minimum increment, settlement value and computation, time to expiration, response time, BBO improvement interval, assignment of certain market makers to FLEX options, and fair split. The purpose of the proposal is also to amend Rules 1079 and 1034 regarding a \$.01 minimum trading increment for FLEX options. Additionally, the proposal would amend Options Floor Procedure Advice F-28 to conform it to proposed Rule 1079.

### Background

Unlike other options, FLEX options are not continuously quoted and series are not pre-established; the variable terms of FLEX options are established through the processes described in Rule 1079 regarding equity, index, and foreign currency FLEX options.<sup>7</sup>

Rule 1079 deals with the process of listing and trading FLEX options on the Exchange. Rule 1079 states that the term "FLEX option" means a FLEX option contract that is traded subject to this rule. Rule 1079(a)(1) permits trading FLEX options on the Exchange on the following: any index upon which options currently trade on the Exchange; any security which is options-eligible pursuant to Rule 1009; or any foreign currency which is options-eligible pursuant to Rule 1009 and which underlies non-FLEX U.S. dollar-settled foreign currency options that are trading on the Exchange.<sup>8</sup> Rule 1079

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<sup>7</sup> However, all FLEX transactions must be in compliance with Section 11 of the Act and the rules promulgated thereunder. 15 U.S.C. 78k. This includes, for example, yielding priority to customer orders.

<sup>8</sup> Rule 1079(a)(1) is more restrictive in respect of index options than the rules of other markets that trade FLEX products and allow FLEX index options to trade

discusses, among other things: opening FLEX options trading through the Request-for-Quote (“RFQ”) process; quotes responsive to RFQs; trading parameters and procedures; and position and exercise limits for FLEX options. The rule also discusses the characteristics of FLEX options in terms of underlying interest, exercise price and style, quote format, expiration and settlement; and who may trade FLEX options; and in subsection (b) sets forth the procedures for quoting and trading FLEX options.

For various reasons, exchange traded options are not listed on every National Market System (“NMS”) stock, index or other products approved for options trading; and even when listed may not be listed in every available series.<sup>9</sup> The Exchange recognizes that market participants may want access to options on such securities. In addition, market participants may want the certainty and safeguards of a regulated and standardized marketplace for listing and trading standardized option products that are cleared on behalf of option exchanges and market participants by The Options Clearing Corporation (“OCC”). The OCC does not, however, engage in the clearing of options (or other derivative products) on behalf of the over the counter (“OTC”) marketplace.<sup>10</sup> The

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even if such exchange does not list and trade the non-FLEX options. See CBOE Rule 24A.4(b)(1).

<sup>9</sup> Moreover, certain products such as, for example, the Exchange’s Foreign Currency Options (also known as World Currency Options) are not fungible with foreign currency options that may be listed and traded on other exchanges (e.g. the International Stock Exchange LLC (“ISE”).

<sup>10</sup> In the fall of 2010, OCC announced that it entered into an agreement marking its first step into OTC equity derivatives clearing of OTC options based on the Standard and Poor’s (S&P) 500. And in April 2011, OCC announced that it entered into an agreement establishing MarkitSERV as a trade source and middleware provider for OTC equity derivative trades to be cleared by OCC. See

OCC clearing function is one of the fundamental and essential distinctions between exchange-listed options contracts and OTC options (derivatives) contracts; whereas the ability to exercise OTC options contracts is dependent on the willingness and ability of the contra-party to meet its obligation. The Exchange is, like all other option exchanges, a self-regulatory organization (“SRO”) with fundamental regulatory responsibilities in respect of the Phlx listed options marketplace; there is no similar regulatory structure for the OTC options marketplace. For these and other reasons, exchange listed options are viewed as a viable, liquid alternative to OTC options, because exchange listed options do not possess the negative characteristics associated with non-exchange listed (OTC) options, namely: lack of transparency, insufficient collateral requirements, inefficient trade processing, insufficient clearing arrangements, insufficient regulation, and counter-party risk.<sup>11</sup>

As an alternative to the OTC marketplace, the Exchange has been offering market participants the ability to trade customized flexible option (FLEX) products in a regulated and centrally cleared trading environment continuously for about thirteen years.<sup>12</sup> With

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<http://www.markitserv.com/ms-en/media-centre/press-releases/detail.page?dcr=/markit/PressRelease/data/ms-en/2011/April-11/13>.

<sup>11</sup> The Exchange/OTC market distinction and the safeguards of central clearing and SRO regulation have become particularly evident and significant in the economic downturn of the last two years.

<sup>12</sup> See Securities Exchange Act Release No. 39549 (January 14, 1998), 63 FR 3601 (January 23, 1998)(SR-Phlx-96-38)(order approving addition of Rule 1079 regarding FLEX options). FLEX options have also been traded on CBOE for about eighteen years. See also Securities Exchange Act Release No. 31920 (February 24, 1993), 58 FR 12280 (March 3, 1993)(SR-CBOE-92-17)(order approving FLEX trading on CBOE).

the onset of the current financial crisis, some Exchange customers have been seeking a means by which they could shift OTC options trading to the Exchange in order to minimize the risks inherent in OTC trading. The Exchange believes that this desire to trade options on regulated exchanges, as opposed to un-regulated OTC transactions, will continue and likely increase.

#### The Proposal

The goal of the Exchange is to make FLEX options more accessible, flexible, and usable trading and hedging vehicles. The Exchange believes that the changes proposed in this rule filing should afford additional trading opportunities and provide market participants and investors with significantly enhanced means to manage their risk exposures and carry out their investment objectives with exchange-traded products.

#### What FLEX Products May Be Traded

Currently, Rule 1079(a)(1) permits trading FLEX index options and FLEX foreign currency options on the Exchange if the associated non-FLEX options are trading on the Exchange. Unlike index options and currency options, however, the rules allow FLEX options to be traded on any securities that are options-eligible pursuant to Rule 1009. The Exchange now proposes to make FLEX trading eligibility the same for all FLEX products.

The Exchange proposes to amend its FLEX rules to state that FLEX products may be traded only if the non-FLEX products are trading on the Exchange. Specifically, the Exchange is modifying its Rule 1079(a)(1)(B) to state that FLEX options can be traded on any security which is options-eligible pursuant to Rule 1009 and in addition is trading on the Exchange.

The Exchange also proposes to add to the opening paragraph of Rule 1079 a statement that a new series of FLEX options may be established on any business day prior to the expiration date as provided for in this rule. The proposed change serves to codify current practice regarding the addition of new series of FLEX options.<sup>13</sup>

The Exchange believes that these proposed amendments should add clarity to its FLEX rules and procedures. Traders that want to trade FLEX products would be able to ascertain whether they could trade FLEX products simply by seeing if the Exchange trades the associated non-FLEX options, and may trade newly added FLEX series any time until expiration.

#### Minimum Increment

Minimum increments for options on stocks, index options, and exchange traded options are established in Rule 1034 as follows: options quoting in decimals at \$3.00 or higher have a minimum increment of \$.10, and options on stocks and index options quoting in decimals under \$3.00 have a minimum increment of \$.05. Rule 1034 has provisions for other trading increments. For example, Rule 1034(a)(i)(B) establishes a Penny Pilot Program for certain high trading volume options overlying the PowerShares QQQ™ Trust ("QQQQ"), SPDR S&P 500® Exchange Traded Funds ("SPY"), and iShares Russell 2000® Index Funds ("IWM"). Rule 1034(a)(ii) establishes that all options on foreign currencies where the underlying foreign currency is not the U.S. dollar have a minimum increment of \$.01. Rule 1034(a)(iii) establishes that all options on Alpha Indexes shall have a minimum increment of \$.01 if options on either component of

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<sup>13</sup> Equity options and index options, on the other hand, have certain restrictions prohibiting addition of new options series within five days of expiration. Rules 1012(a)(i)(B) and 1101A(b)(i).

the index have a minimum increment of \$.01. The Exchange proposes, as discussed below, a similar \$.01 increment for FLEX options in new Rule 1034(a)(iv).

Rule 1079(a) currently sets forth exercise price methodologies for equity, index, and currency FLEX options. The exercise price methodologies are unique to each option type. With respect to FLEX equity options, Rule 1079(a)(3)(B) states that the exercise price may be specified in terms of a specific dollar amount rounded to the nearest \$.10 or a percentage of the underlying security rounded to the nearest minimum increment. With respect to FLEX index options, Rule 1079(a)(3)(A) states that the exercise price may be specified in terms of a specific index value number, a percentage of the index value calculated as of the open or close of trading on the Exchange on the trade date, or a method for fixing such number. With respect to FLEX currency options, Rule 1079(a)(3)(C) states that exercise price may be specified in terms of a specific dollar amount rounded to the nearest hundredth of a dollar.

With respect to quote format for FLEX index options and equity options, Rule 1079(a)(4)(A) states that a bid and/or offer may be specified in the form of a decimal price (e.g. .10 or .25), pursuant to Rule 1034, a specific dollar amount, or a percentage of the underlying equivalent value, in the case of FLEX index options, or security, in the case of FLEX equity options, rounded to the nearest minimum increment. With respect to quote format for FLEX currency options, Rule 1079(a)(4)(B) states that a bid and/or offer may be specified in the form of dollars per unit of underlying foreign currency in the minimum increments set forth for U.S. dollar settled foreign currency options in Rule 1034(a).

The Exchange proposes to clarify subsections (a)(4)(A) and (a)(3)(B) of Rule 1079 to state that the minimum increment will be as specified in proposed amended Rule 1034 (\$.01). The Exchange also proposes to state in subsection (a)(3)(B) that the exercise price for FLEX equity options may be specified in a dollar amount that is rounded to the nearest \$.01.<sup>14</sup> The Exchange simultaneously proposes new Rule 1034(a)(iv) stating that all FLEX options shall have a minimum increment for quoting, trading and exercise purposes that may not be smaller than \$.01.<sup>15</sup> This allows maximum flexibility for FLEX options to trade at any increment that is authorized for trading on the Exchange. The Exchange notes that its minimum increment proposal is similar in nature to what is available on other options markets.<sup>16</sup>

FLEX options are, similarly to options on foreign currencies, unique products that require utmost flexibility to allow investors the ability to precisely establish the parameters of the products. The minimum increment proposal will increase the

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<sup>14</sup> In the alternative, the exercise price may be a percentage of the underlying security rounded to the nearest minimum increment. Subsection (a)(3)(B) to Rule 1079.

<sup>15</sup> The Exchange proposes additional non-substantive changes to Rule 1034 clarifying that exceptions to the general minimum increments provision of Rule 1034 may be located throughout the rule and in proposed subsection 1034(a)(v) indicating that reference is to minimum increments.

<sup>16</sup> As an example, CBOE provides in its Rule 24A.4(c)(2) that there may be a \$.01 minimum increment provision for exercise prices of its FLEX equity options, and that exercise prices may be rounded to the nearest decimal increment determined by CBOE on a class-by-class basis that may not be smaller than \$.01. CBOE also provides in its Rule 24A.5(f) that bids and offers for specified FLEX Index Options may be in \$.01 increments, and that changes in decimal bids and offers for FLEX equity options shall be determined by the CBOE on a class-by-class basis, but may not be smaller than \$.01.

flexibility of FLEX products in relation to OTC products and will enhance the ability to customize FLEX products for trading and hedging purposes.<sup>17</sup> The Exchange believes that allowing FLEX options a similar price improvement opportunity of not less than the minimum increment of one cent would encourage price improvement to the benefit of FLEX trading participants and significantly increase the flexibility of FLEX products.

#### Settlement

Rule 1079(a)(9) currently states that, respecting FLEX index options,<sup>18</sup> the settlement value may be specified as the index value reported at the close (P.M.-settled), opening of trading on the Exchange (A.M.-settled),<sup>19</sup> or as an average over a specified period of time within parameters established by the Exchange.<sup>20</sup> The Exchange has

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<sup>17</sup> Currently, FLEX options trade in the same increments as non-FLEX options.

<sup>18</sup> Respecting currency FLEX options (WCOs or FCOs), Rule 1079(a)(9) states that the settlement value for such options will be the Exchange Spot Price at 12:00:00 Eastern Time (noon) on expiration day, unless the Exchange determines to apply an alternative closing settlement value as a result of extraordinary circumstances. FLEX currency options are settled in U.S. dollars. FLEX currency options will cease trading at 10:15 a.m. eastern time on their designated expiration date.

<sup>19</sup> The restriction that FLEX options could not expire on any business day that falls on, or within two business days of an expiration day for any non-FLEX option on the same underlying security was recently removed. However, in the case of FLEX index options only, FLEX index options expiring on or within two business days of an Expiration Friday may not have an exercise settlement value on the expiration date determined by reference to the closing price of the index or specified averages; the exercise settlement value on such expiration dates may only be determined by a.m. settlement values. See Securities Exchange Act Release No. 60679 (September 16, 2009), 74 FR 48619 (September 23, 2009)(SR-Phlx-2011-81)(notice of filing and immediate effectiveness). FLEX options may now expire on any given business day (and settle thereafter).

<sup>20</sup> FLEX American style index options and FLEX foreign currency options settle pursuant to alternate parameters. See Rule 1079(a)(9)(A) and (B), respectively.

found that while average settlement may have appeared historically to be a viable alternative, this type of settlement is no longer used as a FLEX settlement alternative. As such, the Exchange proposes to delete average settlement from subsection (a)(9), while leaving as settlement values the index value reported at the close or at the opening of trading on the Exchange. The Exchange believes that this proposal is conducive to the goal of streamlining FLEX trading procedures.

#### Expiration

Rule 1079(a)(6)(B) currently states that FLEX equity options effectively have to expire within five years. Specifically, the rule states that a FLEX equity option may expire any month, business day and year within three years, provided, however, that a FLEX Requesting Member<sup>21</sup> may request a longer term to a maximum of five years, and upon the assessment of the regulatory staff (Exchange employee) that sufficient liquidity exists among FLEX equity participants, such request may be granted. The Exchange now proposes to amend subsection (a)(6)(B) to clarify that all FLEX equity options may expire within five years.

The Exchange believes that there is no reason to delay the FLEX trading (RFQ) process by requiring Exchange staff involvement where a Requesting Member wants to trade an equity FLEX option that is between three years and one day and five years long. The Exchange believes that there is no qualitative difference between a FLEX equity option that is more than, as opposed to less than, three years in length (e.g. three years

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<sup>21</sup> A Requesting Member is an Exchange member that requests to do a FLEX option trade through an RFQ and obtains quotes and executes trades in certain non-listed FLEX options at the specialist post of the non-FLEX option on the Exchange. See introductory paragraph and subsection (a)(10) of Rule 1079.

less one day as opposed to three years plus one day in length) that of necessity requires staff involvement; and therefore no reason to mandate Exchange involvement to make a liquidity finding for FLEX products between three and five years in length.<sup>22</sup>

#### Registered Options Traders and Specialists

Rule 1079(c) currently indicates that a Registered Options Trader (“ROT”)<sup>23</sup> or Specialist may apply on a form prescribed by the Exchange to be assigned in FLEX options. Subsection (c) provides further that at least two members shall be assigned to each FLEX option, and that only the Specialist in the non-FLEX option may be the assigned Specialist in that FLEX option. The Exchange proposes to simplify this by eliminating the form application procedure and providing for automatic assignment of FLEX options market makers. The result would be that there will be at least one liquidity provider (specialist) available for each FLEX option.

Specifically, the Exchange proposes in Rule 1079(c)(1) that a Specialist or ROT, including an SQT<sup>24</sup> or RSQT<sup>25</sup> as defined in Rule 1014, that is assigned (allocated) in a

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<sup>22</sup> Other options exchanges that allow FLEX options trading do not have an exchange staff liquidity assessment requirement, while allowing trading of FLEX options products with significantly longer expirations (e.g. fifteen year FLEX options). See CBOE Rule 24A.4(a)(4).

<sup>23</sup> An ROT is a regular member or a foreign currency options participant of the Exchange located on the trading floor who has received permission from the Exchange to trade in options for his own account. See Rule 1014 (b)(i). For discussion regarding other market makers on the Exchange such as, for example, Specialists, see Rule 1020 regarding registration and functions of specialists and Rule 1014(b)(ii)(D)(2) regarding quote obligations.

<sup>24</sup> An SQT is an ROT who has received permission from the Exchange to generate and submit option quotations electronically in eligible options to which such SQT is assigned. An SQT may only submit such quotations while such SQT is physically present on the floor of the Exchange. See Rule 1014(b)(ii)(A).

non-FLEX option is deemed to be assigned in the related FLEX option.<sup>26</sup> This is consistent with the current Rule 1079 specialist assignment process, which indicates that only the specialist in the non-FLEX options may be the specialist in the FLEX options, but makes the process automatic. The Exchange believes that the deemed assignment process whereby a Specialist or ROT is assigned to a non-FLEX option is similar to other Exchange automatic assignment processes that assign related options to specialists that are already assigned in underlying options.<sup>27</sup> Moreover, the Exchange believes that in light of the proposed automatic FLEX allocation process the requirement to have at least two members assigned to each FLEX option is simply not necessary.<sup>28</sup> The Exchange is thereby eliminating the two member requirement and replacing it with a requirement that

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<sup>25</sup> An RSQT is an ROT that is a member or member organization with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically in eligible options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange. See Exchange Rule 1014(b)(ii)(B).

<sup>26</sup> The rules now provide that Specialists (including Remote Specialists) are allocated non-FLEX options pursuant to Rules 501, 505, and 506; and RSQTs and SQTs are assigned options pursuant to Rule 507. These rules are applicable to the specialists that are automatically assigned in FLEX options. For ease of discussion in this proposal, reference may be made to assignment to FLEX options for both Specialists and RSQTs/SQTs.

<sup>27</sup> See Securities Exchange Act Release No. 60455 (August 6, 2009), 74 FR 40857 (August 13, 2009)(SR-Phlx-2009-62)(notice of filing and immediate effectiveness regarding automatic allocation of related options emanating from mergers and acquisitions and spin-offs).

<sup>28</sup> Because FLEX options would be traded only in classes listed on the Exchange (which would have specialists), the automatic allocation process would essentially result in a FLEX specialist for each FLEX option.

at least one member shall be assigned to each FLEX option to provide liquidity. This is wholly consistent with the Exchange's specialist system, which requires (and allows for) one specialist per option issue.<sup>29</sup>

The Exchange does not propose to change any of the fundamental quoting (market making) obligations in Rules 1014 and 1079. Thus, Rule 1079(c) continues to require that the provisions of Rule 1014(c) regarding market making obligations shall be applicable to assigned FLEX Specialists (and assigned ROTs), such that a market must be provided in any FLEX option when requested by an Options Exchange Official.<sup>30</sup> And Rule 1079(b)(2) continues to require that during the response time following an RFQ announcement, each assigned Specialist and assigned ROT who responds is required to respond with a market of minimum size but is not required to provide continuous quotes or a minimum bid-offer differential.

#### Response Time

Section 1079(b)(2) currently indicates that following the RFQ announcement, a preset response time will begin, during which members may provide responsive quotes.

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<sup>29</sup> Moreover, as noted in a comment letter in respect of SR-NASDAQ-2007-004 and NASDQ-2007-080, the Exchange believes that there is no requirement in the Act or rules thereunder for a specialist-based exchange to have more than one specialist per option issue; nor for a non-specialist based exchange to have more than one market maker per option issue. See note 89 and related text in Securities Exchange Act Release No. 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008)(SR-NASDAQ-2007-004 and NASDQ-2007-080)(approval order). See also note 92 and related text in the cited filing, wherein the Commission discusses that although market makers could be an important source of liquidity, the Act does not require an exchange to have market makers.

<sup>30</sup> Rule 1014 also indicates under what circumstances certain market makers are not deemed to be assigned in certain products, and do not have market making obligations. See, e.g., Rule 1014(b)(ii)(D)(4) (regarding SQTs and RSQTs not assigned in Quarterly Option Series and adjusted options series).

The response time, between two and 15 minutes, will be determined by the Exchange (the “response time”). During the response time, members may provide responsive quotes to the RFQ, which may be entered, modified or withdrawn. Each assigned ROT and assigned Specialist who responds is required to respond with a market of the minimum size, but is not required to provide continuous quotes or a minimum bid-offer differential (quotation spread parameters). The Exchange proposes to modify the response time.

Specifically, the Exchange proposes to reduce the lower range of the subsection (b)(2) response time from two minutes to fifteen seconds; as a result, the Exchange would be able to determine a response time between fifteen seconds and 15 minutes. The Exchange believes that the current fast-paced trading environment, driven, in part, by sophisticated on-floor computers and risk management systems that are employed by floor traders, no longer requires several minutes of FLEX response time, unlike when the FLEX program was initiated about a decade ago. The Exchange has noted that as the FLEX program has matured, FLEX responses times have been significantly diminished and are often now measured in seconds. Moreover, the Exchange proposes to make the response time even more transparent to all that want to participate in a FLEX RFQ by specifically adding a provision that the response time will be announced to the Exchange’s membership via Options Trading Alert (“OTA”) and posted on the Exchange’s website. The Exchange believes that the reduction of response time, and publication on the web, should make FLEX options a more attractive trading and hedging vehicle for the investing public. The Exchange proposes to similarly reduce the best bid or offer improvement interval to fifteen seconds.

Best Bid or Offer Improvement Interval

FLEX best bid or offer (“BBO”) procedures are set forth in Rule 1079. Rule 1079(b)(3) states that at the end of the response time, the assigned Specialist, or if none, the Requesting Member shall determine the best bid and offer based on price, but not time or size. However, where two or more bids/offers are at parity, bids/offers submitted by an assigned Specialist, assigned ROT or customer will have priority over bids/offers submitted by non-assigned ROTs and by controlled accounts as defined in Rule 1014(g)(i). The BBO shall be disseminated with reference to the corresponding RFQ. Additionally, Rule 1079(b)(4) currently states that if the Requesting Member rejects the BBO or the BBO is for less than the entire size requested, the BBO improvement interval provides a two minute time period during which the BBO may be matched or improved (the “improvement interval”). An assigned ROT or assigned Specialist who responded with a market during the response time may immediately join any new BBO. The new BBO shall be determined and disseminated with reference to the corresponding RFQ.

The Exchange proposes to reduce the improvement interval in subsection (b)(4) to fifteen seconds. As the Exchange noted previously, the Exchange believes that the current fast-paced trading environment, driven, in part, by sophisticated computers and risk management systems that are employed by floor traders, no longer requires several minutes for the improvement interval. The Exchange has noted that as the FLEX program has matured, BBO improvement intervals, like FLEX response times in general, have been significantly diminished and are often now measured in seconds. Moreover, most FLEX option trades are priced at the BBO, and the improvement interval is rarely, if ever, employed in the modern age of floor trading with rapid electronically computed,

and verbally announced, bids and offers. As such, the current lengthy two minute improvement interval procedure is no longer necessary and, the Exchange believes, is counter-productive to the Exchange's goal of streamlining the trading of FLEX options so that they are efficient and superior trading and hedging vehicles, particularly when compared to OTC options.<sup>31</sup>

#### Fair Split

Rule 1079(b)(6) states that whenever a Requesting Member intends to cross a FLEX option after the BBO is determined, the Requesting Member, having announced an intention to cross, must bid and offer at or better than the BBO. The rule further provides that if the Requesting Member's bid/offer is at the BBO (subsection (b)(6)(A)) or improves the existing BBO (subsection (b)(6)(B)), the Requesting Member may execute 25% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. The Exchange proposes to increase the execution percentage to 40%. The Exchange believes that the split percentage increase is consistent with its goals for this filing in that this proposal should help to incentivize the use of FLEX options.<sup>32</sup>

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<sup>31</sup> Moreover, the Exchange notes that the BBO concept, which applies to and is used extensively in FLEX options trading, is not mandated for OTC trading.

<sup>32</sup> CBOE indicates in its rules that it may determine on a class-by-class basis whether to establish a crossing participation entitlement for facilitations and/or solicitations and the applicable crossing participation entitlement percentage, which shall not exceed 40% of the trade. See CBOE Rule 24A.5(e)(iii). The proposed 40% standard may also be found in current Exchange rules in respect of enhanced participation, such that options specialists may get a 40% to 60% participation in respect of controlled accounts. See Rule 1014(g)(ii).

### Option Floor Procedure Advice

The Exchange proposes to amend OFPA F-28 so the language of the Advice conforms to the proposed rule changes. Specifically, using the same language changes as proposed in Rule 1079 the Exchange proposes the following conforming language changes in OFPA F-28: in the opening paragraph of the Advice to indicate that a new series of FLEX options may be established on any business day prior to the expiration date; in subsection (2) of the Advice to indicate that the response time will be between 15 seconds and 15 minutes and that the response time will be announced to the Exchange's membership; in subsection (3) of the Advice to reflect the process of automatically assigning a FLEX Specialist; in subsection (4) of the Advice to indicate that the BBO improvement interval will be 15 seconds; and in subsection (6) of the Advice to indicate that the Requesting Member may execute 40% or a fair split.

In terms of housekeeping changes, the Exchange proposes to add the word "certain" in the opening sentence of OFPA F-28 to more accurately track the corresponding opening sentence of Rule 1079.

### Discussion of Proposal

The Exchange believes that its proposals to amend Rule 1079 (with corresponding changes to OFPA F-28 and Rule 1034) are important and necessary to the Exchange's efforts to create a product and market that provides members and investors interested in FLEX-type options with an improved and superior alternative to the over the counter (OTC) market in customized options, which can take on contract characteristics similar to FLEX options but are not subject to the same restrictions. The proposed changes should afford all market participants, including public customers and investment banks,

greater flexibility in determining whether to execute their customized options in an exchange environment or in an un-regulated OTC market. The Exchange believes that market participants would benefit from being able to trade these customized FLEX options in an exchange environment in several ways, including, but not limited to, the following: (1) enhanced efficiency in initiating and closing out positions; (2) increased market transparency; and (3) heightened contra-party creditworthiness due to the role of The Options Clearing Corporation (OCC) as issuer and guarantor of FLEX options.

The Exchange notes that when the FLEX option rules were initially proposed and approved about thirteen years ago, there was uncertainty regarding what market impacts, if any, excessive FLEX positions would have on the market or on firms.<sup>33</sup> To minimize the risk of adverse market effects, at the time the FLEX rules were first introduced the Exchange put in place numerous FLEX trading boundaries some of which, such as for example position limits, have been modified over time. Based on the Exchange's experience in trading FLEX options to date -- specifically with respect to the diversity in FLEX option trading, the relatively small percentage of FLEX options traded compared to overall trading on the Exchange, and the lack of market disruptions or problems caused by or on existing FLEX option expirations -- the Exchange believes that many of these restrictions and requirements are no longer necessary. To the contrary, the Exchange believes that the restrictions (procedures) that it proposes to eliminate in this filing

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<sup>33</sup> See Securities Exchange Act Release No. 39549 (January 14, 1998), 63 FR 3601 (January 23, 1998)(SR-Phlx-98-38)(order approving). The trading of FLEX options since the initial FLEX proposal appears to indicate there is limited secondary trading in any FLEX option series having a particular expiration date due to the diversity inherent in FLEX options, and that extensive FLEX expiration concentrations are rare.

actually place the Exchange at a competitive disadvantage to its OTC counterparts in the market for customized options, and unnecessarily limit market participants' ability to trade in an exchange environment that offers the added benefits of transparency, price discovery, liquidity, and financial stability.

The Exchange also notes that position limit, aggregation and exercise limit requirements would continue to be applicable to FLEX options in accordance with Rule 1079.<sup>34</sup> Additionally, FLEX options would remain subject to the reporting requirements.<sup>35</sup> Moreover, member organizations would remain subject to the margin requirements of Rule 721. The Exchange believes these existing safeguards serve sufficiently to help monitor open interest in FLEX option series and significantly reduce potential FLEX trading risk. In addition, the Exchange notes that FLEX options are subject to the options disclosure document ("ODD") requirements of Rule 9b-1<sup>36</sup> under the Act.<sup>37</sup> No broker or dealer can accept an order from a customer to purchase or sell an option contract relating to an options class that is the subject of a definitive ODD (including FLEX options), or approve the customer's account for the trading of such an option, unless the broker or dealer furnishes or has furnished to the customer a copy of the definitive ODD. The ODD contains a description, special features, and special risks

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<sup>34</sup> See Rule 1079(d) and (e). For non-FLEX position and exercise procedures generally, see Rules 1001, 1002, 1001A, and 1002A.

<sup>35</sup> See Rule 1079(b)(7).

<sup>36</sup> 17 CFR 240.9b-1.

<sup>37</sup> 15 U.S.C. 78a et seq.

of FLEX options. Lastly, similar to any other options, FLEX options are subject to member firm supervision and suitability requirements.<sup>38</sup>

The Exchange believes that the proposed changes to the FLEX rules are appropriate in light of the concerns that have been expressed at the highest levels by regulators of the U.S. financial system. The Commission noted in its 2010 concept release (“Concept Release”) that concerns were raised and sought input regarding, among other things, equity market structure about off-exchange, as opposed to on-exchange, trading (for example, over the counter or OTC trading); and recognized the strong policy preference under the Act in favor of price transparency and displayed markets (which OTC are not). The Commission indicated that the Concept Release was being published to invite public comment on a wide range of market structure issues, including OTC (off-exchange) trading, un-displayed (or “dark”) liquidity, and high frequency trading.<sup>39</sup>

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<sup>38</sup> See Rule 763. See also Rule 748.

<sup>39</sup> See Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010)(Concept Release on Equity Market Structure). The Commission noted in the Concept Release that it appears that a significant percentage of the orders of individual investors are executed at OTC market makers and that a significant percentage of the orders of institutional investors are executed in dark pools; and indicated that a review of the order routing disclosures required by Rule 606 of Regulation NMS of eight broker-dealers with significant retail customer accounts revealed that nearly 100% of their customer market orders are routed to OTC market makers. The Chairperson of the Commission, Mary L. Shapiro, referenced the Concept Release, stating that “today, nearly 30 percent of volume in U.S.-listed equities is executed in venues that do not display their liquidity or make it generally available to the public. The percentage executed by these dark, non-public markets is increasing nearly every month.” See Mary L. Schapiro, Strengthening Our Equity Market Structure (Speech at the Economic Club of New York, Sept. 7, 2010) (“Schapiro Speech,” available on the Commission website). Regarding the recent effort of another exchange to bring additional targeted liquidity onto a regulated and lit (displayed) options market, see Securities Exchange Act Release No. 63270 (November 8,

More recently, Congress passed, and the president in July 2010 signed into law, extensive financial reforms that include provisions regarding the regulation of certain OTC derivatives (swaps) markets to make them regulated and transparent (the “Dodd-Frank Act”). To achieve these goals, the Dodd-Frank Act requires that, among other things, these derivatives markets have, like current equity and options markets, participant registration requirements, central clearing, position limits, capital and margin requirements, and recordkeeping and recording responsibilities pursuant to the Act.<sup>40</sup>

The Exchange believes that the proposed changes to the FLEX rules are wholly consistent with the noted concerns and may, in fact, be helpful to ameliorate them. The Exchange believes the proposed changes are appropriate and reasonable and would provide market participants with more opportunities to execute their customized options on a regulated national securities exchange. The Exchange believes that the proposed revisions would promote just and equitable principles of trade, and would facilitate transactions in securities while continuing to foster the public interest and greatly enhanced investor protection.

## 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act<sup>41</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>42</sup> in particular,

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2010), 75 FR 69489 (November 12, 2010)(NASDAQ-2010-141)(notice of filing and immediate effectiveness regarding Investor Support Program).

<sup>40</sup> See H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

<sup>41</sup> 15 U.S.C. 78f(b).

in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanisms of a free and open market and a national market system.

The Exchange is proposing to enhance, clarify, and streamline Rule 1079 regarding FLEX provisions to include: what FLEX products may be traded, minimum increment, settlement value and computation, time to expiration, response time, BBO improvement interval, automatic assignment of market makers to FLEX options, and fair split. The Exchange believes that these proposals will promote the goals of the Act, and in particular will remove impediments to and perfect the mechanisms of a free and open market and a national market system by making FLEX options that are traded on the regulated Exchange more accessible, flexible, and usable trading and hedging vehicles that are a desirable alternative to over the counter trading.

In addition to enhancing competition among lit markets and OTC markets, the Exchange believes that its proposal would enhance competition among options exchanges; provide additional, sought after opportunities to manage risk and trade customized FLEX options on an accessible, regulated, and transparent platform, namely the Exchange; provide benefits to all manner of FLEX option participants including institutional and large traders, retail investors, and retail and public investors; and significantly expand trading, investing, and hedging opportunities in a volatile economic environment.

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15 U.S.C. 78f(b)(5).

The Exchange also believes that its proposal is consistent with investor protection and the public interest in that it is limited to FLEX options on securities that have non-FLEX options listed on them. The criteria for listing such underlying securities (e.g. securities with sufficient trading volume and shareholders) has been carefully crafted over the years to ensure that only appropriate securities have standardized options listed on them to the benefit of investors and the public.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

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

No written comments were either solicited or received.

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

Within 45 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 shall: (a) by order approve or disapprove 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 is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-Phlx-2012-18 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-Phlx-2012-18. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>).

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 website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on

official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-Phlx-2012-18 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>43</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>43</sup> 17 CFR 200.30-3(a)(12).

**EXHIBIT 5**

*Additions are underlined; Deletions are [bracketed]*

**PHLX Option Rules**

\* \* \* \* \*

**Rule 1034. Minimum Increments**

(a) Except as provided [in sub-paragraph (i)(B) and (iii) below] otherwise in this Rule, all options on stocks, index options, and Exchange Traded Fund Shares quoting in decimals at \$3.00 or higher shall have a minimum increment of \$.10, and all options on stocks and index options quoting in decimals under \$3.00 shall have a minimum increment of \$.05.

(i) – (iii) No Change.

(iv) All FLEX options shall have a minimum increment that may not be smaller than \$.01.

([i]v) However, different minimum [changes] increments for dealings in option contracts may also be fixed by the Exchange from time to time for option contracts of a particular series.

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**Rule 1079. FLEX Index, Equity and Currency Options**

A Requesting Member shall obtain quotes and execute trades in certain non-listed FLEX options at the specialist post of the non-FLEX option on the Exchange. The term "FLEX option" means a FLEX option contract that is traded subject to this Rule. A new series of FLEX options may be established on any business day prior to the expiration date as provided for in this Rule. Although FLEX options are generally subject to the Rules in this section, to the extent that the provisions of this Rule are inconsistent with other applicable Exchange Rules, this Rule takes precedence with respect to FLEX options.

**(a) Characteristics:**

(1) Underlying interest —

(A) No Change.

(B) any security which is options-eligible pursuant to Rule 1009 and is trading on the Exchange; or

(C) No Change.

- (2) No Change.
- (3) Exercise price—
- (A) No Change.
- (B) with respect to FLEX equity options, may be specified in terms of a specific dollar amount rounded to the nearest \$.[10]01 or a percentage of the underlying security rounded to the nearest minimum increment, pursuant to Rule 1034; or
- (C) No Change.
- (4) Quote format—
- (A) in the case of FLEX index options and equity options, a bid and/or offer in the form of a decimal price (*e.g.* .01[0 or .25]), pursuant to Rule 1034, a specific dollar amount, or a percentage of the underlying equivalent value, in the case of FLEX index options, or security, in the case of FLEX equity options, rounded to the nearest minimum increment, pursuant to Rule 1034; or
- (B) No Change.
- (5) No Change.
- (6) Expiration date—
- (A) No Change.
- (B) any month, business day and year within [~~three~~five] years for FLEX equity options[, provided, however, that a Requesting Member may request a longer term to a maximum of five years, and upon the assessment of the Regulatory staff that sufficient liquidity exists among FLEX equity participants, such request may be granted. Regulatory staff are Exchange employees responsible for, among other things, assessing that sufficient liquidity exists among FLEX equity participants requesting a term exceeding three years to a maximum of five years. The Exchange may also designate other qualified Exchange employees to assist the regulatory staff as the need arises].
- (C) No Change.
- (7) - (8) No Change.
- (9) Settlement

(A) respecting FLEX index options, the settlement value may be specified as the index value reported at the: (i) close (P.M.-settled); or (ii) opening (A.M.-settled) of trading on the Exchange[, or (iii) as an average over a specified period of time, within parameters established by the Exchange]. American style index options exercised prior to the expiration date can only settle based on the closing value on the exercise date. FLEX index options are settled in U.S. dollars; or

(B) No Change.

(10) No Change.

(b) **Procedure for Quoting and Trading FLEX Options.** FLEX options will not be continuously quoted and series are not pre-established. The Exchange's electronic quoting and trading system will not be available for FLEX options. The variable terms of FLEX options shall be established through the process described in this Rule. All transactions must be in compliance with Section 11 of the Securities Exchange Act of 1934 and the rules promulgated thereunder, which may include yielding priority to customer orders.

(1) No Change.

(2) **Responses.** Following the RFQ announcement, a preset response time will begin, during which members may provide responsive quotes. The response time, between [two]15 seconds and 15 minutes, will be determined by the Exchange. The response time will be announced to the Exchange's membership via OTA and posted on the Exchange's web site. During the response time, members may provide responsive quotes to the RFQ, which may be entered, modified or withdrawn during such response time. Each assigned ROT and assigned Specialist who responds is required to respond with a market of the minimum size, but is not required to provide continuous quotes or a minimum bid-offer differential (quotation spread parameters).

(3) **Determining the BBO.** At the end of the response time, the assigned Specialist[, or if none, the Requesting Member] shall determine the best bid and offer ("BBO"), based on price, but not time or size. However, where two or more bids/offers are at parity, bids/offers submitted by an assigned Specialist, assigned ROT or customer will have priority over bids/offers submitted by non-assigned ROTs and by controlled accounts as defined in Rule 1014(g)(i). The BBO shall be disseminated with reference to the corresponding RFQ.

(4) **BBO Improvement Interval.** If the Requesting Member rejects the BBO or the BBO is for less than the entire size requested, the BBO Improvement Interval provides a [two minute]15 second time period during which the BBO may be

matched or improved. An assigned ROT or assigned Specialist who responded with a market during the response time may immediately join any new BBO. The new BBO shall be determined, and disseminated with reference to the corresponding RFQ.

(5) No Change.

(6) **Crossing.** Whenever a Requesting Member intends to cross, after the BBO is determined, with or without a BBO Improvement Interval, the Requesting Member, having announced an intention to cross, must bid and offer at or better than the BBO.

(A) **At the BBO.** If the Requesting Member's bid/offer is at the BBO, the Requesting Member may execute [25]40% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. The remainder of the contra-side is split in accordance with the parity/priority provision of subparagraph (3) above.

(B) **Improves the BBO.** If the Requesting Member's bid/offer improves the existing BBO, an assigned ROT or assigned Specialist who responded with a market during the response time or BBO Improvement Interval, may immediately join the Requesting Member's improved bid or offer, thus matching for parity purposes. However, the Requesting Member may execute [25]40% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. The remainder of the contra-side is split in accordance with the parity/priority provision of sub-paragraph (3) above.

(C) No Change.

(7) - (9) No Change.

(c) Who May Trade FLEX Options.

(1) **Assigned ROTs and Assigned Specialists.** A[n ROT or] member that is a Specialist or ROT[may apply on a form prescribed by the Exchange], including an SQT or RSQT as defined in Rule 1014 that is assigned in a non-FLEX option is deemed to be assigned in the related FLEX option[s]. At least [two]one member[s] shall be assigned to each FLEX option. [Only the Specialist in the non-FLEX option may be the assigned Specialist in that FLEX option. ]The provisions of Rule 1014(c) regarding market making obligations shall be applicable to assigned ROTs and assigned Specialists, such that a market must be provided in any FLEX option when requested by an Options Exchange Official.

(2) - (3) No Change.

(d) – (f) No Change.

••• *Commentary:* -----

.01 No Change.

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## PHLX Option Floor Procedure Advices

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### F-28 Trading FLEX Index, Equity and Currency Options

A Requesting Member shall obtain quotes and execute trades in certain non-listed FLEX options at the Specialist post of the non-FLEX option on the Exchange, pursuant to Rule 1079. FLEX options will not be continuously quoted and series are not pre-established. The variable terms of FLEX options shall be established through the process described in the Rule. A new series of FLEX options may be established on any business day prior to the expiration date as provided for in this Rule. All transactions must be in compliance with Section 11 of the Securities and Exchange Act of 1934 and the Rule promulgated thereunder, which may include yielding priority to customer orders.

(1) No Change.

(2) Responses. Following the RFQ announcement, a preset response time will begin, during which members may provide responsive quotes. The response time, between [two]15 seconds and 15 minutes, will be determined by the Exchange. The response time will be announced to the Exchange's membership via OTA and posted on the Exchange's web site. During the response time, members may provide responsive quotes to the RFQ, which may be entered, modified or withdrawn during such response time. Each assigned ROT and assigned Specialist who responds is required to respond with a market of the minimum size, but is not required to provide continuous quotes or a minimum bid-offer differential (quotation spread parameters).

(3) Determining the BBO. At the end of the response time, the assigned Specialist[, or if none, the Requesting Member,] shall determine the best bid and offer ("BBO"), based on price, but not time or size. However, where two or more bids/ offers are at parity, bids/offers submitted by an assigned Specialist, assigned ROT or customer will have priority over bids/offers submitted by non/assigned ROTs and by controlled accounts as defined in Rule 1014(g)(i). The BBO shall be disseminated with reference to the corresponding RFQ.

(4) BBO Improvement Interval. If the Requesting Member rejects the BBO or the BBO is for less than the entire size requested, the BBO Improvement Interval provides a [two minute]15 second time period during which the BBO may be matched or improved. An

assigned ROT or assigned Specialist who responded with a market during the response time may immediately join any new BBO. The new BBO shall be determined, and disseminated with reference to the corresponding RFQ.

(5) No Change.

(6) Crossing. Whenever a Requesting Member intends to cross, after the BBO is determined, with or without a BBO Improvement Interval, the Requesting Member, having announced an intention to cross, must bid and offer at or better than the BBO.

(A) At the BBO. If the Requesting Member's bid/offer is at the BBO, the Requesting Member may execute [25]40% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. The remainder of the contra-side is split in accordance with the parity/priority provision of sub-paragraph (3) above.

(B) Improves the BBO. If the Requesting Member's bid/offer improves the existing BBO, an assigned ROT or assigned Specialist who responded with a market during the response time or BBO Improvement Interval, may immediately join the Requesting Member's improved bid or offer, thus matching for parity purposes. However, the Requesting Member may execute [25]40% or a fair split, whichever is greater, of the contra-side of the order that is the subject of the RFQ. The remainder of the contra-side is split in accordance with the parity/priority provision of subparagraph (3) above.

(C) Broker-dealer crosses and solicited orders, as defined in Rule 1064, are not eligible for the split afforded by sub-paragraphs (A) and (B) above, and instead, are, after the announcement of an intention to cross, executable in accordance with sub-paragraph (5) above.

For additional provisions governing FLEX options, see Rule 1079.

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