

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-60550; File No. SR-Phlx-2009-61)

August 20, 2009

Self-Regulatory Organizations; NASDAQ OMX PHLX, Inc.; Order Granting Accelerated Approval of a Proposed Rule Change to Adopt Rules Implementing the Options Order Protection and Locked/Crossed Market Plan

I. Introduction

On July 20, 2009, NASDAQ OMX PHLX, Inc. (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend and adopt rules to implement the Options Order Protection and Locked/Crossed Market Plan. The proposed rule change was published for comment in the Federal Register on July 28, 2009.<sup>3</sup> The Commission received no comments on the proposal. This order approves the proposed rule change on an accelerated basis.

II. Description of the Proposal

The Exchange proposes to amend and adopt new Phlx rules to implement the Options Order Protection and Locked/Crossed Market Plan (“Plan”).<sup>4</sup> Specifically, the Exchange

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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> See Securities Exchange Act Release No. 60363 (July 22, 2009), 74 FR 37270 (“Notice”).

<sup>4</sup> The Plan is a national market system plan proposed by the seven existing options exchanges and approved by the Commission. See Securities Exchange Act Release No. 59647 (March 30, 2009), 74 FR 15010 (April 2, 2009) (File No. 4-546) (“Plan Notice”) and 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546) (“Plan Approval”). The seven options exchanges are: Chicago Board Options Exchange, Incorporated (“CBOE”); International Securities Exchange LLC (“ISE”); NASDAQ OMX BX, Inc. (“BOX”); The NASDAQ Stock Market LLC (“Nasdaq”); NYSE Amex LLC (“NYSE Amex”); NYSE Arca, Inc. (“NYSE Arca”); and Phlx (each exchange individually a “Participant” and, together, the “Participating Options Exchanges”).

proposes to replace the Exchange’s current Intermarket Linkage rules (Phlx Rules 1081 and 1083-1087) with new rules implementing the Plan, amend other Exchange rules to reflect the Plan, and delete or modify provisions rendered unnecessary by the Plan.

### The Old Plan

Each of the Participating Options Exchanges are signatories to the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage (“Old Plan”).<sup>5</sup> In pertinent part, the Old Plan generally requires its participants to avoid trading at a price inferior to the national best bid or offer (“trade-through”), although it provides for a number of exceptions to trade-through liability.<sup>6</sup> The Participating Options Exchanges comply with this requirement of the Old Plan by utilizing a stand alone system (“Linkage Hub”) to send and receive specific order types,<sup>7</sup> namely Principal Acting as Agent Orders (“P/A Orders”), Principal Orders, and Satisfaction Orders.<sup>8</sup> The Old Plan also provided that dissemination of “locked” or “crossed” markets should be avoided, and remedial actions that should be taken to unlock or uncross such market.<sup>9</sup> Each of the Participating Options Exchanges, including the Exchange, has submitted an amendment to

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<sup>5</sup> On July 28, 2000, the Commission approved the Old Plan as a national market system plan for the purpose of creating and operating an intermarket options market linkage proposed by the American Stock Exchange LLC (n/k/a NYSE Amex), CBOE, and ISE. See Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000). Subsequently, Philadelphia Stock Exchange, Inc. (n/k/a Phlx), Pacific Exchange, Inc. (n/k/a NYSE Arca), Boston Stock Exchange, Inc. (n/k/a BOX), and Nasdaq joined the Linkage Plan. See Securities Exchange Act Release Nos. 43573 (November 16, 2000), 65 FR 70851 (November 28, 2000); 43574 (November 16, 2000), 65 FR 70850 (November 28, 2000); 49198 (February 5, 2004), 69 FR 7029 (February 12, 2004); and 57545 (March 21, 2008), 73 FR 16394 (March 27, 2008).

<sup>6</sup> Section 8(c) of the Old Plan.

<sup>7</sup> The Linkage Hub is a centralized data communications network that electronically links the Participating Options Exchanges to one another. The Options Clearing Corporation (“OCC”) operates the Linkage Hub.

<sup>8</sup> Section 2(16) of the Old Plan.

<sup>9</sup> Section 7(a)(i)(C) of the Old Plan.

the Old Plan to withdraw from such Plan.<sup>10</sup> The withdrawals will be effective upon approval by the Commission of such amendments pursuant to Rule 608 of Regulation NMS under the Act (“Regulation NMS”).<sup>11</sup>

### The Plan

The Plan does not require a central linkage mechanism akin to the Old Plan’s Linkage Hub. Instead, the Plan includes the framework for routing orders via private linkages that exist for NMS stocks under Regulation NMS.<sup>12</sup> The Plan requires the Participating Options Exchanges to adopt rules “reasonably designed to prevent Trade-Throughs.”<sup>13</sup> Participating Options Exchanges are also required to conduct surveillance of their respective markets on a regular basis to ascertain the effectiveness of the policies and procedures to prevent Trade-Throughs and to take prompt action to remedy deficiencies in such policies and procedures.<sup>14</sup>

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<sup>10</sup> See Securities Exchange Act Release No. 60360 (July 21, 2009) 74 FR 37265 (July 28, 2009) (File No. 4-429).

<sup>11</sup> 17 CFR 242.608.

<sup>12</sup> See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (File No. S7-10-04); 17 CFR 242.600 *et seq.* For discussions of the similarities between the provisions of Regulation NMS and the provisions in the Plan, see Plan Notice and Plan Approval, *supra* note 4.

<sup>13</sup> Under the Plan, a “Trade-Through” is generally defined as a transaction in an option series, either as principal or agent, at a price that is lower than a Protected Bid or higher than a Protected Offer.” See Section 2(21) of the Plan. A “Protected Bid” and “Protected Offer” generally means a bid or offer in an option series, respectively, that is displayed by a Participant, is disseminated pursuant to the Options Price Reporting Authority (“OPRA”) Plan, and is the Best Bid or Best Offer. See Section 2(17) of the Plan. A “Best Bid” or “Best Offer” means the highest bid price and the lowest offer price. Section (2)(1) of the Plan. “Protected Bid” and “Protected Offer,” together are referred to herein as “Protected Quotation.” See Section 2(18) of the Plan.

<sup>14</sup> Section 5(a)(ii) of the Plan.

As further described below, the Plan incorporates a number of exceptions to trade-through liability.<sup>15</sup>

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<sup>15</sup> Section 5(b) of the Plan.

Some of these exceptions are carried over from the Old Plan, including exceptions for trading rotations, non-firm quotes, and complex trades.<sup>16</sup> Others are substantially similar to exceptions available for NMS stocks under Regulation NMS, such as exceptions for systems issues, crossed markets, quote flickering, customer stopped orders, benchmark trades and, notably, intermarket sweep orders (“ISOs”).<sup>17</sup> In addition, the Plan contains a new exception for stopped orders and price improvement.<sup>18</sup>

The Plan also requires each Participant to establish, maintain, and enforce written rules that: require its members reasonably to avoid displaying locked and crossed markets; assure the reconciliation of locked and crossed markets; and prohibit its members from engaging in a pattern or practice of displaying locked and crossed markets; subject to exceptions as may be contained in the rules of the Participant, as approved by the Commission.<sup>19</sup>

#### The Exchange’s Proposal

To implement the Plan, the Exchange proposes to replace its current rules relating to the Old Plan with new rules relating to the Plan, and make additional changes to other rules, including changes to conform the Exchange’s rules to the requirements of the Plan.<sup>20</sup> As such,

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<sup>16</sup> Subparagraphs (ii), (vii), and (viii), respectively, of Section 5(b) of the Plan.

<sup>17</sup> Subparagraphs (i), (iii), (vi), (ix), (xi), and (iv)-(v), respectively, of Section 5(b) of the Plan.

<sup>18</sup> Subparagraph (x) of Section 5(b) of the Plan.

<sup>19</sup> Section 6 of the Plan. The Plan also contains provisions relating to the operation of the Plan including, for example, provisions relating to the entry of new parties to the Plan; withdrawal from the Plan; and amendments to the Plan.

<sup>20</sup> A more detailed description of the Exchange’s proposed rule change may be found in the Notice, supra, note 3.

the Exchange proposes to adopt all applicable definitions from the Plan into the Exchange's rules.<sup>21</sup>

In addition, the Exchange proposes to prohibit its members from effecting Trade-Throughs, unless an exception applies.<sup>22</sup> Consistent with the Plan, the Exchange also proposes exceptions to the prohibition on trade throughs relating to: system issues; trading rotations; crossed markets; intermarket sweep orders; quote flickering; non-firm quotes; complex trades; customer stopped orders; stopped orders and price improvement; and benchmark trades.<sup>23</sup>

The Exchange also proposes a rule to address locked and crossed markets, as required by the Plan.<sup>24</sup> Specifically, the Exchange proposes that, except for quotations that fall within a stated exception, members shall reasonably avoid displaying, and shall not engage in a pattern or practice of displaying, any quotations that lock or cross a Protected Quote.<sup>25</sup>

The Exchange proposes three exceptions to the prohibition against locked and crossed markets: when the Exchange is experiencing a failure, material delay, or malfunction of its systems or equipment; when the locking or crossing quotation was displayed at a time where there is a crossed market; and when an Exchange member simultaneously routes an ISO to execute against the full displayed size of any locked or crossed Protected Bid or Protected Offer.<sup>26</sup>

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<sup>21</sup> Proposed Phlx Rule 1083.

<sup>22</sup> Proposed Phlx Rule 1084(a).

<sup>23</sup> Proposed Phlx Rule 1084(b)(i)-(xi). In addition, the Exchange proposes to add ISOs as a new type of order under proposed Phlx Rule 1066(i).

<sup>24</sup> A "locked market" is defined as a quoted market in which a Protected Bid is equal to a Protected Offer. Proposed Phlx Rule 1083(i). A "crossed market" is defined as a quoted market in which a Protected Bid is higher than a Protected Offer. Proposed Phlx Rule 1083(e).

<sup>25</sup> Proposed Phlx Rule 1086(a).

<sup>26</sup> Proposed Phlx Rule 1086(b).

The Exchange also proposes rules to permit the Exchange to continue to accept P/A Orders and Principal Orders from Participating Options Exchanges that are not able to send ISOs in order to avoid Trade-Throughs.<sup>27</sup>

The Exchange proposes to rely upon the order routing arrangements already in place on its market, except that the Exchange proposes amendments to Rules 1080(m)(iv)(B) and (C) concerning FIND<sup>28</sup> and SRCH<sup>29</sup> Orders to ensure that these order types comply with requirements of the Plan.<sup>30</sup> The Exchange also proposes to amend its rules concerning orders that have been subject to its Quote Exhaust and Market Exhaust processes to conform their use to the terms of the Plan.<sup>31</sup> Finally, the Exchange proposes to delete various other provisions of the Phlx rules to reflect the Exchange's withdrawal from the Old Plan, and to amend other provisions of Phlx rules to, among other things, reflect the Plan.<sup>32</sup>

The Exchange proposes to implement this proposed rule change upon withdrawal from the current Linkage Plan and effectiveness of the new Plan.

## II. Commission's Findings and Order Granting Accelerated Approval of the Proposed Rule Change

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to

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<sup>27</sup> Proposed Phlx Temporary Rule 1088.

<sup>28</sup> A FIND order is an order that is routable upon receipt, or any time the option goes through an opening process. See Phlx Rule 1080(m)(iv)(B).

<sup>29</sup> A SRCH order is an order that is routable at any time. See Phlx Rule 1080(m)(iv)(C).

<sup>30</sup> See Notice, supra note 3 at 37272 for a complete description of these changes.

<sup>31</sup> See Notice, supra note 3 at 37272-37273 for a complete description of these changes.

<sup>32</sup> See Notice, supra note 3 at 37273-37274 discussing proposed changes to Phlx By-Law Article XII, Section 12-11; Phlx Rule 1017(k); Phlx Rule 1033(a)(ii) and Options Floor Procedure Advice F-32; Phlx Rule 1034(a)(i)(C); Phlx Rule 1080(b)(i)(A), (B) and (C); Phlx Rule 1080(c)(iv)(F); and Phlx Rule 1080(c)(vi).

a national securities exchange.<sup>33</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act<sup>34</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The Commission also finds that the proposal is consistent with Rule 608(c) of Regulation NMS under the Act, which requires that each exchange comply with the terms of any effective national market system plan of which it is a participant.<sup>35</sup> Finally, the Commission finds that the proposed rule change is consistent with the requirements of the Plan.<sup>36</sup>

Proposed Phlx Rule 1083 would define applicable terms in a manner that are substantively identical to the defined terms of the Plan. As such, the Commission finds that proposed Phlx Rule 1083 is consistent with the Act and the Plan.

Proposed Phlx Rule 1084(a) would prohibit members from effecting Trade-Throughs unless an exception applies. Proposed Phlx Rule 1084(b) would provide for eleven exceptions to the general Trade-Through prohibition, relating to systems issues, trading rotations, crossed markets, ISOs, quote flickering, non-firm quotes, complex trades, customer stopped orders, stopped orders and price improvement, and benchmark trades.<sup>37</sup> Aside from the proposed

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<sup>33</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>34</sup> 15 U.S.C. 78f(b)(5).

<sup>35</sup> 17 CFR 242.608(c). Section 1 of the Plan provides in pertinent part that, "The Participants will submit to the [Commission] for approval their respective rules that will implement the framework of the Plan."

<sup>36</sup> See supra note 5.

<sup>37</sup> Proposed Phlx Rule 1084(b)(i)-(xi).

exception relating to systems issues, each proposed exception would be substantively identical to the parallel exception under Section 5(b) of the Plan.

The systems issues exception under proposed Phlx Rule 1084(b)(i) would implement the parallel exception available under Section 5(b)(i) of the Plan and would permit the Exchange to bypass the Protected Quotation of another Participant if such other Participant repeatedly fails to respond within one second to incoming orders attempting to access its Protected Quotations. The Exchange's rule would require the Exchange to notify such non-responding Participant immediately after (or at the same time as) electing self-help, and assess whether the cause of the problem lies with the Exchange's own systems and, if so, take immediate steps to resolve the problem. Finally, the Exchange would be required to promptly document its reasons supporting any such determination to bypass a Protected Quotation. The Commission believes that this exception should provide the Exchange with the necessary flexibility for dealing with problems that occur on an away market during the trading day. At the same time, the exception's requirements to immediately notify such away market of its determination and also assess its own system should help prevent the use of this exception when there in fact is a problem with the Exchange's own systems, rather than those of an away market.

The Commission notes that included among the exceptions in proposed Phlx Rule 1084(b) would be exceptions for certain transactions involving ISOs.<sup>38</sup> An order identified as an ISO would be immediately executable by the Exchange (or any other Plan Participant that received such an order) based on the premise that the market participant sending the ISO has already attempted to access all better-priced Protected Quotations up to their displayed size. The

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<sup>38</sup> Proposed Phlx Rule 1084(b)(iv) and (v).

Commission believes that this exception should help ensure more efficient and faster executions in the options markets.

The Commission notes that, in addition to these rules regarding Trade-Throughs, the Plan requires that each Participant establish, maintain and enforce written policies and procedures that are reasonably designed to prevent Trade-Throughs in that Participant's market that do not fall within an applicable exception and, if relying on such exception, that are reasonably designed to assure compliance with the terms of the exception. In addition, the Commission notes that the Plan requires each Participant to conduct surveillance of its market on a regular basis to ascertain the effectiveness of such policies and procedures and to take prompt action to remedy any deficiencies in such policies and procedures.

Accordingly, the Commission finds that proposed Phlx Rule 1084 is consistent with Section 5 of the Plan and Section 6(b)(5) of the Act<sup>39</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

Proposed Phlx Rule 1086(a) would require Exchange members to reasonably avoid displaying, and not engage in a pattern or practice of displaying, any quotation that locks or crosses a Protected Quotation, subject to certain exceptions delineated in proposed Phlx Rule 1086(b). The Commission recognizes that locked and crossed markets may occur accidentally and cannot always be avoided. However, the Commission believes that giving priority to the first-displayed Protected Bid or Protected Offer, particularly when it includes a public customer's order, will encourage price discovery and contribute to fair and orderly markets.

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<sup>39</sup> 15 U.S.C. 78f(b)(5).

Therefore, the Commission believes that the proposed rule, which corresponds to the Plan's language, to require members to reasonably avoid displaying, and not engaging in a pattern or practice of, locks and crosses is appropriate.

Proposed Phlx Rule 1085(b) would permit three exceptions to the Exchange's general rule relating to locked and crossed markets.<sup>40</sup> These exceptions would be similar to analogous certain trade-through exceptions under proposed Phlx Rule 1084(b), and relate to when the Exchange is experiencing systems issues, when there is exists a crossed market, and when a member simultaneously routes ISOs against the full displayed size of any locked or crossed Protected Bid or Protected Offer.

The Commission believes that the Exchange's proposed rules relating to locked and crossed markets are consistent with the Plan and the Act and should help ensure that the display of locked or crossed markets will be limited and that any such display will be promptly reconciled. The Commission also believes that each of the proposed exceptions to locked and crossed markets relate to circumstances when it is appropriate to permit a limited, narrow exception to the general locked and crossed market rule.

Therefore, the Commission finds that Exchange's rule regarding locked and crossed markets appropriately implements Section 6 of the Plan, and is consistent with Section 6(b)(5) of the Act<sup>41</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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<sup>40</sup> Section 6 of the Plan permits exceptions to the Plan's locked and crossed market rules as may be contained in the rules of a Participant approved by the Commission.

<sup>41</sup> 15 U.S.C. 78f(b)(5).

The Commission also finds that proposed Phlx Temporary Rule 1088, which facilitates the participation of certain Participating Options Exchanges who may require the use of P/A Orders and Principal Orders after implementation of the Plan, is consistent with the Act. Although the Commission has already approved the Plan,<sup>42</sup> the Commission also recognizes that there may be one or more Participating Options Exchanges that may require a temporary transition period during which they may want to continue to utilize these order types that exist currently under the Old Plan.<sup>43</sup> The Exchange and each of the other Participating Options Exchanges have proposed substantially identical temporary provisions to accommodate this possibility.<sup>44</sup> Thus, the Commission finds that the proposed rule relating to the Exchange's receipt and handling of P/A Orders and Principal Orders, and imposing certain obligations on the Exchange with respect to such orders that are similar to those that exist under the Old Plan, is appropriate and consistent with Section 6(b)(5) of the Act<sup>45</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission finds that Phlx's proposed amendments to its rules concerning FIND and SRCH orders, as well as the changes proposed to the Quote Exhaust and Market Exhaust

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<sup>42</sup> See Plan Approval, *supra*, note 5.

<sup>43</sup> The Commission notes that any Participating Options Exchange that wishes to utilize such order types in a manner that would result in a Trade-Through would need to separately request an exemption from the Plan for such use.

<sup>44</sup> The Commission notes that the rules contained in Proposed Phlx Temporary Rule 1088 are not required by the Plan, but rather are rules proposed by the Exchange in order to facilitate the participation in the Plan of certain exchanges during an initial transition period.

<sup>45</sup> 15 U.S.C. 78f(b)(5).

processes, are consistent with the Act and the Plan. These changes should help ensure that the order types and order handling processes will operate in accordance with the principles and provisions of the Plan. The Commission also finds that that Phlx's proposals to amend provisions of other Phlx rules to, among other things, reflect the termination of the Old Plan and implement the Plan are appropriate and consistent with the Act.

In addition, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act<sup>46</sup> for approving the proposed rule change prior to the thirtieth day after the date of publication in the Federal Register. The Commission believes that granting accelerated approval to the proposed rule change will give Phlx members certainty with regard to the rules under which they will be expected to operate under prior to the date of implementation of these rules and the Plan, which the Exchange anticipates for August 31, 2009. The Commission notes that the proposed rule change has been subject to a full comment period and no comments have been received. Accordingly, the Commission finds there is good cause, consistent with Section 6(b)(5) of the Act<sup>47</sup> to approve the Exchange's proposed rule change on an accelerated basis.

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<sup>46</sup> 15 U.S.C. 78s(b)(2).

<sup>47</sup> 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>48</sup> that the proposed rule change (SR-Phlx-2009-61), be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>49</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>48</sup> 15 U.S.C. 78s(b)(2).

<sup>49</sup> 17 CFR 200.30-3(a)(12).