

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-64688; File No. SR-Phlx-2011-56)

June 16, 2011

Self-Regulatory Organizations; The NASDAQ OMX PHLX LLC; Order Granting Approval of Proposed Rule Change Establishing a Qualified Contingent Cross Order for Execution on the Floor of the Exchange

I. Introduction

On May 4, 2011, NASDAQ OMX PHLX LLC (“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 establish a qualified contingent cross order for execution on the floor of the Exchange (“Floor QCC Order”). The proposed rule change was published in the Federal Register on May 12, 2011.<sup>3</sup> The Commission received one comment letter on the proposal.<sup>4</sup> Phlx submitted a comment response letter on June 3, 2011.<sup>5</sup> This order grants approval of the proposed rule change.

II. Description of the Proposal

Phlx proposes to amend Rule 1064 to establish a Floor QCC Order type.<sup>6</sup>

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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. 64415 (May 5, 2011), 76 FR 27732 (“Notice”).

<sup>4</sup> See Letter to Elizabeth M. Murphy, Secretary, Commission, from Michael J. Simon, Secretary, International Securities Exchange (“ISE”), dated May 27, 2011 (“ISE Letter”).

<sup>5</sup> See Letter to Elizabeth M. Murphy, Secretary, Commission, from Jeffrey S. Davis, Vice President and Deputy General Counsel, Phlx, dated June 3, 2011 (“Phlx Response Letter”).

<sup>6</sup> Phlx established an electronic QCC Order set forth in PHLX Rule 1080(o). See Securities Exchange Act Release No. 64249 (April 7, 2011), 76 FR 20773 (April 13, 2011) (SR-Phlx-2011-047).

As proposed, the Floor QCC Order would be required to: (i) be for at least 1,000 contracts, (ii) meet the six requirements of Phlx Rule 1080(o)(3),<sup>7</sup> (iii) be executed at a price at or between the National Best Bid and Offer (“NBBO”); and (iv) be rejected if a Customer order is resting on the Exchange book at the same price. Specifically, proposed Phlx Rule 1064(e) would provide that Floor QCC Orders may be immediately executed upon entry into the system by an Options Floor Brokers and without exposure if no Customer Orders<sup>8</sup> exist on the Exchange’s order book at the same price.

Floor QCC Orders would be electronically entered by an Options Floor Broker on the floor of the Exchange using the Floor Broker Management System (“FBMS”) and the orders would then be executed electronically. Only Options Floor Brokers would be permitted to enter Floor QCC Orders. In addition, under proposed Rule 1064(e)(2), Options Floor Brokers would be prohibited from entering Floor QCC Orders for their own accounts, the account of an

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<sup>7</sup> Phlx Rule 1080(o)(3) defines a qualified contingent cross trade substantively identical to the Commission’s definition in the QCT Release. A qualified contingent cross trade must meet the following conditions: (i) at least one component must be an NMS stock, as defined in Rule 600 of Regulation NMS, 17 CFR 242.600; (ii) all components must be effected with a product or price contingency that either has been agreed to by all the respective counterparties or arranged for by a broker-dealer as principal or agent; (iii) the execution of one component must be contingent upon the execution of all other components at or near the same time; (iv) the specific relationship between the component orders (*e.g.*, the spread between the prices of the component orders) is determined by the time the contingent order is placed; (v) the component orders must bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or cancelled; and (vi) the transaction must be fully hedged (without regard to any prior existing position) as a result of other components of the contingent trade. The Commission has granted an exemption for QCTs that meet certain requirements from Rule 611(a) of Regulation NMS, 17 CFR 242.611(a) (“QCT Exemption”). See Securities Exchange Act Release No. 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008) (“QCT Release,” which supersedes a release initially granting the QCT exemption, Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006) (“Original QCT Release”).

<sup>8</sup> Phlx would reject Floor QCC Orders that attempt to execute when any Customer Orders are resting on the Exchange limit order book at the same price.

associated person, or an account with respect to which it or an associated person thereof exercises investment discretion. The Exchange notes that the restrictions set forth in proposed Rule 1064(e)(2) do not limit in any way the obligation of Options Floor Brokers and other Exchange members to comply with Section 11(a) or the rules thereunder.<sup>9</sup>

Additionally, the Exchange proposes to modify subsections (a), (b), and (c) of Rule 1064 to establish that the requirements applicable to Floor QCC Orders that are set forth in new subsection (e) are distinct from those applicable to the orders described in such subsections.

### III. Comment Letter

One commenter raised an objection to the proposal.<sup>10</sup> The commenter questioned the ability of a floor-based exchange to verify that there is not a customer order on the book at the price as a Floor QCC Order at the time of execution.<sup>11</sup> The commenter argued that in an electronic trading environment, an exchange's systems can automatically determine if there is a customer order on the book before a Floor QCC Order is executed.<sup>12</sup> The commenter stated that how this function would be performed on a floor-based exchange should be clarified, as well as what the time of execution would be for a floor-based trade.<sup>13</sup> The commenter argued that “[a]llowing a QCC to be implemented in a non-automated environment without a systemic check of whether there is a customer order on the book at the time of execution would effectively eliminate the protections guaranteed in an all electronic trading environment, thus returning [the

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<sup>9</sup> Proposed Rule 1064(e)(2) would also require Options Floor Brokers to maintain books and records demonstrating that no Floor QCC Order was entered by an Options Floor Broker in such a prohibited account.

<sup>10</sup> See note 4, *supra*.

<sup>11</sup> See ISE Letter.

<sup>12</sup> Id.

<sup>13</sup> Id.

exchanges] to the unequal competitive environment from which the ISE's QCC proposal originated."<sup>14</sup>

In its letter, Phlx responded to the issues raised in the ISE Letter and explained that, even when Floor QCC Orders are entered by the Options Floor Broker, they are submitted electronically to the Phlx order book where a systemic check would be performed to determine whether a customer order is resting on the book at the same price as any leg of the Floor QCC Order, in which case the Phlx trading system would reject the entire Floor QCC Order.<sup>15</sup> If, however, there is no customer order resting on the Phlx book at the same price as any leg of the Floor QCC order, the system would execute the Floor QCC Order and simultaneously assign it an execution time.<sup>16</sup>

#### IV. Discussion and Commission's Findings

The Commission has carefully reviewed the proposed rule change, the one comment letter received, and finds that it is consistent with the requirements of Section 6(b) of the Act.<sup>17</sup> Specifically, the Commission finds that the proposal is consistent with Sections 6(b)(5)<sup>18</sup> and 6(b)(8),<sup>19</sup> which require, 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 and that the rules of an exchange do not impose any

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<sup>14</sup> Id.

<sup>15</sup> See Phlx Response Letter, supra note 5.

<sup>16</sup> Id.

<sup>17</sup> 15 U.S.C. 78f(b). 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>18</sup> 15 U.S.C. 78f(b)(5).

<sup>19</sup> 15 U.S.C. 78f(b)(8).

burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In addition, the Commission finds that the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act,<sup>20</sup> in which Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure, among other things, the economically efficient execution of securities transactions.

The Commission believes that the proposed rule change, which would permit a clean cross of the options leg of a subset of qualified contingent trades from the Exchange floor, is appropriate and consistent with the Act.<sup>21</sup> The Commission believes that the Floor QCC Order type may facilitate the execution of qualified contingent trades, which the Commission found to be beneficial to the market as a whole by contributing to the efficient functioning of the securities markets and the price discovery process.<sup>22</sup> The Floor QCC Order would provide assurance to parties to stock-option qualified contingent trades that their hedge would be maintained by allowing the options component to be executed as a clean cross.

While the Commission believes that order exposure is generally beneficial to options markets in that it provides an incentive to options market maker to provide liquidity and therefore plays an important role in ensuring competition and price discovery in the options markets, it also has recognized that contingent trades can be “useful trading tools for investors and other market participants, particularly those who trade the securities of issuers involved in mergers, different classes of shares of the same issuers, convertible securities, and equity

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<sup>20</sup> 15 U.S.C. 78k-1(a)(1)(C).

<sup>21</sup> See also Securities Exchange Act Release No. 63955 (February 24, 2011), 76 FR 11533 (March 2, 2011) (SR-ISE-2010-73).

<sup>22</sup> See Original QCT Release, supra note 7.

derivatives such as options [italics added],”<sup>23</sup> and that “[t]hose who engage in contingent trades can benefit the market as a whole by studying the relationships between prices of such securities and executing contingent trades when they believe such relationships are out of line with what they believe to be fair value.”<sup>24</sup> As such, the Commission stated that the transactions that meet the specified requirements of the QCT Exemption could be of benefit to the market as a whole, contributing to the efficient functioning of the securities markets and the price discovery process.<sup>25</sup>

Thus, in light of the benefits provided by both the requirement for exposure as well as by qualified contingent trades such as Floor QCC Orders, the Commission must weigh the relative merits of both for the options markets.<sup>26</sup> The Commission believes that the proposal, in requiring a Floor QCC Order be: (1) part of a qualified contingent trade under Regulation NMS; (2) for at least 1,000 contracts; (3) executed at a price at or between the NBBO; and (4) rejected if there is a public customer on the electronic book, strikes an appropriate balance for the options market in that it is narrowly drawn and establishes a limited exception to the general principle of exposure and retains the general principle of customer priority in the options markets. Furthermore, not only must a Floor QCC Order be part of a qualified contingent trade by satisfying each of the six underlying requirements of the QCT Exemption, the requirement that a

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<sup>23</sup> See id. at 52830-52831.

<sup>24</sup> Id.

<sup>25</sup> See QCT Release, supra note 7 at 19273.

<sup>26</sup> The Commission notes that it has previously permitted the crossing of two public customer orders, for which no exposure is required on ISE and CBOE. See CBOE Rule 6.74A.09 and ISE Rule 715(i) and 721.

QCC Order be for a minimum size of 1,000 contracts provides another limit to its use by ensuring only transactions of significant size may avail themselves of this order type.<sup>27</sup>

The Commission notes that, under Phlx's proposal, Floor QCC Orders must be submitted by an Options Floor Broker electronically from on the floor through Phlx's FBMS. Phlx has represented that to effect Floor QCC Orders, members must ensure that their orders comply with Section 11(a)(1) of the Act,<sup>28</sup> which concerns proprietary trading on an exchange by an exchange member, and the rules thereunder.

Additionally, the Commission believes that the Phlx Response Letter clarified the questions raised by ISE in the ISE Letter.

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with Section 6(b)(5)<sup>29</sup> and 6(b)(8)<sup>30</sup> of the Act. Further, the Commission finds that the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act.<sup>31</sup>

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<sup>27</sup> The Commission notes that the requirement that clean crosses be of a certain minimum size is not unique to the Floor QCC Order. See, e.g., NSX 11.12(d), which requires, among other things, that a Clean Cross be for at least 5,000 shares and have an aggregate value of at least \$100,000.

<sup>28</sup> 15 U.S.C. 78k(a)(1). Generally, Section 11(a)(1) of the Act restricts any member of a national securities exchange from effecting any transaction on such exchange for: (i) the member's own account, (ii) the account of a person associated with the member, or (iii) an account over which the member or a person associated with the member exercises discretion, unless a specific exemption is available.

<sup>29</sup> 15 U.S.C. 78f(b)(5).

<sup>30</sup> 15 U.S.C. 78f(b)(8).

<sup>31</sup> 15 U.S.C. 78k-1(a)(1)(C).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>32</sup> that the proposed rule change (SR-Phlx-2011-56) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>33</sup>

Cathy H. Ahn  
Deputy Secretary

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<sup>32</sup> 15 U.S.C. 78s(b)(2).

<sup>33</sup> 17 CFR 200.30-3(a)(12).