

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61667; File No. SR-Phlx-2010-36)

March 5, 2010

Self-Regulatory Organizations; NASDAQ OMX PHLX, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Establish Procedures to Prevent Informational Advantages Resulting From the Affiliation Between PHLX and NOS

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on February 26, 2010, NASDAQ OMX PHLX, Inc. (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange has designated the proposed rule change as constituting a non-controversial rule change under Rule 19b-4(f)(6) under the Act,³ which renders the proposal effective upon filing with the Commission. 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 proposes a rule change to establish procedures designed to manage potential informational advantages resulting from the affiliation between the Exchange and NASDAQ Options Services, LLC (“NOS”), a registered broker-dealer and a Phlx member.

The text of the proposed rule change is below. Proposed new language is underlined; proposed deletions are in [brackets].

Rule 985. Affiliation and Ownership Restrictions

(a) - (b) No change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 17 CFR 240.19b-4(f)(6).

(c) The NASDAQ OMX Group, Inc., which owns NASDAQ Options Services, LLC and the Exchange, shall establish and maintain procedures and internal controls reasonably designed to ensure that NASDAQ Options Services, LLC does not develop or implement changes to its system on the basis of non-public information regarding planned changes to the Exchange's systems, obtained as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members in connection with the provision of inbound routing to the Exchange.

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Rule 1080. Phlx XI and Phlx XL II

(a)-(l) No change.

(m) (i)-(ii) No change.

(iii)(A)-(B) No change.

(C) The Exchange shall establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange and the Routing Facility, and any other entity, including any affiliate of the Routing Facility[, and, if the Routing Facility or any of its affiliates engages in any other business activities other than providing routing services to the Exchange, between the segment of the Routing Facility or affiliate that provides the other business activities and the routing services].

(D) No change.

(iv) No change.

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

In its filing with the Commission, the 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

a. Background

The Exchange is a wholly-owned subsidiary of The NASDAQ OMX Group, Inc. (“NASDAQ OMX”), a Delaware corporation. NASDAQ OMX also indirectly owns NASDAQ Options Services, LLC (“NOS” or the “Routing Facility”), a registered broker-dealer and a Phlx member. Thus, NOS is deemed an affiliate of Phlx.

The Exchange is proposing that NOS be permitted to route certain orders from The NASDAQ Option Market (“NOM”) to the Exchange without checking the NOM book prior to routing. NOM is an options market operated by The NASDAQ Stock Market (the “NASDAQ Exchange”) and NOS is the approved outbound routing facility of the NASDAQ Exchange for NOM. With the exception of Exchange Direct Orders, all routable orders for options that are trading on NOM check the NOM book prior to routing. In addition, NOS also routes orders in options that are not trading on NOM (referred to in the NOM Rules as “Non-System Securities”). When routing orders in options that are not listed and open for trading on NOM, NOS is not regulated as a facility of the NASDAQ Exchange but rather as a broker-dealer regulated by its designated examining authority. As provided by Chapter IV, Section 5 of the NOM Rules, all

orders routed by NOS under these circumstances are routed to away markets that are at the best price, and solely on an immediate-or-cancel basis.

Under NOM Rule Chapter VI, Section 11: 1) NOM routes orders in options via NOS, which serves as the sole “routing facility” of NOM; 2) the sole function of the routing facility is to route orders in options to away markets pursuant to NOM rules, solely on behalf of NOM; 3) NOS is a member of an unaffiliated self-regulatory organization, which is the designated examining authority for the broker-dealer; 4) the routing facility is subject to regulation as a facility of the NASDAQ Exchange, including the requirement to file proposed rule changes under Section 19 of the Act; 5) NOM must establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the NASDAQ Exchange and its facilities (including the routing facility), and any other entity; and 6) the books, records, premises, officers, directors, agents, and employees of the routing facility, as a facility of the NASDAQ Exchange, shall be deemed to be the books, records, premises, officers, directors, agents, and employees of the NASDAQ Exchange for purposes of and subject to oversight pursuant to the Act, and the books and records of the routing facility, as a facility of the NASDAQ Exchange, shall be subject at all times to inspection and copying by the NASDAQ Exchange and the Commission.

The Commission has approved NOS’s affiliation with the Exchange subject to the conditions that: (1) NOS is a facility of the NASDAQ Exchange; (2) use of NOS’s routing function by NASDAQ Exchange members is optional⁴ and (3) NOS does not provide routing of

⁴ Because only NASDAQ Exchange members who are Options Participants may enter orders into NOM, it also follows that routing by NOS is available only to NASDAQ Exchange members who are Options Participants. Pursuant to Chapter I, Section 1(a)(40) of the NOM Rules, the term “Options Participant” means a firm, or organization that is

orders in options from NOM to the Exchange or any trading facilities thereof, unless such orders first attempt to access any liquidity on the NOM book.⁵

The NASDAQ Exchange has filed a proposed rule change to modify the last of these conditions to permit NOS to route Exchange Direct Orders in NOM system securities to the Exchange without checking the NOM book prior to routing.⁶ Exchange Direct Orders are orders that route directly to other options markets on an immediate-or-cancel basis without first checking the NOM book for liquidity.⁷ In addition, the proposed rule change would permit the routing by NOS of orders (including Exchange Direct Orders) in NOM non-system securities from NOM to the Exchange.

The principles that govern the routing of orders to an exchange by an affiliated broker-dealer are well-established. The Exchange and other exchanges previously have adopted rules that permit exchanges to accept routing of inbound orders from affiliates, subject to certain limitations and conditions intended to address the Commission's concerns regarding affiliation.⁸ In the orders approving these rule changes, the Commission noted its concerns about potential

registered with the NASDAQ Exchange for purposes of participating in options trading on NOM as a "Nasdaq Options Order Entry Firm" or "Nasdaq Options Market Maker".

⁵ See Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008).

⁶ SR-NASDAQ-2010-028.

⁷ See NOM Rule Chapter VI, Section 1(e)(7).

⁸ See Securities Exchange Act Release Nos. 60354 (July 21, 2009), 74 FR 37074 (July 27, 2009)(SR-NASDAQ-2009-065); 60349 (July 20, 2009), 74 FR 37071 (July 27, 2009)(SR-BX-2009-035); 59153 (December 23, 2008), 73 FR 80485 (December 31, 2008)(SR-NASDAQ-2008-098); 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008)(SR-BSE-2008-48); 59010 (November 24, 2008), 73 FR 73373 (December 2, 2008) (SR-NYSEArca-2008-130); 58681 (September 29, 2008), 73 FR 58285 (October 6, 2008)(SR-NYSEArca-2008-90); 58680 (September 29, 2008), 73 FR 58283 (October 6, 2008)(SR-NYSE-2008-76); 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008)(SR-Amex-2008-62) (collectively, the "Affiliation Orders").

informational advantages and conflicts of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, but determined that the limitations and conditions proposed in the rule changes were sufficient to mitigate its concerns.

To appropriately address the concerns raised by the Commission regarding the potential for conflicts of interest and informational advantages, the Exchange is proposing certain restrictions and undertakings. These commitments are consistent with the undertakings made by: (i) NASDAQ OMX BX ("BX") in adopting rule changes to permit NOS, in its operation as a routing facility of NASDAQ Exchange, to route orders from NOM to the Boston Options Exchange, a facility of BX, which is an affiliate of the NASDAQ Exchange, and (ii) in the equities markets, by BX in adopting rule changes to permit NASDAQ Execution Services, Inc., in its operation as the routing facility of the NASDAQ Exchange, to route orders from NASDAQ Exchange to BX.⁹

In order to manage the concerns raised by the Commission regarding conflicts of interest in instances where a broker-dealer is affiliated with an exchange to which it is routing orders, the Exchange notes that, with respect to orders routed to the Exchange by NOS, NOS is subject to independent oversight and enforcement by FINRA, an unaffiliated SRO that is NOS's designated examining authority. In this capacity, FINRA is responsible for examining NOS with respect to its books and records and capital obligations and also has the responsibility for reviewing NOS's compliance with applicable trading rules. In addition, the Exchange has entered into a regulatory services agreement with FINRA under which FINRA staff will review NOS's compliance with

⁹ See Securities Exchange Act Release Nos. 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008)(SR-BSE-2008-48); 60349 (July 20, 2009), 73 FR 37071 (July 27, 2009)(SR-BX-2009-035).

the Exchange's rules through FINRA's examination program. FINRA and the Exchange will also monitor NOS for compliance with the Exchange's trading rules, subject, of course, to Commission oversight of the regulatory program of the Exchange and FINRA. The Exchange will, however, retain ultimate responsibility for enforcing its rules with respect to NOS except to the extent that they are covered by an agreement with FINRA pursuant to Rule 17d-2,¹⁰ in which case regulatory responsibility will be allocated to FINRA as provided in Rule 17d-2(d).¹¹

Furthermore, in order to minimize the potential for conflicts of interest, the Exchange and FINRA will collect and maintain all alerts, complaints, investigations and enforcement actions in which NOS (in routing orders to the Exchange) is identified as a participant that has potentially violated applicable Commission or Exchange rules. The Exchange and FINRA will retain these records in an easily accessible manner in order to facilitate any potential review conducted by the Commission's Office of Compliance Inspections and Examinations. FINRA will then provide a report to the Exchange's Chief Regulatory Officer, on at least a quarterly basis, which will list all investigations that identify NOS as a participant that has potentially violated an Exchange or Commission rule.¹²

In order to address the Commission's concerns about potential for information advantages that could place an affiliated broker-dealer at a competitive advantage vis-à-vis other

¹⁰ 17 CFR 240.17d-2.

¹¹ The Exchange and FINRA are parties to the Industry Rule 17d-2 Plan for the allocation of regulatory responsibilities relating to surveillance, investigation, and enforcement of insider trading rules and the Industry Rule 17d-2 Plan relating to certain options-related sales practice matters. See Securities Act Release Nos. 58536 (September 12, 2008), 73 FR 54646 (September 22, 2008) (File No. 4-566); 57987 (June 18, 2008), 73 FR 36156 (June 25, 2008) (File No. S7-966) (File No. 4-551). These plans, however, do not cover any responsibilities relating to NOS.

¹² The Exchange, FINRA and SEC staff may agree going forward to reduce the number of applicable or relevant surveillances that form the scope of the agreed upon report.

non-affiliated broker-dealers, the Exchange is proposing to adopt Rule 985(c). Rule 985(c) will require the parent company of both the Exchange and NOS to implement policies and procedures that are reasonably designed to prevent NOS from acting on non-public information regarding the Exchange's systems prior to the time that such information is made available generally to all market participants of such entity performing inbound routing functions. These policies and procedures would include systems development protocols to facilitate an audit of the efficacy of these policies and procedures.

Specifically, Rule 985(c) shall provide as follows:

The NASDAQ OMX Group, Inc., which owns NASDAQ Options Services, LLC and the Exchange, shall establish and maintain procedures and internal controls reasonably designed to ensure that NASDAQ Options Services, LLC does not develop or implement changes to its system on the basis of non-public information regarding planned changes to the Exchange's systems, obtained as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members in connection with the provision of inbound routing to the Exchange.

In addition, existing rules require: (i) NOS to establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the NASDAQ Exchange and its facilities (including NOS) and any other entity, and (ii) the Exchange to establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange and NOS and any other entity, including any affiliate of NOS.¹³ The Exchange proposes to amend Exchange Rule 1080(m)(iii)(C) to conform the language to match

¹³ See NOM Rule Chapter VI, Section 11(e); Exchange Rule 1080(m)(iii)(C).

the parallel commitments of NOS and NES to establish and maintain procedures and internal controls to restrict the flow of confidential and proprietary information.¹⁴ Furthermore, the Exchange proposes to delete language in Exchange Rule 1080(m)(iii)(C) that is more consistent with the use a non-affiliated third party for routing services since NOS, an affiliated entity, acts as the exclusive order router of the Exchange. The Exchange believes these measures will effectively address the concerns identified by the Commission regarding the potential for informational advantages favoring NOS vis-à-vis other Exchange participants.

b. Pilot Period

The Exchange proposes that the Commission authorize NOS to route Exchange Direct Orders and orders in NOM non-system securities inbound to the Exchange from NOM for a pilot period of 12 months from the effectiveness date of this rule filing. The Exchange believes that this pilot period is of sufficient length to permit both the Exchange and the Commission to assess the impact of the rule change described herein.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with the provisions of Section 6 of the Act,¹⁵ in general, and with Section 6(b)(5) of the Act,¹⁶ in particular, in that the proposal 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 regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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

¹⁴ See NOM Rule Chapter VI, Section 11(e); NASDAQ Rule 4758(b)(8).

¹⁵ 15 U.S.C. 78f.

¹⁶ 15 U.S.C. 78f(b)(5).

proposed rule change would permit inbound routing of orders from NOM to the Exchange through NOS while minimizing the potential for conflicts of interest and informational advantages involved where a broker-dealer is affiliated with an exchange facility to which it is routing orders.

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

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

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

Written comments were neither solicited nor received.

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

Because the proposed rule change: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁷ and Rule 19b-4(f)(6) thereunder.¹⁸

A proposed rule change filed under 19b-4(f)(6) normally may not become operative prior to 30 days after the date of filing.¹⁹ However, Rule 19b-4(f)(6)(iii)²⁰ permits the Commission to

¹⁷ 15 U.S.C. 78s(b)(3)(A).

¹⁸ 17 CFR 240.19b-4(f)(6).

¹⁹ 17 CFR 240.19b-4(f)(6)(iii). In addition, Rule 19b-4(f)(6)(iii) requires that a self-regulatory organization submit to the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such

designate a shorter time if such action is consistent with the protection of investors and the public interest. The Exchange has requested that the Commission waive the 30-day operative delay. The Commission notes that the Exchange's proposal is consistent with the rules of other national securities exchanges and does not raise any new substantive issues.²¹ For these reasons, the Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest, and designates the proposed rule change to be operative upon filing with the Commission.²²

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

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. Please include File Number SR-Phlx-2010-36 on the subject line.

shorter time as designated by the Commission. The Exchange has satisfied this requirement.

²⁰ Id.

²¹ See Affiliation Orders, supra notes 8 and 9.

²² For the purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

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-2010-36. 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 Web site 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-2010-36 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.²³

Florence E. Harmon
Deputy Secretary

²³ 17 CFR 200.30-3(a)(12).