

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-66362; File No. SR-Phlx-2012-13)

February 9, 2012

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Exchange Rule 705 (Fidelity Bonds)

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 January 26, 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 substantially 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 proposes to amend Exchange Rule 705, entitled “Members Must Carry,” to create new requirements regarding fidelity bonds and also rename the Rule “Fidelity Bonds.”

The Exchange intends for this Rule to become operative on April 2, 2012.

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.

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

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

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, which are substantially set forth below in sections A, B, and C, 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 Exchange proposes to amend Exchange Rule 705, entitled “Members Must Carry,” to create new requirements regarding fidelity bonds and also rename the Rule “Fidelity Bonds,” in substantially the same form as a rule at the Financial Industry Regulatory Authority, Inc. (“FINRA”).<sup>3</sup>

Currently, Exchange Rule 705 requires each member organization that is a partnership and is doing business with the public and each member organization that is a corporation to carry fidelity bonds covering its general partners and employees or covering its officers and employees in such form and in such amounts as the Exchange may require. The Rule does not apply to member organizations that are partnerships or corporations which are members of another exchange, which has comparable rules and regulations to which such member organizations are subject and with which they comply.

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<sup>3</sup> See FINRA Rule 4360 “Fidelity Bonds.”

The Exchange proposes to adopt language similar to a FINRA Rule which would provide members and member organizations with more specific guidelines with respect to fidelity bonds and better reflect current industry practices.<sup>4</sup> The purpose of a fidelity bond is to protect a member or member organization against certain types of losses, including, but not limited to, those caused by the malfeasance of its officers and employees, and the effect of such losses on the member or member organization's capital.

The new proposed text would require each member and member organization that is required to join the Securities Investor Protection Corporation (“SIPC”) to maintain blanket fidelity bond coverage with specified amounts of coverage based on the member or member organization's net capital requirement, with certain exceptions. Proposed Rule 705 would require members and member organizations to maintain fidelity bond coverage that provides for per loss coverage without an aggregate limit of liability. Members or member organizations may apply for this level of coverage with any product that meets these requirements, including the Securities Dealer Blanket Bond or a properly endorsed Financial Institution Form 14 Bond. Most fidelity bonds contain a definition of the term “loss” (or “single loss”), for purposes of the bond, which generally includes all covered losses resulting from any one act or a series of related acts. A payment by an insurer for covered losses attributed to a “single loss” does not reduce a member or member organization's coverage amount for losses attributed to other, separate acts. A fidelity bond with an aggregate limit of liability caps a member or member organization's coverage during the bond period at a certain amount if a loss (or losses) meets this

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<sup>4</sup> See Securities Exchange Act Release No. 63961 (February 24, 2011), 76 FR 11542 (March 2, 2011) (SR-FINRA-2010-059) (a rule change to adopt a rule of the National Association of Securities Dealers, Inc. (“NASD”) as part of the consolidation of the FINRA rulebook).

aggregate threshold. The Exchange believes that per loss coverage without an aggregate limit of liability provides members and member organizations with the most beneficial coverage since the bond amount cannot be exhausted by one or more covered losses, so it will be available for future losses during the bond period.

Under the proposed Rule, a member or member organization's fidelity bond must provide against loss and have Insuring Agreements covering at least the following: fidelity, on premises, in transit, forgery and alteration, securities and counterfeit currency. The Rule requires that coverage for all Insuring Agreements be equal to 100 percent of the member or member organization's minimum required bond coverage. Members and member organizations may elect to carry additional, optional Insuring Agreements not required by the proposed Rule for an amount less than 100 percent of the minimum required bond coverage. The proposed Rule would require that a member or member organization's fidelity bond include a cancellation rider providing that the insurer will use its best efforts to promptly notify the Exchange in the event the bond is cancelled, terminated or "substantially modified."

The Exchange is proposing to add supplementary material to the proposed Rule text that would require members or member organizations that do not qualify for a bond with per loss coverage without an aggregate limit of liability to secure alternative coverage. Specifically, a member or member organization that does not qualify for blanket fidelity bond coverage as required by Rule 705(a)(3) would be required to maintain substantially similar fidelity bond coverage in compliance with all other provisions of the proposed Rule, provided that the member or member organization maintains written correspondence from two insurance providers stating that the member

or member organization does not qualify for the coverage required by proposed Rule 705(a)(3). The member or member organization would be required to retain such correspondence for the period specified by Rule 17a-4(b)(4) of the Act.

*Minimum Coverage*

Proposed Rule 705 would require each member or member organization to maintain, at a minimum, fidelity bond coverage for any person associated with the member or member organization, except directors or trustees of a member or member organization who are not performing acts within the scope of the usual duties of an officer or employee. Proposed Rule 705 would require a member or member organization with a net capital requirement that is less than \$250,000 to maintain minimum coverage of the greater of 120 percent of the firm's required net capital under Rule 15c3-1 of the Act or \$100,000. Members or member organizations with a net capital requirement of at least \$250,000 would use a table in the rule to determine their minimum fidelity bond coverage requirement. Under the proposed Rule, the entire amount of a member or member organization's minimum required coverage must be available for covered losses and may not be eroded by the costs an insurer may incur if it chooses to defend a claim. Specifically, any defense costs for covered losses must be in addition to a member or member organization's minimum coverage requirements. A member or member organization may include defense costs as part of its fidelity bond coverage, but only to the extent that it does not reduce a member or member organization's minimum required coverage under the proposed Rule.

### *Deductible*

Proposed Rule 705 would provide for an allowable deductible amount of up to 25 percent of the fidelity bond coverage purchased by a member or member organization. Any deductible amount elected by the member or member organization that is greater than 10 percent of the coverage purchased by the member or member organization<sup>5</sup> would be deducted from the member or member organization's net worth in the calculation of its net capital for purposes of Rule 15c3-1 of the Act.<sup>6</sup> If the member or member organization is a subsidiary of another Exchange member or member organization, this amount may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.

### *Annual Review*

The proposed Rule would require a member or member organization (including a member or member organization that signs a multi-year insurance policy), annually as of the yearly anniversary date of the issuance of the fidelity bond, to review the adequacy of its fidelity bond coverage and make any required adjustments to its coverage, as set forth in the proposed Rule. Under proposed Rule 705(d), a member or member organization's highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), would be used as the basis for determining the member or member organization's minimum required fidelity bond coverage for the succeeding 12-month

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<sup>5</sup> The Exchange notes that a member or member organization may elect, subject to availability, a deductible of less than 10 percent of the coverage purchased.

<sup>6</sup> Such deduction would be based on net worth on coverage purchased by the member or member organization.

period. The “preceding 12-month period” includes the 12-month period that ends 60 days before the yearly anniversary date of a member or member organization's fidelity bond. This would give a member or member organization time to determine its required fidelity bond coverage by the anniversary date of the bond.

Rule 705 would allow a member or member organization that has only been in business for one year and elected the aggregate indebtedness ratio for calculating its net capital requirement to use, solely for the purpose of determining the adequacy of its fidelity bond coverage for its second year, the 15 to 1 ratio of aggregate indebtedness to net capital in lieu of the 8 to 1 ratio (required for broker-dealers in their first year of business) to calculate its net capital requirement. Notwithstanding the above, such member or member organization would not be permitted to carry less minimum fidelity bond coverage in its second year than it carried in its first year.

A member or member organization would be required to immediately advise the Exchange in writing if its fidelity bond is cancelled, terminated or substantially modified.<sup>7</sup>

#### *Exemptions*

Proposed Rule 705 would exempt from the fidelity bond requirements members or member organizations in good standing with another national securities exchange or FINRA that maintain a fidelity bond subject to the requirements of such exchange that are equal to or greater than the requirements set forth in the proposed rule.<sup>8</sup> Additionally,

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<sup>7</sup> See Proposed Rule 705(e).

<sup>8</sup> In general, the notification provisions of the corresponding exchange rules (*i.e.*, cancellation rider and notification upon cancellation, termination or substantial modification of the bond) require notification to the respective exchange rather

the Rule would exempt from the fidelity bond requirements any firm that acts solely as a Registered Options Trader (“ROT”)<sup>9</sup>, Specialist<sup>10</sup> or Floor Broker and does not conduct business with the public.

The Exchange intends for this Rule to become operative on April 2, 2012.

## 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act<sup>11</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>12</sup> in particular, in that it is designed to promote just and equitable principles of trade, to remove

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than to the Exchange or FINRA. Accordingly, the practical effect for a member or member organization that avails itself of the proposed exemption is that such member or member organization must maintain a fidelity bond subject to the same or greater requirements as in proposed Rule 705; however, such member or member organization would be exempt from the requirement that the Exchange be notified of changes to the bond and would alternatively comply with the notification provisions of the respective exchange or FINRA.

<sup>9</sup> An ROT includes a Streaming Quote Trader (“SQT”), a Remote Streaming Quote Trader (“RSQT”) and a Non-SQT, which by definition is neither a SQT or an RSQT. An ROT is defined in Exchange Rule 1014(b) as a regular member of the Exchange located on the trading floor who has received permission from the Exchange to trade in options for his own account. See Exchange Rule 1014 (b)(i) and (ii). An SQT is defined in Exchange Rule 1014(b)(ii)(A) as an ROT who has received permission from the Exchange to generate and submit option quotations electronically in options to which such SQT is assigned. An RSQT is defined Exchange Rule in 1014(b)(ii)(B) as 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 options to which such RSQT has been assigned. An RSQT may only submit such quotations electronically from off the floor of the Exchange.

<sup>10</sup> A Specialist is an Exchange member who is registered as an options specialist pursuant to Rule 1020(a).

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

<sup>12</sup> 15 U.S.C. 78f(b)(5).



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 Exchange believes that its proposed amendment to Exchange Rule 705 provides specificity to the Rule. The proposed amendment to the Rule requires members and member organizations to continue to carry fidelity bonds, but also provides additional specificity regarding the amount of coverage. This Rule will update and clarify the requirements governing fidelity bonds consistent with industry practice.

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

Because the foregoing proposed rule change does not: (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate, it has become effective pursuant to 19(b)(3)(A) of the Act<sup>13</sup> and Rule 19b-4(f)(6)<sup>14</sup> thereunder.

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<sup>13</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>14</sup> 17 CFR 240.19b-4(f)(6). In addition, Rule 19b-4(f)(6)(iii) requires the Exchange to give the Commission written notice of the Exchange's intent to file the proposed rule change, along with a brief description and text of the proposed rule

The Exchange intends for Rule 705 to become operative on April 2, 2012. This operative delay will allow members or member organizations that are not exempt from the Rule to comply with the requirements set forth under the Rule.

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend 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. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or 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-2012-13 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.

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change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

All submissions should refer to File Number SR-Phlx-2012-13. 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 website (<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-2012-13 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>15</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>15</sup> 17 CFR 200.30-3(a)(12).