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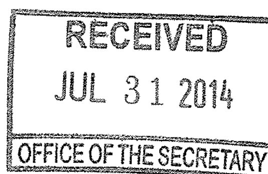
July 30, 2014



VIA HAND DELIVERY

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

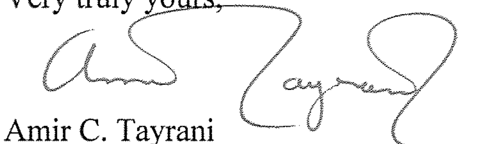
Re: Petition for Review of Order Disapproving Proposed Rule Change to Offer a Rebate Based on Members' Aggregate Customer Volume in Multiply-listed Options Transacted on NASDAQ OMX PHLX LLC or Its Affiliated Options Exchanges, Release No. 34-72633, File No. SR-Phlx-2013-113

Dear Ms. Murphy:

I am writing as counsel for NASDAQ OMX PHLX LLC ("Phlx"). Please find enclosed the original and three copies of Phlx's Petition for Review of Order Disapproving NASDAQ OMX PHLX's Proposal to Reduce Members' Trading Costs (Securities Exchange Act Release No. 34-72633, File No. SR-Phlx-2013-113).

Any questions concerning this matter can be directed to me. My contact information appears above.

Very truly yours,



Amir C. Tayrani

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Petition of: NASDAQ OMX PHLX LLC	File No. SR-Phlx-2013-113

PETITION FOR REVIEW OF ORDER DISAPPROVING NASDAQ OMX PHLX'S PROPOSAL TO REDUCE MEMBERS' TRADING COSTS

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TABLE OF CONTENTS

Page

INTRODUCTION 1

BACKGROUND 4

ARGUMENT 8

I. The Proposed Rule Is Deemed Approved Because The Commission Did Not Issue An Order Disapproving The Rule Within The Period Prescribed By The Exchange Act 8

II. The Division's Disapproval Order Conflicts With The Unambiguous Terms Of The Exchange Act And Lacks A Reasoned Basis 12

A. The Division's Artificially Narrow Individual-Exchange Analysis Is Unambiguously Foreclosed By The Exchange Act 12

1. The Exchange Act Requires Cross-Exchange Analysis Of Cross-Exchange Pricing 13

2. PHLX's Proposed Rule Is Equitable And Nondiscriminatory 17

B. Even Assuming That The Exchange Act Is Ambiguous, The Division Erred By Failing To Articulate A Reasoned Basis For Analyzing The Proposed Rule Change At The Individual-Exchange Level 19

III. The Division's Order Is Inconsistent With Prior Actions By The Commission 24

CONCLUSION 28

TABLE OF AUTHORITIES

Page(s)

Cases

Am. Equity Inv. Life Ins. Co. v. SEC,
613 F.3d 166 (D.C. Cir. 2010) 22

Am. Fed'n of Gov't Emps., AFL-CIO, Council of Locals No. 214 v. FLRA,
798 F.2d 1525 (D.C. Cir. 1986) 17

Bus. Roundtable v. SEC,
647 F.3d 1144 (D.C. Cir. 2011) 13, 22, 23

Busic v. United States,
446 U.S. 398 (1980) 11

Chamber of Commerce v. SEC,
412 F.3d 133 (D.C. Cir. 2005) 13, 22

Ethyl Corp. v. EPA,
541 F.2d 1 (D.C. Cir. 1976) 23

FAIC Sec., Inc. v. United States,
768 F.2d 352 (D.C. Cir. 1985) 14

FCC v. Fox Television Stations, Inc.,
556 U.S. 502 (2009) 24, 27

Indep. Petroleum Ass'n of Am. v. Babbitt,
92 F.3d 1248 (D.C. Cir. 1996) 24

ITT Indus., Inc. v. NLRB,
251 F.3d 995 (D.C. Cir. 2001) 21

Jicarilla Apache Nation v. U.S. Dep't of Interior,
613 F.3d 1112 (D.C. Cir. 2010) 27

Motor Vehicle Mfrs. Ass'n v. State Farm Auto. Ins. Co.,
463 U.S. 29 (1983) 21

Neuren v. Adduci, Mastriani, Meeks & Schill,
43 F.3d 1507 (D.C. Cir. 1995) 17

Pirlott v. NLRB,
522 F.3d 423 (D.C. Cir. 2008) 16

Time Warner Entm't Co. v. FCC,
56 F.3d 151 (D.C. Cir. 1995) 23

Statutes

15 U.S.C. § 78c(f) 3, 13

15 U.S.C. § 78d(a) 10

15 U.S.C. § 78d-1(b) 10, 11
15 U.S.C. § 78d-1(c) 10, 11
15 U.S.C. § 78f(b)(4) 2, 18
15 U.S.C. § 78f(b)(5) 2, 14, 17, 18
15 U.S.C. § 78s(b)(1) 10
15 U.S.C. § 78s(b)(2)(B)(ii) 8, 9, 11
15 U.S.C. § 78s(b)(2)(D) 2, 8, 12
15 U.S.C. § 78s(b)(2)(D)(ii) 8, 9
15 U.S.C. § 78s(b)(3)(A) 6
Pub. L. No. 111-203, 124 Stat. 1376 (2010) 8

Regulations

17 C.F.R. § 200.10 10
17 C.F.R. § 200.30-3(a)(12) 10
17 C.F.R. § 200.30-3(a)(57) 10
69 Fed. Reg. 71,459 (Dec. 2, 2004) (SR-NASD-2004-170) 25
73 Fed. Reg. 74,770 (Dec. 9, 2008) (SR-NYSEArca-2006-21) 19, 20, 21
76 Fed. Reg. 59,466 (Sept. 26, 2011) (SR-NASDAQ-2011-10) 11
77 Fed. Reg. 20,079 (Apr. 3, 2012) (SR-NASDAQ-2011-10) 11
78 Fed. Reg. 69,472 (Nov. 19, 2013) (SR-Phlx-2013-113) 9
78 Fed. Reg. 71,700 (Nov. 29, 2013) (SR-Phlx-2013-113) 1, 6, 9
79 Fed. Reg. 20,287 (Apr. 11, 2014) (SR-Phlx-2013-113) 9
79 Fed. Reg. 42,578 (July 22, 2014) (SR-Phlx-2013-113) 2, 7, 9, 17, 18, 19, 22

Other Authorities

H.R. Rep. No. 94-229 (1975) (Conf. Rep.), *reprinted in* 1975 U.S.C.C.A.N. 321 16
Memorandum from the Division of Risk, Strategy, and Financial Innovation and the General Counsel to the Staff of the Rulewriting Divisions and Offices, Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf 22

INTRODUCTION

NASDAQ OMX PHLX LLC ("Phlx") hereby challenges an action taken pursuant to delegated authority disapproving a Phlx rule proposal that would lower prices, enhance competition, and promote market efficiency. Specifically, on July 16, 2014, the Division of Trading and Markets ("Division") of the Securities and Exchange Commission issued an Order disapproving Phlx's proposal to reduce trading costs for certain liquidity providers who transact electronically delivered customer orders on Phlx or its affiliated options exchanges (the "Proposed Rule"). The Division's Order conflicts with the unambiguous terms of the Exchange Act, lacks any reasoned basis, and departs sharply from the Commission's approval of materially indistinguishable customer rebates.

Phlx proposed to reduce trading costs for liquidity providers who exceed a designated volume threshold on any of the three Nasdaq-affiliated options exchanges. The Proposed Rule would benefit those Phlx customers who are eligible for the cost reduction by providing them with lower prices; more broadly, the Proposed Rule would benefit all market participants by increasing order flow to Phlx—resulting in tighter spreads, increased trading opportunities, and a better functioning trading platform—and by providing Phlx's competitors with an incentive to respond with price cuts of their own. Notwithstanding these pro-competitive, efficiency-enhancing benefits, the Division suspended the Proposed Rule and instituted proceedings to determine whether to approve or disapprove the rule change. *See* Securities Exchange Act Release No. 34-70940, 78 Fed. Reg. 71,700 (Nov. 29, 2013) (SR-Phlx-2013-113) (Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Offer a Customer Rebate) ("Suspension Order"). After granting itself a 60-day extension, and only one day before the 240-day deadline under the Dodd-Frank amendments to the Exchange Act was set to expire, the Division issued an order disapproving the Proposed

Rule. *See* Securities Exchange Act Release No. 34-72633, 79 Fed. Reg. 42,578 (July 22, 2014) (SR-Phlx-2013-113) (Order Disapproving Proposed Rule Change to Offer a Rebate Based on Members' Aggregate Customer Volume in Multiply-listed Options Transacted on NASDAQ OMX PHLX LLC or its Affiliated Options Exchanges) ("Order"). But the Division's Order came too late because the Dodd-Frank amendments provide that a proposed rule "shall be deemed to have been approved" unless the *Commission* itself, rather than the Commission's staff acting pursuant to delegated authority, takes action on the proposed rule within 240 days. 15 U.S.C. § 78s(b)(2)(D). Because the Commission did not disapprove the Proposed Rule within the statutorily prescribed time period, the rule is now "deemed . . . approved."

The substance of the Division's Order is also flawed in multiple respects. The Order contains little actual analysis supporting its conclusion that the Proposed Rule would not "provide for the equitable allocation of . . . fees" under Section 6(b)(4) of the Exchange Act, 15 U.S.C. § 78f(b)(4), and would "permit unfair discrimination between customers" under Section 6(b)(5) of the Act, *id.* § 78f(b)(5). The Division's Order simply assumes—based on unsupported dicta from the ArcaBook Order—that the Proposed Rule should be analyzed at the individual-exchange level, rather than on a cross-exchange basis that considers a customer's activities on all Nasdaq-affiliated options exchanges. In reliance on that flawed premise, the Order concludes—with no additional reasoning or evidentiary support—that the rule is inequitable and unfairly discriminatory because it could result in two supposedly "similarly situated" Phlx members being charged different fees for transacting the same amount and type of customer options volume on the Phlx exchange. Order, 79 Fed. Reg. at 42,585-87.

The Division's narrow focus on the individual securities exchange offering the reduced price—rather than customer transactions on all affiliated exchanges—conflicts with the

unambiguous terms of the Exchange Act, which requires the Commission, whenever "engaged . . . in the review of a rule of a self-regulatory organization," to determine whether the proposed rule "protect[s] investors" and "promote[s] efficiency, competition, and capital formation." 15 U.S.C. § 78c(f). As the extensive evidence submitted by Phlx makes clear, rules that operate on a cross-exchange basis—including Phlx's pro-competitive, efficiency-enhancing cross-exchange cost reduction—often further each of these statutory objectives. The Exchange Act therefore unambiguously requires the Commission to analyze proposed fees on a cross-exchange, as opposed to an individual-exchange, basis because adopting an individual-exchange approach would result in the across-the-board disapproval of cross-exchange fees—even where those fees lower prices, promote competition, and improve market efficiency. Congress plainly did not intend the Commission to adopt a mode of analysis that would categorically invalidate an entire class of rules capable of furthering these core statutory objectives.

Moreover, even assuming that the Exchange Act is ambiguous as to the appropriate level of analysis, the Division erred by failing to provide a reasoned basis for analyzing the Proposed Rule at the individual-exchange level; by neglecting to consider Phlx's evidence regarding the pro-investor, pro-competitive nature of the proposed cross-exchange discount; and by ignoring its statutory obligation to meaningfully consider the Proposed Rule's impact on efficiency, competition, and capital formation. The ArcaBook Order—on which the Division's analysis is entirely premised—did not conclude that the Commission must examine a cross-exchange price reduction on an individual-exchange basis when determining whether the reduction is inequitable or discriminatory, and, in any event, does not provide any reasoned basis for applying an individual-exchange approach. Thus, to the extent that the unambiguous language of the Exchange Act does not compel a cross-exchange analysis, the Division was required to decide

for itself whether to apply an individual-exchange or cross-exchange approach. As Phlx's evidence makes clear, the Division should have exercised its discretion to evaluate the rule on a cross-exchange basis because cross-exchange cost reductions can—and, with respect to the Proposed Rule, will—lead to lower prices, more efficient markets, and enhanced competition. It was arbitrary and capricious for the Division to ignore this evidence, which bears directly on whether the Division should apply an individual- or cross-exchange analysis.

Finally, the Division's Order is inconsistent with prior actions by the Commission approving materially indistinguishable pricing arrangements. The Commission has already permitted exchanges to consider transactions on other trading venues when calculating fees, and has a long history of approving volume-based discounts that result in differential pricing. There was no reasoned basis for the Division to depart from the Commission's prior practice when evaluating Phlx's proposed cross-exchange price reduction. Accordingly, if the Proposed Rule has not already been "deemed . . . approved," the Commission should set aside the Division's Order as arbitrary and capricious and approve the Proposed Rule.

BACKGROUND

The Proposed Rule would reduce costs for liquidity providers who trade on Phlx. To obtain the proposed cost savings, a liquidity provider must execute at least 2.5% of its national customer volume in multiply-listed options in a particular month on any of three Nasdaq-affiliated options exchanges—Phlx, The NASDAQ Options Market LLC ("NOM"), and/or NASDAQ OMX BX, Inc. ("BX Options"). A liquidity provider could execute the entire 2.5% of volume on Phlx alone and qualify for the cost reduction. Alternatively, the liquidity provider could aggregate volume across any of the three affiliated exchanges to meet the proposed threshold. In either case, the liquidity provider would receive the cost reduction (an additional

$0.02 per contract, above and beyond other available customer rebates) only on orders executed on Phlx itself.

The Proposed Rule would further the purposes of the Exchange Act in multiple respects. By increasing the rebates available to liquidity providers who transact customer orders on Phlx, the Proposed Rule would reduce the transaction costs of doing business on the Exchange, which would ultimately reduce the costs passed on to investors. As a result, investors would be more likely to direct customer liquidity to the Exchange, which would result in tighter spreads, increased trading opportunities, and an overall better functioning trading platform. Thus, the proposed price reduction would redound to the benefit of both the liquidity providers who receive it and the investing public as a whole. The price reduction would also provide an incentive for other exchanges to match the discounted prices by developing their own innovative pricing strategies or increasing the quality of their execution services.

In addition, the Proposed Rule would enable Phlx to serve the diverse needs of its customers more effectively. Each of the Nasdaq-affiliated options exchanges offers a somewhat different pricing and service model, which accommodates the wide array of demands that liquidity providers make on behalf of investors. For example, NOM appeals to customers who prefer "maker-taker" pricing structures, while Phlx allows liquidity providers to execute Complex Orders and benefit from price improvement. The Proposed Rule would enable liquidity providers to route an order to NOM or BX Options when they believe that is in the best interests of their clients—while still receiving credit toward Phlx's volume-based cost reduction. The Proposed Rule would therefore offer Phlx's customers better prices and simultaneously provide them with greater leeway to route orders to alternative exchanges when they believe that doing so would be better for investors.

Phlx designated the Proposed Rule as immediately effective pursuant to Section 19(b)(3)(A) of the Exchange Act. 15 U.S.C. § 78s(b)(3)(A). Shortly after the Proposed Rule was published in the *Federal Register* on November 19, 2013, the Division temporarily suspended it and instituted proceedings to determine whether the rule should be approved or disapproved. Suspension Order, 78 Fed. Reg. at 71,701. During the ensuing comment period, the Commission received thirteen comment letters on the Proposed Rule. Comments on the Proposed Rule generally addressed whether the proposal: (1) is an equitable allocation of reasonable fees; (2) is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers; (3) imposes a burden on competition not necessary or appropriate in furtherance of the purposes of the Act; and (4) has an impact on market structure and efficiency. Several of Phlx's competitors—International Securities Exchange LLC, Direct Edge Holdings LLC, Miami International Securities Exchange, LLC, and Chicago Board Options Exchange, Inc.—encouraged the Commission to disapprove the Proposed Rule. Notably, the only customer to weigh in on the Proposed Rule, Citadel LLC, requested that the Commission approve the rule and "resist calls from other commenters (who also happen to be competitor exchanges) to disapprove it." Citadel Comment at 2 (Dec. 18, 2013).

In support of its Proposed Rule, and in response to the competitor exchanges' comment letters, Phlx submitted five comment letters and two expert reports. Phlx's submissions demonstrated, among other things, that the Proposed Rule would reduce the trading costs for liquidity providers who transact orders on Phlx, attract additional order flow to the Exchange and thereby enhance the Exchange's liquidity and efficiency, and promote competition among options exchanges. Ignoring this overwhelming evidence, the Division concluded that the Proposed Rule violates Sections 6(b)(4) and 6(b)(5) of the Exchange Act.

Essential to this conclusion was the Division's decision to "analyze[ ] whether this proposed rule change is consistent with the Act at the level of the individual registered securities exchange—not the group level." Order, 79 Fed. Reg. at 42,586. Relying solely on dicta from the ArcaBook Order, the Division stated that "the Commission historically has reviewed whether a proposed exchange rule is consistent with the provisions of Section 6 of the Act on an exchange-by-exchange basis." *Id.* at 42,585-86. Although it explicitly acknowledged "that there are other plausible approaches to the interpretation of the Act," the Division did "not believe a sufficiently compelling case has been made for the Commission to alter its historical position at this time." *Id.* at 42,586.

Accordingly, the Division evaluated whether the Proposed Rule is consistent with the Act by applying a "market-based approach" on a single-exchange basis. Order, 79 Fed. Reg. at 42,585-86.[1] First, the Division determined that "Phlx is subject to significant competitive forces in setting the terms of the Proposal" because "there is significant competition for order flow in the options market at the individual exchange level." *Id.* at 42,585. Notwithstanding these competitive forces, the Division went on to conclude that "there is a substantial countervailing basis to find that [the Proposed Rule's] terms do not meet the Act's requirements that an exchange's rules be equitable, fair, reasonable, and not unreasonably discriminatory: namely, the Proposal could result in two similarly situated Phlx members being charged different fees for transacting the same amount and type of customer option volume on the Phlx exchange." *Id.* The Division therefore disapproved the Proposed Rule. *Id.* at 42,588.

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[1] While the Division erred by evaluating the Proposed Rule on a single-exchange basis, *see infra* Section II, it was correct to apply the ArcaBook Order's "market-based approach" to the analysis of transaction fees.

ARGUMENT

I. The Proposed Rule Is Deemed Approved Because The Commission Did Not Issue An Order Disapproving The Rule Within The Period Prescribed By The Exchange Act.

In the Dodd-Frank Act, Congress amended Section 19(b) of the Exchange Act to impose a firm time limit on the period in which the Commission may approve or disapprove a proposed rule change filed by a self-regulatory organization ("SRO"). Pub. L. No. 111-203, § 916(a), 124 Stat. 1376, 1834 (2010). Where the Commission fails to act within the statutorily prescribed time period, a "proposed rule change shall be deemed to have been approved." 15 U.S.C. § 78s(b)(2)(D). Because the Commission itself—rather than the Commission's staff acting pursuant to delegated authority—did not disapprove Phlx's proposed rule change within the period mandated by the Exchange Act, that rule change is now "deemed . . . approved."

Section 19(b)(2)(B)(ii) of the Exchange Act provides that "not later than 180 days after the date of publication [of a proposed SRO rule change in the *Federal Register*], the Commission shall issue an order approving or disapproving the rule change" and that the "Commission may extend the period for issuance . . . by not more than 60 days." 15 U.S.C. § 78s(b)(2)(B)(ii). To enforce compliance with this time limit, Congress further provided that a "proposed rule change shall be deemed to have been approved by the Commission, if the Commission does not issue an order approving or disapproving the proposed rule change . . . within the period described in" the statute. *Id.* § 78s(b)(2)(D)(ii).

The Commission failed to disapprove Phlx's proposed rule change within the 240-day period prescribed by the Exchange Act. Phlx filed its proposed rule change on October 31, 2013, and designated the rule change as immediately effective. The statutorily prescribed time period for the Commission's consideration of the proposed rule change began when the rule change was published in the *Federal Register* on November 19, 2013. *See* Securities Exchange Act Release

No. 34-70866, 78 Fed. Reg. 69,472 (Nov. 19, 2013) (SR-Phlx-2013-113) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Offer a Customer Rebate); *see also* 15 U.S.C. § 78s(b)(2)(B)(ii). The Division of Trading and Markets, acting pursuant to delegated authority from the Commission, temporarily suspended the rule change and instituted proceedings to determine whether to approve or disapprove the rule change in an order published in the *Federal Register* on November 29, 2013. Suspension Order, 78 Fed. Reg. at 71,700. In a notice published on April 11, 2014, the Division of Trading and Markets exercised its delegated authority to extend the time for the Commission to issue an order approving or disapproving the proposed rule change by 60 days, and "designate[d] July 17, 2014, as the date by which the Commission should either approve or disapprove the proposed rule change." Securities Exchange Act Release No. 34-71891, 79 Fed. Reg. 20,287, 20,288 (Apr. 11, 2014) (SR-Phlx-2013-113) (Request for Comment and Notice of Designation of Longer Period for Commission Action on Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Offer a Customer Rebate). On July 16, 2014, the Division, again acting pursuant to its delegated authority from the Commission, issued an order disapproving Phlx's proposed rule change. *See* Order, 79 Fed. Reg. at 42,578.

Although the Division of Trading and Markets exercised its delegated authority to disapprove Phlx's proposed rule change within the 240-day period prescribed by the Exchange Act, the Commission itself did not act before that period expired on July 17, 2014. The proposed rule change is therefore "deemed to have been approved by the Commission." 15 U.S.C. § 78s(b)(2)(D)(ii). The Exchange Act is clear that the "*Commission*"—not the Commission's staff acting pursuant to delegated authority—"shall issue an order approving or disapproving the proposed rule change" within the statutorily prescribed period. *Id.* § 78s(b)(2)(B)(ii) (emphasis

added). Indeed, both the Exchange Act and the Commission's regulations explicitly differentiate between the Commission and the Commission's staff. *See, e.g.*, *id.* § 78d(a) ("There is hereby established a Securities and Exchange Commission (hereinafter referred to as the 'Commission') to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate."); 17 C.F.R. § 200.10 ("The Commission is composed of five members, not more than three of whom may be members of the same political party. . . . The Commission is assisted by a staff . . . ."); *see also* 17 C.F.R. § 200.30-3(a)(57) (authorizing the Division of Trading and Markets "to extend for a period not exceeding 240 days from the date of publication of notice of the filing of a proposed rule change pursuant to Section 19(b)(1) of the Act, 15 U.S.C. § 78s(b)(1), the period during which *the Commission* must issue an order approving or disapproving the proposed rule change") (emphasis added).

To be sure, the Commission has the statutory authority to "delegate . . . its functions" to the Commission's staff, 15 U.S.C. § 78d-1(a), and has delegated to the Division of Trading and Markets the authority to approve or disapprove proposed rule changes filed by SROs. 17 C.F.R. § 200.30-3(a)(12), (57). The Exchange Act further provides, however, that the "Commission shall retain a discretionary right to review the action of any such division of the Commission," 15 U.S.C. § 78d-1(b), and makes clear that "the action of any such division of the Commission . . . shall . . . be deemed the action of the Commission" *only* "[i]f the right to exercise such review is declined, or if no such review is sought within the time stated in the rules promulgated by the Commission." *Id.* § 78d-1(c); *see also* Commission Rule of Practice 431(e) ("Upon filing

with the Commission of a notice of intention to petition for review, . . . an action made pursuant to delegated authority shall be stayed until the Commission orders otherwise . . . .").[2]

Here, Phlx submitted timely notice of its intention to petition the Commission for review of the Division of Trading and Markets' order disapproving its proposed rule change and is hereby filing this timely petition for review of that order. *See* Commission Rule of Practice 430(b). The order of the Division of Trading and Markets therefore does not constitute action by the Commission because Phlx timely sought review of the Division's exercise of its delegated authority. *See* 15 U.S.C. § 78d-1(c). Despite Phlx's timely filing, however, the statutorily prescribed period for the Commission to "issue an order approving or disapproving the rule change" (15 U.S.C. § 78s(b)(2)(B)(ii)) has already expired because the Division of Trading and Markets did not issue its disapproval order until July 16, 2014, and thereby exhausted 239 of the 240 days available for the Commission to issue a decision.[3] In the absence of a timely decision by the Commission approving or disapproving Phlx's proposed rule change, that rule change was

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[2] The Exchange Act provides that the Commission's discretionary review of delegated actions may occur "within such time and in such manner as the Commission by rule shall prescribe." 15 U.S.C. § 78d-1(b). That statutory authority to establish internal procedural rules cannot displace the Exchange Act's explicit requirement that the Commission "issue an order approving or disapproving [a] rule change" within 240 days of its publication, 15 U.S.C. § 78s(b)(2)(B)(ii), because it is well-settled that "a more specific statute will be given precedence over a more general one," *Busic v. United States*, 446 U.S. 398, 406 (1980).

[3] This is not the first time that the Division has used virtually all of the 240-day statutory period to disapprove a proposed rule change. The Division took 237 days to disapprove The NASDAQ Stock Market's "Platform Pricing" Proposal. *See* Securities Exchange Act Release No. 34-65362, 76 Fed. Reg. 59,466 (Sept. 26, 2011) (SR-NASDAQ-2011-10) (Order Disapproving a Proposed Rule Change to Link Market Data Fees and Transaction Execution Fees). The Commission subsequently granted The NASDAQ Stock Market's petition for review, and the proposed rule currently remains pending before the Commission more than three and a half years after it was proposed. *See* Securities Exchange Act Release 34-66667, 77 Fed. Reg. 20,079 (Apr. 3, 2012) (SR-NASDAQ-2011-10) (Order Granting Petition for Review and Scheduling Filing of Statements). Such a lengthy review process is at odds with Congress's intention in the Dodd-Frank amendments to facilitate the prompt consideration of proposed SRO rule changes.

"deemed to have been approved by the Commission" upon the expiration of the 240-day statutory period on July 17, 2014. 15 U.S.C. § 78s(b)(2)(D).

II. The Division's Disapproval Order Conflicts With The Unambiguous Terms Of The Exchange Act And Lacks A Reasoned Basis.

Even if the Proposed Rule were not already "deemed . . . approved," the Division's Order disapproving the rule still could not stand because its conclusion that the Proposed Rule is inequitable and unfairly discriminatory conflicts with the unambiguous terms of the Exchange Act and lacks a reasoned basis. By evaluating the Proposed Rule on a single-exchange basis—rather than considering customers' transactions on all affiliated exchanges—the Division adopted a mode of analysis that would categorically condemn an entire class of fee filings that can provide pro-investor, pro-competitive cost reductions, simply because they operate on a cross-exchange basis. That result is impossible to reconcile with the plain language of the Exchange Act, which requires the Commission to protect investors, promote competition, and facilitate efficient markets. Moreover, even if the Exchange Act were ambiguous with respect to the appropriate level of inquiry, the Division erred by failing to articulate a reasoned basis for analyzing the Proposed Rule at the individual-exchange level. As the extensive evidence submitted by Phlx makes clear, cross-exchange pricing can—and, in the case of the Proposed Rule, plainly would—lower prices, promote competition, and enhance efficiency. The Division's unreasoned rejection of Phlx's Proposed Rule based on an unsupported (and insupportable) individual-exchange approach could not plausibly survive judicial review.

A. The Division's Artificially Narrow Individual-Exchange Analysis Is Unambiguously Foreclosed By The Exchange Act.

The Division violated the unambiguous terms of the Exchange Act when it is examined Phlx's Proposed Rule on an individual-exchange basis and concluded that it was inequitable and unfairly discriminatory without taking into account liquidity providers' transactions on other

Nasdaq-affiliated exchanges. Phlx's Proposed Rule advances the core purposes of the Exchange Act in an equitable and nondiscriminatory manner.

1. The Exchange Act Requires Cross-Exchange Analysis Of Cross-Exchange Pricing.

The Exchange Act imposes "unique obligation[s]" on the Commission, requiring it to take account of costs, benefits, and competitive effects in analyzing a proposed rule. *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011). Specifically, Section 3(f) of the Exchange Act provides that

> [w]henever . . . the Commission is engaged in . . . the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

15 U.S.C. § 78c(f). This is not a pro forma requirement. As the D.C. Circuit held when construing identical language in the Investment Company Act of 1940, the Commission has a "statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure." *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005). In *Business Roundtable*, the D.C. Circuit again emphasized the importance of these statutory obligations, invalidating a rule as arbitrary and capricious based, in part, on the Commission's failure to connect the economic consequences of the rule to efficiency, competition, and capital formation. *See* 647 F.3d at 1148-49. Section 3(f) of the Exchange Act therefore requires the Commission to undertake a careful, reasoned assessment of the economic effects of a proposed rule, including the costs and benefits to liquidity providers, and prohibits the Commission from imposing undue burdens on competition.

In addition, Section 6(b)(5) of the Exchange Act—the *very same provision* that prohibits exchanges from adopting rules that permit "unfair discrimination"—provides that an exchange's rules must be designed 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." 15 U.S.C. § 78f(b)(5). This requirement explicitly permits an exchange to consider factors that extend *beyond* the individual exchange, such as a "free and open market," a "national market system," and the "public interest," when framing its fees and discounts. *Id.*

Together, Sections 3(f) and 6(b)(5) make clear that, in determining whether a proposed cross-exchange discount is inequitable and discriminatory under the Exchange Act, the Commission is required to consider not only transactions that a liquidity provider conducts on the exchange that is proposing the discount, but also transactions on affiliated exchanges that are relevant to a provider's eligibility for the discount. *See FAIC Sec., Inc. v. United States*, 768 F.2d 352, 363 (D.C. Cir. 1985) ("[I]ndividual sections of a single statute should be construed together.") (internal quotation marks omitted). This statutory mandate is plain and unambiguous because the Division's unduly narrow, individual-exchange approach would undermine the fundamental statutory objectives embodied in Sections 3(f) and 6(b)(5) by categorically invalidating a class of cost reductions that are capable of protecting investors, promoting competition, and strengthening the national market system.

The evidence that Phlx submitted in support of the Proposed Rule—which the Division did not dispute—makes clear that cross-exchange price reductions in general, and Phlx's Proposed Rule in particular, can reduce costs to investors, improve market efficiency, and enhance competition among exchanges. The Proposed Rule would reduce trading costs for liquidity providers who transact orders on Phlx by offering an additional discount to liquidity

providers who meet the specified volume threshold on Phlx and other Nasdaq-affiliated options exchanges. By reducing costs, the Proposed Rule would encourage liquidity providers to direct more liquidity to the Exchange. Customer liquidity benefits all market participants by providing greater trading opportunities, which in turn facilitate tighter spreads, promoting a "virtuous cycle" that could lead liquidity providers to direct yet more order flow to the Exchange. Phlx's Proposed Rule would therefore benefit not only the liquidity providers receiving the proposed cost reduction, but all other Phlx market participants as well.

The Proposed Rule would also enable Phlx members to take advantage of an additional cost reduction without neglecting their execution obligations. If a liquidity provider believes that it would better satisfy its duty of best execution to direct a certain percentage of customer volume to another Nasdaq-affiliated exchange, it may do so, without fearing that it would thereby sacrifice a discount. If, on the other hand, a liquidity provider directed sufficient liquidity to Phlx alone, it could qualify for the cost savings on that basis as well. Phlx's proposal simply expands the options available to liquidity providers. Thus, the Proposed Rule actually helps level the playing field for liquidity providers who trade on more than one Nasdaq-affiliated exchange.

The Proposed Rule would also promote competition among the exchanges. Phlx faces robust competition from other exchanges, which could respond to the Proposed Rule by adopting their own discounts, improving their services, or otherwise offering more attractive or differentiated products that appeal to members. This is the essence of competition. By promoting competition—while simultaneously reducing costs and encouraging liquidity providers to direct more liquidity to Phlx—the Proposed Rule furthers the investor-protection purposes of the Exchange Act and strengthens the national market system as a whole. That is

precisely what Congress intended when it created the national market system through the 1975 amendments to the Exchange Act. *See* H.R. Rep. No. 94-229, at 92 (1975) (Conf. Rep.), *reprinted in* 1975 U.S.C.C.A.N. 321, 323 ("it is the intent of the conferees that the national market system evolve through the interplay of competitive forces as unnecessary regulatory restrictions are removed").

Notwithstanding all of the pro-investor, efficiency-enhancing effects of the Proposed Rule, the Division deemed the cost reduction to be unfairly discriminatory and inequitably allocated when examined on an individual-exchange basis. By disapproving a rule change that would have benefitted all market participants, increased market efficiency, and promoted competition between exchanges, the Division demonstrated precisely why the Exchange Act unambiguously requires the Commission to analyze proposed fees on a cross-exchange basis. Congress plainly did not intend the Commission to apply the Exchange Act in a manner that harms investors, weakens markets, and dilutes competition. Cross-exchange analysis of proposed rules will allow exchanges to institute flexible, investor-friendly pricing structures, such as those permitting fragmentation of order flow among different options markets to improve execution quality and lower costs. In contrast, single-exchange analysis would inevitably result in the invalidation of rules—such as Phlx's proposed cross-exchange price reduction—that promote the core purposes of the Exchange Act. Because the Division examined the Proposed Rule at the individual-exchange level—in contravention of the unambiguous requirements of the Exchange Act—its order must be set aside. *See Pirlott v. NLRB*, 522 F.3d 423, 433 (D.C. Cir. 2008) (agency interpretation must be overturned when "at odds with the plain meaning of the authorizing statute").

2. PHLX's Proposed Rule Is Equitable And Nondiscriminatory.

The Commission should not only reject the Division's flawed statutory interpretation, but should also approve Phlx's Proposed Rule because, when examined on a cross-exchange basis, the rule provides for the equitable allocation of fees and is nondiscriminatory.

Where two "Phlx members . . . transact[ ] the same amount and type of customer option volume on the Phlx exchange," Order, 79 Fed. Reg. at 42,585—but one of those members is eligible for the Proposed Rule's enhanced cost savings due to transactions on other Nasdaq-affiliated exchanges—then those two liquidity providers are not "similarly situated" because one of the providers is transacting greater volume on the Nasdaq-affiliated exchanges than the other. *Cf. Neuren v. Adduci, Mastriani, Meeks & Schill*, 43 F.3d 1507, 1514 (D.C. Cir. 1995) ("similarly situated" means "nearly identical" in "all . . . relevant aspects"). It is perfectly equitable and nondiscriminatory for Phlx to offer an enhanced price reduction to the liquidity provider who adds greater value to the Nasdaq-affiliated exchanges.

In reaching a contrary conclusion, the Division overlooked that the Exchange Act does not prohibit all forms of price differentiation, but only "*unfair*" discrimination against members, issuers, or customers. 15 U.S.C. § 78f(b)(5) (emphasis added). The Division did not offer any analysis of what constitutes "unfair" discrimination or cite any evidence in support of the supposed unfairness of Phlx's Proposed Rule. Its failure to give effect to each word in the statute that it is charged with administering constitutes arbitrary and capricious agency action. *See Am. Fed'n of Gov't Emps., AFL-CIO, Council of Locals No. 214 v. FLRA*, 798 F.2d 1525, 1528 (D.C. Cir. 1986).

If the Division had considered the statutory language, it would have been compelled to conclude that Congress included the word "unfair" in Section 6(b)(5) because it recognized that

certain forms of price differentiation may further the *other purposes* of the Exchange Act listed in the *very same* provision of the statute: such as "perfect[ing] the mechanism of a free and open market," or "protect[ing] investors and the public interest." 15 U.S.C. § 78f(b)(5). The Commission itself has approved pro-competitive price differentiation in the past, including volume-based discounts and other cross-exchange offerings similar to the Proposed Rule. *See* Part III, *infra*. It was therefore insufficient for the Division to assert that "the Proposal could result in two similarly situated Phlx members being charged different fees for transacting the same amount and type of customer option volume on the Phlx exchange," Order, 79 Fed. Reg. at 42,585, without offering any justification or evidence that could explain why this *particular type* of price differentiation is "unfair" within the meaning of the Act. In fact, there is nothing unfair about distinguishing between customers who direct different amounts of order flow—and thus add different amounts of value—to the Nasdaq-affiliated options exchanges.

For the same reason, the Proposed Rule is also consistent with Section 6(b)(4) of the Exchange Act, which requires that the rules of an exchange "provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities." 15 U.S.C. § 78f(b)(4). Focusing on the phrase "persons using *its* facilities," several commenters nevertheless contended before the Division that the Exchange Act somehow requires that "dues, fees, and other charges" not be allocated "based on some activity other than use of the fee-imposing exchange's own facilities." Order, 79 Fed. Reg. at 42,580. According to these commenters, the Proposed Rule is inconsistent with this statutory language because the phrase "its facilities" prohibits Phlx from offering a cost reduction based in part on volume executed on another exchange. *Id.* That reading of Section 6(b)(4) is flawed, however, because the phrase "persons using its facilities" simply refers to one category of liquidity provider that is

bound by an exchange's rules—along with "members" and "issuers." It does not purport to describe the basis on which fees may be determined, or to restrict the right of an exchange to offer its liquidity providers a discount that may be based in part on their trading activity on an affiliated exchange. Because the Proposed Rule is appropriately limited to liquidity providers who transact business on Phlx, and the cost reduction only applies to orders executed on Phlx, it is fully consistent with this aspect of Section 6(b)(4).

B. Even Assuming That The Exchange Act Is Ambiguous, The Division Erred By Failing To Articulate A Reasoned Basis For Analyzing The Proposed Rule Change At The Individual-Exchange Level.

The Exchange Act unambiguously requires the Commission to determine whether a cross-exchange discount is equitable and nondiscriminatory through an analysis that takes into account transactions on all affiliated exchanges. Even if the Act were ambiguous on this issue, however, the Division's Order would still be arbitrary and capricious because the Division failed to provide any reasoned basis for exercising its discretion to examine the Proposed Rule using a single-exchange analysis, ignored the overwhelming evidence that the rule furthers the goals of the Exchange Act, and neglected its statutory obligation to genuinely consider the Proposed Rule's impact on efficiency, competition, and capital formation.

The Division premised its adoption of an individual-exchange analysis exclusively on the Commission's ArcaBook Order. *See* Securities Exchange Act Release No. 34-59039, 73 Fed. Reg. 74,770 (Dec. 9, 2008) (SR-NYSEArca-2006-21) (Order Setting Aside Action by Delegated Authority and Approving Proposed Rule Change Relating to NYSE Arca Data) ("ArcaBook Order"). Indeed, while it placed dispositive weight on the Commission's purported "historical position" of applying exchange-by-exchange analysis, Order, 79 Fed. Reg. at 42,586, the Division failed to cite any other instance in which the Commission employed this supposedly longstanding practice. And the Division's only support for its position, the ArcaBook Order, did

not involve the question whether a cross-exchange discount must be considered on an individual-exchange or cross-exchange basis, and provides no support for an individual-exchange approach.

In the ArcaBook Order, the Commission approved NYSE Arca, Inc.'s proposed rule change to establish fees for the receipt and use of certain depth-of-book market data that the exchange makes available, concluding that the proposal was consistent with the requirements of the Exchange Act. ArcaBook Order, 73 Fed. Reg. at 74,779. In considering whether NYSE Arca was subject to significant competitive forces in setting the terms of the market-data fees, the Commission discussed commenters' economic assessments of a previously released draft order. *Id.* at 74,788-94. Two of the assessments contended that the market shares of The New York Stock Exchange LLC ("NYSE") and NYSE Arca should be combined for purposes of analyzing market power because the exchanges are under common control and would thus have an incentive to coordinate their pricing and not compete with one another. *Id.* at 74,793. In rejecting this argument, the Commission concluded that the economic assessments "fail[ed] to acknowledge the extent to which the current Exchange Act regulatory structure effectively promotes competition," and noted in passing that the requirements set out in Section 6 of the Exchange Act "are applied at the level of the individual registered securities exchange, not at the group level of exchanges that are under common control." *Id.* Ultimately, the Commission concluded that "an economic analysis of jointly-controlled corporate behavior that might apply to other less regulated industries is inapplicable to equity exchanges that are subject to the pro-competitive Exchange Act regulatory structure." *Id.*

Although the ArcaBook Order includes a passing statement suggesting that the Exchange Act's requirements are applied at the individual-exchange level, that statement was presented without citation or analysis and was in no way essential to the Commission's approval of NYSE

Arca's market-data fee; that approval was premised on several independent grounds, including the availability of substitute products. ArcaBook Order, 73 Fed. Reg. at 74,782-85. Thus, contrary to the Division's reading of the ArcaBook Order, the Commission's non-binding dicta—arising in a context completely different from the one at hand—did not compel the Division to analyze Phlx's Proposed Rule at the individual-exchange level. The Division therefore failed to articulate any legitimate basis for engaging in an individual-exchange analysis, and its order must be set aside as arbitrary and capricious. *See, e.g.*, *Motor Vehicle Mfrs. Ass'n v. State Farm Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) ("[T]he agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'") (citation omitted).

Moreover, even if the ArcaBook Order had adopted an individual-exchange analysis, that order would still be insufficient to sustain the Division's disapproval of the Proposed Rule because the ArcaBook Order itself does not identify a reasoned basis for applying an individual-exchange approach. As explained above, the ArcaBook Order's statement that the Exchange Act requirements "are applied at the level of the individual registered securities exchange" was made in passing, without any citation or analysis whatsoever. There is nothing in the ArcaBook Order that explains why, as a matter of statutory interpretation, economic analysis, or public policy, an individual-exchange approach must be used to determine whether a cross-exchange cost reduction is inequitable or discriminatory. The Division therefore cannot derive support from the ArcaBook Order for its individual-exchange analysis. *See ITT Indus., Inc. v. NLRB*, 251 F.3d 995, 1004 (D.C. Cir. 2001) (agency is "obligated to justify its interpretation anew" if it has not done so "adequately in a previous decision").

The Division compounded its misreading of the ArcaBook Order by declining to consider the evidence submitted by Phlx that bears directly on the question whether the proposed rule change furthers the purposes of the Exchange Act. Phlx presented extensive evidence—including two expert reports—demonstrating that the Proposed Rule would reduce costs to investors, enhance market efficiency, and promote competition among exchanges. But despite the Commission's recent emphasis on the importance of using data and economic analysis in rulemaking, *see, e.g.*, Memorandum from the Division of Risk, Strategy, and Financial Innovation and the General Counsel to the Staff of the Rulewriting Divisions and Offices, Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf, the Division did not address Phlx's analysis. By declining to consider this evidence, the Division failed to "examine the relevant data and articulate a satisfactory explanation for its action." *State Farm*, 463 U.S. at 43; *see also Bus. Roundtable*, 647 F.3d at 1148 (Commission action was arbitrary where it "failed . . . [to] adequately . . . assess the economic effects of a new rule"); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 167-68 (D.C. Cir. 2010); *Chamber of Commerce*, 412 F.3d at 136. Indeed, because Phlx's evidence relates to statutory factors under the Exchange Act that the Division was obligated to consider but wholly ignored, the Division has "entirely failed to consider an important aspect of the problem," and its action must be set aside on that ground also. *State Farm*, 463 U.S. at 43.

Likewise, while the Division acknowledged its obligation to consider the Proposed Rule's impact on efficiency, competition, and capital formation under Section 3(f), *see* Order, 79 Fed. Reg. at 42,587-88, it failed to engage in any meaningful analysis of that impact. Instead, the Division merely repeated the arguments of the commenters and summarily stated: "The

Commission has considered whether the action will promote efficiency, competition, and capital formation, but, as discussed above, the Commission does not find that the Proposal is consistent with Sections 6(b)(4) and 6(b)(5) of the Act." *Id.* at 42,588. The Division cannot satisfy the requirements of the Exchange Act by simply reciting that it has considered certain essential goals. The word "consider" in Section 3(f) means not merely to contemplate a rule's likely effects, but to take account of those effects in deciding whether to approve the rule. *See Bus. Roundtable*, 647 F.3d at 1148-50 (invalidating a rule because the Commission "inconsistently and opportunistically framed the costs and benefits of the rule," and "relied upon insufficient empirical data" when it determined the benefits); *see also Time Warner Entm't Co. v. FCC*, 56 F.3d 151, 175 (D.C. Cir. 1995) (when a statute by its terms requires an agency to consider certain factors, the agency "must reach an express and considered conclusion about the bearing of a factor") (internal quotation marks and citation omitted); *Ethyl Corp. v. EPA*, 541 F.2d 1, 32 n.66 (D.C. Cir. 1976) (mandatory "consideration" of statutory factors means "actual good faith consideration" of those factors). In short, Congress did not instruct the Commission merely to "tally" or "identify" the economic effects of proposed rules; it instructed the Commission to "consider" them. The Division was therefore required to analyze the Proposed Rule with attention to its likely costs and benefits, not merely to make a pro forma recital that it contemplated the rule's economic effects prior to disapproval.

Rather than erroneously applying dicta from the ArcaBook Order, inventing a purportedly longstanding "historical position" on the basis of that order alone, casting aside Phlx's highly probative evidence, and failing to meaningfully consider its obligations under Section 3(f), the Division—to the extent that the Exchange Act is ambiguous—should have exercised its regulatory discretion to evaluate whether a rule is inequitable or discriminatory on a

cross-exchange basis. As explained above, *see supra* Section II.A, cross-exchange pricing can—and, in the case of Phlx's Proposed Rule, indisputably will—lead to lower prices, more efficient markets, and enhanced competition. In light of the pro-investor and pro-competitive benefits of Phlx's proposed cross-exchange cost reduction, it would be unreasonable to adopt any other interpretation of the Exchange Act.

III. The Division's Order Is Inconsistent With Prior Actions By The Commission.

The Division's conclusion that the Proposed Rule is inequitable and discriminatory, and therefore violates the Exchange Act, also conflicts with prior Commission precedent. The Division's unexplained and unacknowledged departure from the Commission's treatment of materially indistinguishable pricing proposals was arbitrary and capricious. *See, e.g.*, *Indep. Petroleum Ass'n of Am. v. Babbitt*, 92 F.3d 1248, 1258 (D.C. Cir. 1996) ("An agency must treat similar cases in a similar manner unless it can provide a legitimate reason for failing to do so."); *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515-16 (2009).

The Commission has already approved similar pricing arrangements that take into account trading activity on affiliated exchanges. For example, NYSE waives certain annual fees for issuers that transfer the listing of their primary class of common shares from NYSE Arca or NYSE MKT LLC to NYSE. The Exchange assesses issuers an Initial Application Fee of $25,000 in connection with applying to list an equity security, but that fee is waived if an issuer transfers a listing of any class of equity security from another NYSE-affiliated exchange. Thus, issuers who switch to NYSE from an NYSE-affiliated exchange are exempt from an application fee that applies to all other issuers. In a similar manner, the Proposed Rule would reduce trading costs for liquidity providers who meet a specified volume threshold through transactions on any of the three Nasdaq-affiliated options exchanges—but would not take into account transactions

on exchanges not affiliated with Nasdaq. In so doing, the Proposed Rule would promote the ability of Phlx's members to spread their customer order flow across multiple exchanges, thereby improving execution quality and reducing trading costs.

Moreover, on at least four occasions, the Commission has permitted particular trading venues to consider volume executed away from that venue for rebate and fee calculation purposes. First, there is a NOM rebate available to participants who transact a certain amount of volume on NOM and also execute orders on NASDAQ's cash equity market. *See* NOM Rules at Chapter XV, Section 2. A NOM participant may qualify for this rebate based on its activity in both options and cash equities markets—even though some market participants may prefer to trade only on one or the other. Second, Phlx members can qualify for a customer rebate by including SPDR S&P 500 ("SPY") volume in the calculation of qualifying orders for the purpose of determining customer rebate tiers. *See* Section B of the Exchange's Pricing Schedule. Because Phlx does not pay customer rebates on SPY volume as specified in the Customer Rebate Programs, *see id.*, this policy allows volume other than the volume on which the rebate is paid to be considered for eligibility purposes. The Proposed Rule does the same thing by permitting volume traded on Nasdaq-affiliated exchanges to be used to determine eligibility for an enhanced cost reduction on Phlx. Third, the options regulatory fee ("ORF") is a fee that some exchanges charge based on the total volume of a market participant's trades across all exchanges. *See, e.g.*, Section IV, Part D of the Exchange's Pricing Schedule. The ORF structure is not dependent on a transaction on a particular SRO; rather, it is based on transactions on other SROs. Fourth, the Commission has affirmatively approved a proposal in which volume tiers are calculated based on a market participant's aggregate activity on two affiliated markets. *See* Securities Exchange Act Release No. 34-50787, 69 Fed. Reg. 71,459 (Dec. 2, 2004) (SR-NASD-2004-170) (Notice of

Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. To Establish Combined Nasdaq Market Center and Brut Pricing for Non-NASD Members).

More broadly, the Proposed Rule is merely one example of the type of pro-competitive discount that the Commission historically has approved when made available (like the Proposed Rule) to all market participants. To be sure, *all* cost reductions predicated on volume or some other condition differentiate between customers who meet the condition and those who do not. But that does not mean that the cost reduction is inequitably allocated or unfairly discriminatory. The Commission has for many years accepted multiple pricing structures that result in differential pricing and permit exchanges to charge less to customers who contribute more, including:

- ***Volume tiers:*** Equity and options pricing has long included volume tiers that provide discounts to the heaviest liquidity providers, highly capitalized broker/dealers or takers;

- ***Fee caps:*** Many exchanges have fee caps and enterprise licenses that favor heavy users of a system over other users;

- ***Enhanced rebates:*** The Chicago Board Options Exchange offers enhanced rebates for proprietary options contracts to members who meet certain volume thresholds for multiply-listed options contracts;

- ***Professional vs. Non-professional data recipients:*** Different recipients pay different fees for the same market data based upon their status;

- ***Equity Investors:*** The Commission has accepted the sale and purchase of equity ownership in exchanges predicated upon incentives for continued order flow provision;

- ***Directed Participants:*** Several exchanges have programs differentiating between participants who accept directed orders and those who do not;

- ***Order Capacity Differentiation:*** The options exchanges have differentiated between retail customers and professional customers, broker/dealers clearing in the "Firm" range at The Options Clearing Corp, broker/dealers registered as

market makers, away market makers, early-adopting market makers, and many others; and

- ***Order Handling Methods:*** The Commission has permitted price differentiation based on whether an order is processed manually versus electronically.

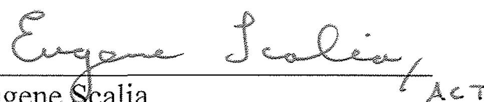
Phlx's evidentiary submissions—which the Division did not dispute—make clear that the Proposed Rule would have the same pro-investor, pro-competitive benefits as these other forms of differential pricing. The Division nevertheless failed to provide any explanation for its sudden departure from these past positions. That is the epitome of arbitrary and capricious decision-making. *See, e.g.*, *Fox Television Stations, Inc.*, 556 U.S. at 515 (an agency must "display awareness that it *is* changing position," and "may not . . . depart from a prior policy *sub silentio* or simply disregard rules that are still on the books"); *Jicarilla Apache Nation v. U.S. Dep't of Interior*, 613 F.3d 1112, 1119 (D.C. Cir. 2010) ("We have held that [r]easoned decision making . . . necessarily requires the agency to acknowledge and provide an adequate explanation for its departure from established precedent, and an agency that neglects to do so acts arbitrarily and capriciously.") (internal quotation marks omitted).

The Division's oft-repeated refrain that Phlx's Proposed Rule could result in charging different fees to "similarly situated" liquidity providers is insufficient to distinguish Phlx's proposed price reduction from the types of discounts that the Commission has long approved on a routine basis. Despite incanting the phrase "similarly situated" throughout its decision, the Division fails even to discuss the meaning of the term and applies it in a way that would invalidate rules that promote the core purposes of the Exchange Act. The Commission should set aside this flawed analysis and permit Phlx's Proposed Rule—like numerous analogous pricing proposals already approved by the Commission—to take effect.

CONCLUSION

For the foregoing reasons, Phlx's Proposed Rule is deemed approved because the statutorily prescribed period for the Commission to act has expired. In the alternative, Phlx requests that, in the event the Commission concludes that the proposal has not been deemed approved, the Commission review and set aside the Division's Order and approve the Proposed Rule because it is consistent with the requirements of the Exchange Act.

Respectfully submitted,



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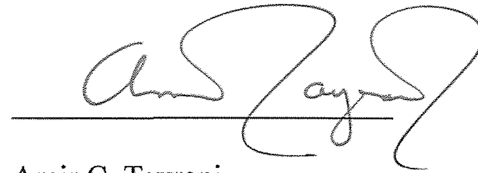
CERTIFICATE OF SERVICE

I, Amir C. Tayrani, counsel for NASDAQ OMX PHLX, hereby certify that on July 30, 2014, I served the foregoing Petition for Review of Order Disapproving NASDAQ OMX PHLX's Proposal To Reduce Members' Trading Costs (Release No. 34-72633, File No. SR-Phlx-2013-113) on Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, by causing hand delivery of the original and three copies to 100 F Street, N.E., Washington, D.C. 20549-1090.

Dated: July 30, 2014



Amir C. Tayrani