

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-65399; File No. SR-Phlx-2011-111)

September 26, 2011

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Approving a Proposed Rule Change Requesting Permanent Approval of the Pilot Program Permitting NASDAQ OMX PHLX to Receive Inbound Routes by NOS

I. Introduction

On August 8, 2011, NASDAQ OMX PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change requesting permanent approval of the Exchange’s pilot program to permit the Exchange to accept certain inbound orders that Nasdaq Options Services, LLC (“NOS”) routes from Nasdaq Options Market (“NOM”). The proposed rule change was published for comment in the Federal Register on August 19, 2011.³ The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Background

Exchange Rule 985(b) prohibits the Exchange or any entity with which it is affiliated from, directly or indirectly, acquiring or maintaining an ownership interest in, or engaging in a business venture with, an Exchange member or an affiliate of an Exchange member in the absence of an effective filing under Section 19(b) of the Exchange Act.⁴ NOS is a broker-dealer that is a member of the Exchange, and currently provides to members of The NASDAQ Stock

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 65135 (August 15, 2011), 76 FR 52030 (“Notice”).

⁴ 15 U.S.C. 78s(b).

Market LLC (“Nasdaq”) that are NOM participants optional routing services to other market centers.⁵ NOS is owned by The NASDAQ OMX Group, Inc. (“NASDAQ OMX”), which also owns three registered securities exchanges – Nasdaq, the Exchange, and NASDAQ OMX BX, Inc.⁶ Thus, NOS is an affiliate of each of these exchanges. Absent an effective filing, Exchange Rule 985(b) would prohibit NOS from being a member of the Exchange.

On July 17, 2008, in connection with the acquisition of the Exchange by NASDAQ OMX, the Commission approved an affiliation between the Exchange and NOS for the limited purpose of permitting NOS to provide routing services for Nasdaq for orders that first attempt to access liquidity on Nasdaq’s system before routing to the Exchange, subject to certain other limitations and conditions.⁷ On February 26, 2010, the Exchange filed an immediately effective proposed rule change to modify the conditions for the affiliation between NOS and the Exchange, to permit the Exchange to receive certain orders routed by NOS from NOM without first checking the NOM book for liquidity on a one-year pilot basis.⁸ Specifically, the Exchange proposed to permit NOS to route from NOM Exchange Direct Orders and orders in NOM Non-

⁵ NOS operates as a facility of Nasdaq that provides outbound routing from NOM to other market centers, subject to certain conditions. See NOM Rules Chapter VI, Section 11(e).

⁶ See Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (SR-Phlx-2008-31) (“Phlx Approval Order”). See also Securities Exchange Act Release No. 58324 (August 7, 2008), 73 FR 46936 (August 12, 2008) (SR-BSE-2008-02; SR-BSE-2008-23; SR-BSE-2008-25; SR-BSECC-2008-01).

⁷ See Phlx Approval Order, 73 FR at 42887.

⁸ See Securities Exchange Act Release No. 61667 (March 5, 2010), 75 FR 11964 (March 12, 2010) (SR-Phlx-2010-36) (“Phlx Routing Pilot Release”). The inbound routing pilot was subsequently extended and is set to expire on November 25, 2011. See Securities Exchange Act Release Nos. 63873 (February 9, 2011), 76 FR 8798 (February 15, 2011) (SR-Phlx-2011-16); and 65140 (August 16, 2011) 76 FR 52374 (August 22, 2011) (SR-Phlx-2011-116).

System Securities (including Exchange Direct Orders).⁹ The Exchange now seeks permanent approval of this inbound routing pilot.¹⁰

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹¹ Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act,¹² which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulation thereunder, and the rules of the Exchange. Further, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹³ which requires, among other things, that the rules of a national securities exchange be 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, and processing information with respect to, and facilitating transactions in

⁹ NOS provides to NOM participants routing services to other market centers. Pursuant to Nasdaq's rules, NOS: (1) routes orders in options currently trading on NOM, referred to as "System Securities;" and (2) routes orders in options that are not currently trading on NOM ("Non-System Securities"). See NOM Rules, Chapter VI, Section 1(b) and 11. When routing Non-System Securities, NOS is not regulated as a facility of Nasdaq, but as a broker-dealer regulated by its designated examining authority. See also Phlx Routing Pilot Release, 75 FR at 11964. "Exchange Direct Orders" are orders that are directed to an exchange other than NOM as directed by the entering party without checking the NOM book. See NOM Rules Chapter VI, Section 1(e)(7).

¹⁰ See Notice.

¹¹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹² 15 U.S.C. 78f(b)(1).

¹³ 15 U.S.C. 78f(b)(5).

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. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

Recognizing that the Commission has previously expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange of which it is a member, the Exchange previously proposed, and the Commission approved, limitations and conditions on NOS's affiliation with the Exchange.¹⁴ Also recognizing that the Commission has expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange to which it is routing orders, the Exchange previously implemented limitations and conditions to NOS's affiliation with the Exchange to permit the Exchange to accept orders routed inbound to Phlx by NOS from NOM that do not first attempt to access liquidity on the NOM book.¹⁵ The Exchange states it has met these conditions:¹⁶

- First, the Exchange and FINRA have entered into a regulatory services agreement ("Regulatory Contract") pursuant to which FINRA has been allocated regulatory responsibilities to review NOS's compliance with the Exchange's rules through FINRA's examination program.¹⁷ The Exchange, however, retained ultimate responsibility for enforcing its rules with respect to NOS except to the extent that

¹⁴ See Phlx Approval Order, 73 FR at 42886 - 42887.

¹⁵ See Phlx Routing Pilot Release.

¹⁶ See Notice, 76 FR at 52031.

¹⁷ The Exchange also states that NOS is subject to independent oversight by FINRA, its Designated Examining Authority, for compliance with financial responsibility requirements. See Notice, 76 FR at 52031, n.9.

they are covered by an agreement with FINRA pursuant to Rule 17d-2 under the Act,¹⁸ in which case FINRA is allocated regulatory responsibility.

- Second, FINRA and the Exchange will monitor NOS for compliance with Phlx’s trading rules, and collect and maintain certain related information;¹⁹
- Third, FINRA will provide a report to the Exchange’s Chief Regulatory Officer (“CRO”), on at least a quarterly basis, that: (i) quantifies all alerts (of which the Exchange and FINRA become aware) that identify NOS as a participant that has potentially violated Commission or Exchange rules and (ii) quantifies the number of investigations that identify NOS as a participant that has potentially violated Exchange or Commission Rules;²⁰
- Fourth, the Exchange adopted Rule 985(c), which requires NASDAQ OMX, as the holding company owning NOS and the Exchange, to establish and maintain procedures and internal controls reasonably designed to ensure that NOS 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

¹⁸ 17 CFR 240.17d-2.

¹⁹ Pursuant to the Regulatory Contract, both 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. See Notice, 76 FR at 52031, n.11.

²⁰ See id.

provision of inbound routing to the Exchange;²¹ and

- Fifth, the Exchange proposed that NOS be authorized to route 1) Exchange Direct Orders without checking the NOM book and 2) orders in NOM non-system securities inbound to the Exchange from NOM for a pilot period of twelve months, as further extended to November 25, 2011.²²

The Exchange believes that by meeting the above-listed conditions it has set up mechanisms that protect the independence of the Exchange's regulatory responsibility with respect to NOS, and has demonstrated that NOS cannot use any information advantage it may have because of its affiliation with the Exchange.²³

In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest, and the potential for unfair competitive advantage.²⁴ Although the Commission continues to be concerned about potential unfair competition 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, for the reasons discussed below, the Commission believes that it is consistent with the Act to permit

²¹ See Phlx Rule 985(c)(1). See also Notice, 76 FR at 52031.

²² See Notice, 76 FR at 52031. See also supra note 8.

²³ See Notice, 76 FR at 52031 - 52032.

²⁴ See, e.g., Securities Exchange Act Release Nos. 54170 (July 18, 2006), 71 FR 42149 (July 25, 2006) (SR-NASDAQ-2006-006) (order approving Nasdaq's proposal to adopt Nasdaq Rule 2140, restricting affiliations between Nasdaq and its members); 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (order approving the combination of the New York Stock Exchange, Inc. and Archipelago Holdings, Inc.); 58673 (September 29, 2008), 73 FR 57707 (October 8, 2008) (SR-Amex-2008-62) (order approving the combination of NYSE Euronext and the American Stock Exchange LLC); 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) (SR-ISE-2009-85) (order approving the purchase by ISE Holdings of an ownership interest in DirectEdge Holdings LLC); and 59281 (January 22, 2009), 74 FR 5014 (January 28, 2009) (SR-NYSE-2008-120) (order approving a joint venture between NYSE and BIDS Holdings L.P.).

NOS to provide inbound routing to the Exchange on a permanent basis instead of a pilot basis, subject to the other conditions described above.²⁵

The Exchange has proposed four ongoing conditions applicable to NOS's routing activities, which are enumerated above. The Commission believes that these conditions mitigate its concerns about potential conflicts of interest and unfair competitive advantage. In particular, the Commission believes that FINRA's oversight of NOS,²⁶ combined with FINRA's monitoring of NOS's compliance with the Exchange's rules and quarterly reporting to Phlx's CRO, will help to protect the independence of the Exchange's regulatory responsibilities with respect to NOS.

²⁵ The Commission notes that it recently issued an order granting permanent approval of NASDAQ OMX BX, Inc.'s pilot program permitting Boston Options Exchange to accept inbound routes by NOS of 1) NOM Exchange Direct Orders without checking the NOM book prior to routing, and 2) NOM non-system securities orders, including Exchange Direct Orders that NOS routes from NOM. See Securities Exchange Act Release No. 65199 (August 25, 2011), 76 FR 54277 (August 31, 2011) (SR-BX-2011-045).

²⁶ This oversight will be accomplished through the Regulatory Contract between the Exchange and FINRA, and, as applicable, a 17d-2 Agreement.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁷ that the proposed rule change (SR-Phlx-2011-111) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁸

Elizabeth M. Murphy
Secretary

²⁷ 15 U.S.C. 78s(b)(2).

²⁸ 17 CFR 200.30-3(a)(12).