SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67654; File No. SR-Phlx-2012-81)

August 14, 2012

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Approving a Proposed Rule
Change With Respect to the Authority of the Exchange or NASDAQ Execution Services To
Cancel Orders When a Technical or Systems Issue Occurs on the Exchange's NASDAQ OMX
PSX Facility and To Describe the Operation of an Error Account for NES

I.   Introduction

On June 27, 2012, NASDAQ OMX PHLX LLC ("Exchange" or "Phlx") 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 to

amend Phlx Rule 3315 by adding a new paragraph (d) that addresses the authority of the

Exchange or Nasdaq Execution Services LLC ("NES") to cancel orders when a technical or

systems issue occurs on the Exchange's NASDAQ OMX PSX facility ("PSX") and describes the

operation of an error account for NES. The proposed rule change was published for comment in

the Federal Register on July 10, 2012.[3] The Commission received no comment letters regarding

the proposed rule change. This order approves the proposed rule change.

II.   Description of the Proposal

NES, a broker-dealer that is a facility and an affiliate of Phlx, provides outbound routing

services from the Exchange to other market centers pursuant to Phlx rules.[4] In its proposal, Phlx

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1   15 U.S.C. 78s(b)(1).

2   17 CFR 240.19b-4.

3   Securities Exchange Act Release No. 67343 (July 3, 2012), 77 FR 40684 (July 10, 2012)
        (SR-Phlx-2012-81) ("Notice").

4   See Notice, 77 FR at 40685 n.3 and accompanying text, and text accompanying n.4. See
        also Phlx Rule 3315.

        The Exchange also has authority to receive equities orders routed inbound to PSX by
        NES from The NASDAQ Stock Market LLC ("NASDAQ") and, on a pilot basis,

states that a technical or systems issue may occur at Phlx, NES, or a routing destination that causes the Exchange or NES to cancel orders, if the Exchange or NES determines that such action is necessary to maintain a fair and orderly market.[5] Phlx also states that a technical or systems issue that occurs at the Exchange, NES, a routing destination, or a non-affiliate third-party Routing Broker[6] may result in NES acquiring an error position that it must resolve.[7]

New paragraph (d) to Phlx Rule 3315 provides Phlx or NES with general authority to cancel orders to maintain fair and orderly markets when a technical or systems issue occurs at the Exchange, NES, or a routing destination. It also provides authority for NES to maintain an error account for the purpose of addressing, and sets forth the procedures for resolving, error positions. Specifically, paragraph (d)(1) of Phlx Rule 3315 authorizes Phlx or NES to cancel orders as either deems necessary to maintain fair and orderly markets if a technical or systems issue occurs at Phlx, NES, or a routing destination. Phlx or NES will be required to provide notice of the cancellation to all affected members as soon as practicable.[8]

NASDAQ OMX BX, Inc. ("BX"). See Notice, 77 FR at 40685 n.4. See also Securities Exchange Act Release No. 66178 (January 18, 2012), 77 FR 3539 (January 24, 2012) (SR-Phlx-2011-170); and 65553 (October 13, 2011) 76 FR 64987 (October 19, 2011) (SR-Phlx-2011-138).

[5] See Notice, 77 FR at 40685. For examples of some of the circumstances in which the Exchange or NES may decide to cancel orders, see Notice, 77 FR at 40685–86.

[6] The Exchange states that, from time to time, it also uses non-affiliate third-party broker-dealers to provide outbound routing services. In its proposal, the Exchange refers to these broker-dealers as "third-party Routing Brokers." See Notice, 77 FR at 40685 n.3.

[7] See Notice, 77 FR at 40685. Specifically, Phlx Rule 3315(d)(2) defines "error positions" as "positions that result from a technical or systems issue at Nasdaq Execution Services, the Exchange, a routing destination, or a non-affiliate third-party Routing Broker that affects one or more orders."

For examples of some of the circumstances that may lead to error positions, see Notice, 77 FR at 40685–86.

[8] See Phlx Rule 3315(d)(1).

Paragraph (d)(2) of Phlx Rule 3315 will allow NES to maintain an error account for the purpose of addressing error positions that result from a technical or systems issue at Phlx, NES, a routing destination, or a non-affiliate third-party Routing Broker.

For purposes of Phlx Rule 3315(d), an error position will not include any position that results from an order submitted by a member to Phlx that is executed on the Exchange and automatically processed for clearance and settlement on a locked-in basis.[9] NES will not be permitted to (i) accept any positions in its error account from a member's account or (ii) permit any member to transfer any positions from the member's account to NES's error account.[10] In other words, NES may not accept from a member positions that are delivered to the member through the clearance and settlement process, even if those positions may have been related to a technical or systems issue at Phlx, NES, a routing destination, or a non-affiliate third-party Routing Broker.[11] If a member receives locked-in positions in connection with a technical or systems issue and experiences a loss in unwinding those positions, that member may seek to rely on Phlx Rule 3226, which provides members with the ability to file claims against Phlx "for losses directly resulting from the [PSX] system's actual failure to correctly process an order,

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[9]   See Phlx Rule 3315(d)(2)(A).

[10] See Phlx Rule 3315(d)(2)(B).

[11] See Notice, 77 FR at 40686 n.11. This provision would not apply if NES incurred a short position to settle a member's purchase, as the member would not have had a position in its account as a result of the purchase at the time of NES's action. Similarly, if a systems issue occurs that causes one member to receive an execution for which there is not an available counterparty, action by NES would be required for the positions to settle into that member's account. See id.

   If error positions result in connection with the Exchange's use of a third-party Routing Broker for outbound routing and those positions are delivered to NES through the clearance and settlement process, NES would be permitted to resolve those positions. If, however, such positions were not delivered to NES through the clearance and settlement process, then the third-party Routing Broker would resolve the error positions itself, and NES would not be permitted to accept the positions. See Notice, 77 FR at 40685 n.3.

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message, or other data, provided PSX has acknowledged receipt of the order, message, or data."[12] If, however, a technical or systems issue results in the Exchange not having valid clearing instructions for a member to a trade, NES may assume that member's side of the trade so that the trade can be automatically processed for clearance and settlement on a locked-in basis.[13]

Paragraph (d)(3) of Phlx Rule 3315 permits the Exchange or NES, in connection with a particular technical or systems issue, to either (i) assign all resulting error positions to members or (ii) have all resulting error positions liquidated. Any determination to assign or liquidate error positions, as well as any resulting assignments, will be made in a nondiscriminatory fashion.[14]

Phlx and NES will be required to assign all error positions resulting from a particular technical or systems issue to the members affected by that technical or systems issue if Phlx or NES:

(i) Determines that it has accurate and sufficient information (including valid clearing information) to assign the positions to all of the members affected by that technical or systems issue;

(ii) Determines that it has sufficient time pursuant to normal clearance and settlement deadlines to evaluate the information necessary to assign the positions to all of the members affected by that technical or systems issue; and

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[12] See Notice, 77 FR at 40686 n.11.

[13] See Phlx Rule 3315(d)(2)(C).

[14] See Phlx Rule 3315(d)(3).

(iii)   Has not determined to cancel all orders affected by that technical or systems issue in accordance with Phlx Rule 3315(d)(1).[15]

If Phlx or NES is unable to assign all error positions resulting from a particular technical or systems issue to all of the affected members, or if Phlx or NES determines to cancel all orders affected by the technical or systems issue, then NES will be required to liquidate the error positions as soon as practicable.[16] NES will be required to provide complete time and price discretion for the trading to liquidate the error positions to a third-party broker-dealer, and would be prohibited from attempting to exercise any influence or control over the timing or methods of such trading.[17] Further, NES will be required to establish and enforce policies and procedures that are reasonably designed to restrict the flow of confidential and proprietary information between the third-party broker-dealer, on one hand, and the Exchange and NES, on the other, associated with the liquidation of the error positions.[18]

Finally, paragraph (d)(4) of Phlx Rule 3315 requires the Exchange and NES to make and keep records to document all determinations to treat positions as error positions; all determinations to assign error positions to members or to liquidate error positions; and the liquidation of error positions through the third-party broker-dealer.

III.   Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b) of the Act[19] and the rules and regulations thereunder

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[15]   See Phlx Rule 3315(d)(3)(A)(i)–(iii).

[16]   See Phlx Rule 3315(d)(3)(B).

[17]   See Phlx Rule 3315(d)(3)(B)(i).

[18]   See Phlx Rule 3315(d)(3)(B)(ii).

[19]   15 U.S.C. 78f(b).

applicable to a national securities exchange.[20] In particular, the Commission finds that the

proposed rule change is consistent with Section 6(b)(5) of the Act,[21] 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, processing

information with respect to, and facilitating transactions in securities, to remove impediments to

and perfect the mechanism of a free and open market and a national market system, and, in

general, to protect investors and the public interest; and are not designed to permit unfair

discrimination between customers, issuers, brokers, or dealers. In addition, the Commission

believes the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act[22] in that it

seeks to assure economically efficient execution of securities transactions.

The Commission recognizes that technical or systems issues may occur, and believes that

Phlx Rule 3315, in allowing Phlx or NES to cancel orders affected by technical or systems

issues, should provide a reasonably efficient means for Phlx to handle such orders, and appears

reasonably designed to permit Phlx to maintain fair and orderly markets.[23]

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

[21] 15 U.S.C. 78f(b)(5).

[22] 15 U.S.C. 78k-1(a)(1)(C).

[23] The Commission notes that Phlx states that the proposed amendments to Phlx Rule 3315 are designed to maintain fair and orderly markets, ensure full trade certainty for market participants, and avoid disrupting the clearance and settlement process. See Notice, 77 FR at 40687. The Commission also notes that Phlx states that a decision to cancel orders due to a technical or systems issue is not equivalent to the Exchange declaring self-help against a routing destination pursuant to Rule 611 of Regulation NMS. See 17 CFR 242.611(b). See also Notice, 77 FR at 40686 n.10.

The Commission also believes that allowing the Exchange to resolve error positions through the use of an error account maintained by NES pursuant to the procedures set forth in the rule, and as described above, is consistent with the Act. The Commission notes that the rule establishes criteria for determining which positions are error positions,[24] and that Phlx or NES, in connection with a particular technical or systems issue, will be required to either (i) assign all resulting error positions to members or (ii) have all resulting error positions liquidated.[25] Also, Phlx or NES will assign error positions that result from a particular technical or systems issue to members only if all such error positions can be assigned to all of the members affected by that technical or systems issue.[26] If Phlx or NES cannot assign all error positions to all members, NES will liquidate all of those error positions.[27] In this regard, the Commission believes that the new rule appears reasonably designed to further just and equitable principles of trade and the protection of investors and the public interest, and to help prevent unfair discrimination, in that it should help assure the handling of error positions will be based on clear and objective criteria, and that the resolution of those positions will occur promptly through a transparent process.

Additionally, the Commission notes that it has previously expressed concern about the potential for 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.[28] The Commission is also concerned about the potential for misuse of confidential

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[24]   See Phlx Rule 3315(d)(2).

[25]   See Phlx Rule 3315(d)(3).

[26]   See Phlx Rule 3315(d)(3)(A).

[27]   See Phlx Rule 3315(d)(3)(B).

[28]   See, e.g., Securities Exchange Act Release No. 65455 (September 30, 2011), 76 FR 62119 (October 6, 2011) (SR-NYSEArca-2011-61) at 62120 n.16 and accompanying text.

and proprietary information. The Commission believes that the requirement that NES provide

complete time and price discretion for the liquidation of error positions to a third-party broker-

dealer, including that NES not attempt to exercise any influence or control over the timing or

methods of such trading, combined with the requirement that Phlx establish and enforce policies

and procedures that are reasonably designed to restrict the flow of confidential and proprietary

information to the third-party broker-dealer liquidating such positions, should help mitigate the

Commission's concerns. In particular, the Commission believes that these requirements should

help assure that none of Phlx, NES, or the third-party broker-dealer is able to misuse confidential

or proprietary information obtained in connection with the liquidation of error positions for its

own benefit. The Commission also notes that Phlx and NES would be required to make and

keep records to document all determinations to treat positions as error positions; all

determinations to assign error positions to members or liquidate error positions; and the

liquidation of error positions through the third-party broker-dealer.[29]

Finally, the Commission notes that the proposed procedures for canceling orders and the

handling of error positions are consistent with procedures the Commission has approved for

other exchanges.[30]

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[29]   See Phlx Rule 3315(d)(4).

[30]   See, e.g., Securities Exchange Act Release Nos. 67281 (June 27, 2012), 77 FR 39543
        (July 3, 2012) (SR-NASDAQ-2012-057); 66963 (May 10, 2012), 77 FR 28919 (May 16,
        2012) (SR-NYSEArca-2012-22); 67010 (May 17, 2012), 77 FR 30564 (May 23, 2012)
        (SR-EDGX-2012-08); and 67011 (May 17, 2012), 77 FR 30562 (May 23, 2012) (SR-
        EDGA-2012-09).

IV.   Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[31] that the

proposed rule change (SR-Phlx-2012-81) be, and it hereby is, approved.

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

authority.[32]

Kevin M. O'Neill
Deputy Secretary

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[31]   15 U.S.C. 78s(b)(2).

[32]   17 CFR 200.30-3(a)(12).