

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-64415; File No. SR-Phlx-2011-56)

May 5, 2011

Self-Regulatory Organizations; The NASDAQ OMX PHLX LLC; Notice of Filing of Proposed Rule Change to Establish a Qualified Contingent Cross Order for Execution on the Floor of the Exchange

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4<sup>2</sup> thereunder, notice is hereby given that on May 4, 2011, NASDAQ OMX PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is filing with the Commission a proposal to amend PHLX Rule 1064(e) to establish a Floor Qualified Contingent Cross Order (“Floor QCC Order”). The Floor QCC Order will facilitate the execution of stock/option Qualified Contingent Trades that satisfy the requirements of the trade through exemption in connection with Rule 611(d) of Regulation NMS (“QCT Trade Exemption”).<sup>3</sup>

The text of the proposed rule change is available on the Exchange’s Website at <http://nasdaqomxphlx.cchwallstreet.com/NASDAQOMXPHLX/Filings/>, at the principal office of the Exchange, and at the Commission’s Public Reference Room.

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

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

<sup>3</sup> See Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006); Securities Exchange Act Release No. 57620 (April 4, 2008) 73 FR 19271 (April 9, 2008).

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

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

On February 24, 2011, the Commission issued an order approving SR-ISE-2010-073, a proposal by the ISE to establish a Qualified Contingent Cross ("ISE QCC Proposal"). The ISE QCC Proposal was controversial, attracting opposition from multiple exchanges including PHLX. In its comment letter on the ISE QCC Proposal, PHLX asserted that the QCC Proposal deviated from "long-held principles in the options market by permitting the crossing of orders without requiring prior exposure" and that the ISE QCC Proposal failed adequately to protect customers with orders resting on the ISE limit order book.<sup>4</sup>

The Commission, in a thorough and thoughtful decision, concluded that the QCC Proposal - including the lack of prior order exposure - is consistent with the Act. With respect to order exposure, the Commission stated:

While the Commission believes that order exposure is generally beneficial to options markets in that it provides an incentive to options market makers to provide liquidity and therefore plays an important role in ensuring competition and price discovery in the options

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<sup>4</sup> See Letter, dated August 13, 2010, from Thomas Wittman, President, NASDAQ OMX PHLX to Elizabeth Murphy, Secretary, US Securities and Exchange Commission.

markets, it also has recognized that contingent trades can be “useful trading tools for investors and other market participants, particularly those who trade the securities of issuers involved in mergers, different classes of shares of the same issuer, convertible securities, and equity derivatives such as options [italics added].” and that “[t]hose who engage in contingent trades can benefit the market as a whole by studying the relationships between the prices of such securities and executing contingent trades when they believe such relationships are out of line with what they believe to be fair value.” As such, the Commission stated that transactions that meet the specified requirements of the NMS QCT Exemption could be of benefit to the market as a whole, contributing to the efficient functioning of the securities markets and the price discovery process.<sup>5</sup>

The Approval Order succinctly sets forth the material elements of ISE’s Qualified Contingent Cross:

Thus, as modified, an ISE member effecting a trade pursuant to the NMS QCT Exemption could cross the options leg of the trade on ISE as a QCC Order immediately upon entry, without exposure, only if there are no Priority Customer orders on the Exchange’s limit order book at the same price and if the order: (i) is for at least 1,000 contracts; (ii) meets the six requirements of the NMS QCT Exemption; and (iii) is executed at a price at or between the NBBO (“Modified QCC Order”). In the Notice, ISE stated that the modifications to the Original QCC Order (i.e., to prevent the execution of a QCC if there is a Priority Customer on its book and to increase the minimum size of a QCC Order) remove the appearance that such orders are trading ahead of Priority Customer orders or that the QCC Order could be used to disadvantage retail customers (citations omitted).<sup>6</sup>

The Exchange believes that the Commission, having considered and addressed all arguments in favor and in opposition to the QCC, has established binding precedent under which other exchanges can establish a QCC Order that is also consistent with the Act.

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<sup>5</sup> Approval Order at p. 28 (citing to Regulation NMS QCT Exemption).

<sup>6</sup> Id. at p. 18.

In keeping with that precedent, PHLX hereby proposes to add PHLX Rule 1064(e) to establish a Floor QCC Order based on the precedent of ISE's QCC Order.<sup>7</sup> Specifically, PHLX proposes to amend Rule 1064 to provide that a PHLX member effectuating a trade on the floor of the Exchange pursuant to the Regulation NMS Qualified Contingent Trade Exemption to Rule 611(a) ("QCT Exemption") can cross the options leg's of the trade on PHLX as a Floor QCC Order immediately upon entry and without order exposure if no Customer Orders<sup>8</sup> exist on the Exchange's order book at the same price. Floor QCC Orders will be electronically entered by a Floor Broker on the floor of the Exchange using the Floor Broker Management System and the execution will then be executed electronically. Only Floor Brokers will be permitted to enter Floor QCC Orders.

The Commission in the Approval Order carefully considered the comparison between floor-based and electronic trading, including commissioning a study by the Division of Risk, Strategy and Financial Innovation ("RiskFin Study"). The RiskFin Study and the Approval Order compare electronic trading and floor trading, the similarities between the two forms of trading, and the ability of one to replicate the other. Additionally, the Commission received comment letters from multiple floor-based exchanges that challenged the comparison that ISE drew between floor-based and electronic trading.

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<sup>7</sup> PHLX previously established an electronic QCC Order set forth in PHLX Rule 1080(o). See Securities Exchange Act Release No. 64249 (April 7, 2011), 76 FR 20773 (April 13, 2011) (SR-Phlx-2011-047).

<sup>8</sup> PHLX will reject QCC Orders that attempt to execute when any Customer orders are resting on the Exchange limit order book at the same price. ISE QCC Orders will be cancelled only when they encounter resting orders of Priority Customers. The Commission has previously approved the rejection of crossing transactions when there is a customer order on the book at the same price. See, e.g., ISE Rule 721(a); and CBOE Rule 6.74A, Interpretations and Policies .08.

Despite facing direct comparisons between floor-based trading and electronic trading by multiple commenters, as well as by its own Division of RiskFin, the Commission Approval focuses on similarities between the two. On its face, the Commission Approval Order draws no distinctions and identifies no material differences between floor-based and electronic trading that would confound the comparison between cross orders executed electronically and those executed on an exchange floor. The Exchange believes that the Floor QCC Order is consistent with the requirements stated in the Approval Order and consistent with the Act. The Exchange also believes that the Commission, in writing the Approval Order assumed that QCC orders entered on the floor of an exchange that meet the requirements stated in the Approval Order are equally consistent with the Act.

The Exchange has analyzed the application to Floor QCC Orders of Section 11(a) of the Act and the rules thereunder. Section 11(a) and the rules thereunder generally prohibit members of an exchange from effecting transactions on the exchange for their own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion unless an exemption applies.<sup>9</sup> Section 11(a) contains multiple exemptions, including exemptions for those acting in the capacity of market makers, as odd-lot dealers, and those engaged in stabilizing conduct; there are also rule-based exemptions such as the “effect vs. execute” exception under SEC Rule 11a2-2(T) under the Act.<sup>10</sup>

The Exchange has in the past analyzed the application of Section 11(a) to various Exchange systems and order types.<sup>11</sup> In analyzing Floor QCC Orders, the Exchange has

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<sup>9</sup> See 15 U.S.C. 78k(a).

<sup>10</sup> See 17 C.F.R. 240.11a2-2(T).

<sup>11</sup> See, e.g., Securities Exchange Act Release No. 63027 (Oct. 1, 2010), 75 FR 62160 (Oct. 7, 2010) (order approving Price Improvement XL System).

concluded that the entry and execution of Floor QCC Orders raises no novel issues under Section 11(a) and the rules thereunder from a compliance, surveillance or enforcement perspective. In other words, Exchange Floor Brokers are currently required to comply and the Exchange surveils for compliance with Section 11(a) and the rules thereunder when using Exchange systems to effect transactions using existing order types, and they will be required to comply with Section 11(a) and the rules thereunder when using the Floor QCC Order.

Nonetheless, out of an abundance of caution, the Exchange has added subsection (e)(2) which prohibits Options Floor Brokers from entering Floor QCC Orders for their own accounts, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion. This modification is designed to remove even a theoretical time and place advantage available to an Options Floor Broker on the Floor of the Exchange that is reflected in the prohibitions of Section 11a of the Exchange Act and the rules thereunder. The Exchange is prohibiting by rule certain conduct that runs afoul of Section 11(a) and the rules thereunder, and providing both a surveillance and enforcement mechanism to promote compliance. Thus, it would be incorrect to say that the Floor QCC Order differs from the electronic QCC Order due to the Options Floor Broker's presence on the Floor.

These restrictions set forth in subsection (e)(2) do not limit in any way the obligation of Options Floor Brokers and other Exchange members to comply with Section 11(a) or the rules thereunder. For example, Options Floor Brokers cannot avoid or circumvent their obligations with respect to a Floor QCC Order that triggers a Section 11(a) obligation by transmitting that order to another Options Floor Broker or to an Exchange member off the floor of the Exchange. Likewise, Exchange members off the floor must ensure that their Floor QCC Orders comply with Section 11(a) and the rules thereunder. In both cases, Exchange members must ensure

compliance with Section 11(a) and the rules thereunder, including by relying upon an exemption such as those listed above.

Additionally, to provide a mechanism for the Exchange to review whether Floor QCC Orders have been entered properly by Options Floor Brokers, the Exchange proposes to adopt proposed Rule 1064(e)(2). This provision would require Options Floor Brokers to maintain books and records demonstrating that no Floor Qualified Contingent Cross Order was entered by the Options Floor Broker in a prohibited account.<sup>12</sup> Any Floor Qualified Contingent Cross Order that does not have a corresponding record required by this provision would be deemed to have been entered in violation of Rule 1064(e).

Finally, the Exchange proposes to modify subsections (a), (b), and (c) of Rule 1064. These changes are designed clearly to establish that the requirements applicable to Floor QCC Orders that are set forth in subsection (e) are different from those applicable to the orders described in subsections (a), (b) and (c).

As set forth in proposed Rule 1064(e), the Floor QCC Order must: (i) be for at least 1,000 contracts,<sup>13</sup> (ii) meet the six requirements of Rule 1080(o)(3) which are modeled on the QCT Exemption, (iii) be executed at a price at or between the National Best Bid and Offer (“NBBO”); and (iv) be rejected if a Customer order is resting on the Exchange book at the same

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<sup>12</sup> The Exchange System will also be programmed to require certain order entry parameters for submission of Floor QCC Orders. For example, a Floor QCC Order must include data reflecting the number of shares of stock sold/purchased in the stock leg of the QCT trade. Floor QCC Orders lacking this data will be rejected by the System. The order entry parameters will be included in the Exchange’s published specifications and described in an Options Trader Alert prior to launch.

<sup>13</sup> In order to satisfy the 1,000-contract requirement, a Floor QCC Order must be for 1,000 contracts and could not be, for example, two 500-contract orders or two 500-contract legs.

price.<sup>14</sup> As a result, the PHLX Floor QCC Order proposed herein satisfies all of the requirements the Commission enumerated in the Approval Order.

The Exchange's proposal addresses the mechanics of executing the stock and options components of a net-price transaction. The Exchange believes that it is necessary that it provide members and their customers with the same trading capabilities available on other exchanges with respect to QCCs, including the change proposed herein, which would permit members to execute the options legs of their customers' large complex orders on the Exchange.

## 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act<sup>15</sup> in general, and furthers the objectives of Section 6(b)(5)<sup>16</sup> and 6(b)(8)<sup>17</sup> of the Act in particular, in that it is designed to promote just and equitable principles of trade, 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 the rules of an exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In addition, the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act,<sup>18</sup> in which Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure, among other things, the

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<sup>14</sup> While the Floor QCC would not provide exposure for price improvement for the options leg of a stock-option order, the options leg must be executed at the NBBO or better. The Commission has previously approved crossing transactions with no opportunity for price improvement. See, e.g., ISE Rule 721(a) and Chicago Board Options Exchange Rule 6.74A, Interpretations and Policies .08.

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

<sup>16</sup> 15 U.S.C. 78f(b)(5).

<sup>17</sup> 15 U.S.C. 78f(b)(8).

<sup>18</sup> 15 U.S.C. 78k-1(a)(1)(C).



economically efficient execution of securities transactions. As described in detail above, the proposed rule change is also consistent with Section 11(a) of the Act and the rules thereunder.

The statutory basis for PHLX's proposed Floor QCC Order is identical to the Commission's basis for finding that the ISE's QCC Proposal is consistent with the Act "in that it would facilitate the execution of qualified contingent trades, for which the Commission found in the Original QCT Exemption to be of benefit to the market as a whole, contributing to the efficient functioning of the securities markets and the price discovery process. The Floor [sic] QCC Order would provide assurance to parties to stock-option qualified contingent trades that their hedge would be maintained by allowing the options component to be executed as a clean cross." In addition, like the ISE's QCC Order, the Exchange's Floor QCC Order "is narrowly drawn to provide a limited exception to the general principle of exposure, and retains the general principle of customer priority."

PHLX's proposed Floor QCC Order promotes the same Commission goals as or more effectively, and it is as or more narrowly drawn than ISE's QCC Order. Accordingly, the Exchange believes that the proposed rule change must also be consistent with the Act.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. To the contrary, the proposed Floor QCC Order is a competitive response to the ISE QCC Order and similar orders adopted by other exchanges.

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

No written comments were either solicited or received.

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

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission shall: (a) by order approve or disapprove such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

#### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-Phlx-2011-56 on the subject line.

#### Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington DC 20549-1090.

All submissions should refer to File Number SR-Phlx-2011-56. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the

proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-Phlx-2011-56 and should be submitted on or before [insert date 21 days from date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>19</sup>

Elizabeth M. Murphy  
Secretary

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<sup>19</sup> 17 CFR 200.30-3(a)(12).