

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-66178; File No. SR-Phlx-2011-170)

January 18, 2012

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Approving a Proposed Rule Change Requesting Permanent Approval of the Pilot Program Permitting NASDAQ OMX PSX to Accept Inbound Orders that Nasdaq Execution Services, LLC Routes in its Capacity as a Facility of the NASDAQ Stock Market LLC

I. Introduction

On December 1, 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’s NASDAQ OMX PSX system (“PSX”) to accept certain inbound orders that Nasdaq Execution Services, LLC (“NES”) routes in its capacity as a facility of the NASDAQ Stock Market LLC (“Nasdaq”). The proposed rule change was published for comment in the Federal Register on December 15, 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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 65934 (December 9, 2011), 76 FR 78060 (“Notice”).

absence of an effective filing under Section 19(b) of the Exchange Act.⁴ NES is a broker-dealer that is a member of the Exchange, and currently provides to members of Nasdaq optional routing services to other market centers.⁵ NES 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, NES is an affiliate of each of these exchanges. Absent an effective filing, Exchange Rule 985(b) would prohibit NES from being a member of the Exchange.

On September 9, 2010, the Commission approved the Exchange’s proposed rule change relating to the establishment of PSX as a platform for trading NMS stocks.⁷ As part of this approval, the Exchange was approved to receive inbound routes of cash equities orders by NES in its capacity as an order routing facility of Nasdaq on a pilot basis.⁸ The Exchange now seeks permanent approval of this inbound routing pilot.⁹

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

⁴ 15 U.S.C. 78s(b).

⁵ NES operates as a facility of Nasdaq that provides outbound routing from Nasdaq to other market centers, subject to certain conditions. See Nasdaq Exchange Rule 4758(b).

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 Securities Exchange Act Release No. 62877 (September 9, 2010), 75 FR 56633 (September 16, 2010) (SR-Phlx-2010-79) (“PSX Approval Order”).

⁸ See PSX Approval Order. See also Securities Exchange Act Release No. 65552 (October 13, 2011), 76 FR 64989 (October 19, 2011) (SR-Phlx-2011-139) (extending the inbound routing pilot through April 8, 2012).

⁹ See Notice.

securities exchange.¹⁰ Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act,¹¹ 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,¹² 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 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 to which it is routing orders, the Exchange previously implemented limitations and conditions to NES's affiliation with the Exchange to permit the Exchange to accept inbound orders that NES routes in its capacity as a facility of Nasdaq, on a pilot basis.¹³ The Exchange now seeks to make this pilot permanent. Specifically, the Exchange states it is in compliance with the

¹⁰ 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).

¹¹ 15 U.S.C. 78f(b)(1).

¹² 15 U.S.C. 78f(b)(5).

¹³ See PSX Approval Order, 75 FR at 56637 - 56638.

following limitations and conditions:¹⁴

- First, the Exchange and FINRA have entered into a regulatory services agreement (“FINRA RSA”) pursuant to which FINRA reviews NES’s compliance with the Exchange’s rules through FINRA’s examination program.¹⁵ Pursuant to the FINRA RSA, however, the Exchange retains ultimate responsibility for enforcing its rules with respect to NES.
- Second, FINRA and the Exchange¹⁶ will monitor NES for compliance with PSX’s trading rules, and collect and maintain certain related information.¹⁷
- 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 NES as a participant that has potentially violated Commission or Exchange rules and (ii) quantifies the number of investigations that identify NES as a participant that has potentially violated

¹⁴ See Notice, 76 FR at 78061.

¹⁵ The Exchange also states that NES is subject to independent oversight by FINRA, its Designated Examining Authority, for compliance with financial responsibility requirements. See Notice, 76 FR at 78061, n.5.

¹⁶ Personnel performing real-time oversight of equity trading on Nasdaq will also perform similar functions with respect to PSX pursuant to a regulatory services agreement among Nasdaq, the Exchange, NASDAQ OMX BX, Inc., and NASDAQ OMX (the “Intercompany RSA”) under the direction, authority, and oversight of Phlx’s Chief Regulatory Officer (“CRO”) and the Regulatory Oversight Committee (“ROC”) of its Board of Directors.

¹⁷ Pursuant to the FINRA RSA, both the Exchange and FINRA will collect and maintain all alerts, complaints, investigations and enforcement actions in which NES (in its capacity as a facility of Nasdaq 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 78061, n.7.

Exchange or Commission Rules.¹⁸

- Fourth, the Exchange adopted Rule 985(c)(2), which requires NASDAQ OMX, as the holding company owning NES and the Exchange, to establish and maintain procedures and internal controls reasonably designed to ensure that NES 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 provision of inbound routing to the Exchange.¹⁹
- Fifth, routing of orders from NES to the Exchange, in NES's capacity as a facility of Nasdaq, will be authorized for a pilot period of twelve months, as further extended to April 8, 2012.²⁰

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 NES, and has demonstrated that NES cannot use any information advantage it may have because of its affiliation with the Exchange.²¹

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.²² Although the Commission continues to be concerned about potential

¹⁸ See id.

¹⁹ See Phlx Rule 985(c)(2). See also Notice, 76 FR at 78061.

²⁰ See Notice, 76 FR at 78061.

²¹ See id.

²² 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

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 NES, in its capacity as a facility of Nasdaq, to provide inbound routing to the Exchange on a permanent basis instead of a pilot basis, subject to the other conditions described above.

The Exchange has proposed four ongoing conditions applicable to NES's inbound routing activities in its capacity as a facility of Nasdaq, 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 NES,²³ combined with FINRA's monitoring of NES'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 NES.

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.).

²³ This oversight will be accomplished through the FINRA RSA between the Exchange and FINRA, and, as applicable, a 17d-2 Agreement. See PSX Approval Order, 75 FR at 56638, n.80 and accompanying text.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change (SR-Phlx-2011-170) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

Kevin M. O'Neill
Deputy Secretary

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).