

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-72633; File No. SR-Phlx-2013-113)

July 16, 2014

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; 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

I. Introduction

On October 31, 2013, 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 to amend the Customer Rebate Program in Section B of the Exchange's Pricing Schedule to increase customer rebates available to certain market participants that transact electronically-delivered customer orders on Phlx (the "Proposal") or its affiliated options exchanges. Phlx designated the proposed rule change as immediately effective upon filing with the Commission pursuant to Section 19(b)(3)(A) of the Act.³ The Commission published notice of filing of the proposed rule change in the Federal Register on November 19, 2013.⁴

The Commission initially received two comment letters on the Proposal.⁵ On November 25, 2013, the Commission temporarily suspended and initiated proceedings to determine whether

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ See Securities Exchange Act Release No. 70866 (November 13, 2013), 78 FR 69472 ("Notice").

⁵ See letters to Elizabeth M. Murphy, Secretary, Commission from: Michael J. Simon, Secretary, International Securities Exchange, LLC ("ISE"), dated November 11, 2013 ("ISE Letter"); and William O'Brien, Chief Executive Officer, Direct Edge Holdings LLC, dated November 13, 2013 ("DirectEdge Letter").

to approve or disapprove the proposed rule change.⁶ In response to the Order Instituting Proceedings, the Commission received four additional comment letters on the Proposal.⁷ On January 24, 2014, Phlx submitted a letter responding to the commenters and to the Order Instituting Proceedings.⁸

On April 7, 2014, the Commission sought additional comment on the proposed rule change and extended the time period for Commission action to July 17, 2014.⁹ On April 18, 2014, Phlx submitted a letter responding to questions from the Commission staff.¹⁰ In response to the request for additional comment in the Extension Notice, the Commission received two

⁶ See Securities Exchange Act Release No. 70940 (November 25, 2013), 78 FR 71700 (November 29, 2013) (“Order Instituting Proceedings”).

⁷ See letters to Elizabeth M. Murphy, Secretary, Commission from: Brian O’Neill, Vice President and Senior Counsel, Miami International Securities Exchange, LLC (“MIAX”), dated November 27, 2013 (“MIAX Letter”); John C. Nagel, Managing Director and General Counsel, Citadel LLC, dated December 18, 2013 (“Citadel Letter”); Angelo Evangelou, Associate General Counsel, Chicago Board Options Exchange, Inc. (“CBOE”), dated December 20, 2013 (“CBOE Letter”); and Michael J. Simon, Secretary, ISE, dated December 20, 2013 (“ISE Letter II”).

⁸ See letter to Elizabeth M. Murphy, Secretary, Commission, from Joan C. Conley, Senior Vice President & Corporate Secretary, Phlx, dated January 24, 2014 (“Phlx Response Letter”). In the Phlx Response Letter, Phlx included an evaluation of the Proposal by economists Drs. Robert Willig and Gustavo Bamberger (“Willig and Bamberger Statement”). On January 24, 2014, Phlx also submitted a request to make an oral presentation in the proceeding. The Commission denied Phlx’s request. See letter from Lynn M. Powalski, Deputy Secretary, Commission, to Eugene Scalia, Partner, Gibson, Dunn & Crutcher LLP, dated June 30, 2014.

⁹ See Securities Exchange Act Release No. 71891 (April 7, 2014), 79 FR 20287 (April 11, 2014) (“Extension Notice”). In the Extension Notice, the Commission requested comment from market participants on the potential impact the Proposal would have on, among other things, fragmentation of the options market.

¹⁰ See letter to Elizabeth M. Murphy, Secretary, Commission, from Jeffrey S. Davis, Vice President & Deputy General Counsel, Phlx, dated April 18, 2014 (“Phlx Response Letter II”).

additional comment letters on the Proposal.¹¹ On May 9, 2014, Phlx submitted a letter responding to the request for additional comment in the Extension Notice.¹² On May 20, 2014, Phlx submitted a letter responding to the Normann Letter.¹³ On May 30, 2014, Phlx submitted a letter responding to ISE's May 20, 2014 comment letter.¹⁴ This order disapproves the proposed rule change.

II. Summary of the Proposal

Under the Phlx's existing Customer Rebate Program in its Pricing Schedule, the Exchange pays tiered rebates to members for executions of customer option orders on Phlx. The different tiers are based on a member organization's (and its affiliates under common ownership)¹⁵ total monthly volume in electronically-delivered customer orders executed on Phlx as a percentage of the total national customer volume in multiply-listed options that are transacted monthly on Phlx. These rebates apply separately to both the execution of simple

¹¹ See letters to Elizabeth M. Murphy, Secretary, Commission, from Michael J. Simon, Secretary, ISE, dated May 20, 2014 ("ISE Letter III") and Parker M. Normann, Ph.D., Partner, Edgeworth Economics LLC, dated May 8, 2014, on behalf of the CBOE, ISE, and MIAX ("Normann Letter").

¹² See letter to Elizabeth M. Murphy, Secretary, Commission, from Jeffrey S. Davis, Vice President & Deputy General Counsel, Phlx, dated May 9, 2014 ("Phlx Response Letter III").

¹³ See letter to Elizabeth M. Murphy, Secretary, Commission, from Joan C. Conley, Senior Vice President & Corporate Secretary, Phlx, dated May 20, 2014 ("Phlx Response Letter IV"). In Phlx Response Letter IV, Phlx included a statement by economists Drs. Robert Willig and Gustavo Bamberger in response to the Normann Letter ("Willig and Bamberger Reply").

¹⁴ See letter to Elizabeth M. Murphy, Secretary, Commission, from Joan C. Conley, Senior Vice President & Corporate Secretary, Phlx, dated May 30, 2014 ("Phlx Response Letter V").

¹⁵ Phlx defines common ownership as a member or member organization under 75% common ownership or control. See Notice, supra note 4, at 69472 n.3.

orders and complex orders on Phlx.¹⁶

Phlx proposed amending its Customer Rebate Program in two ways. First, the Proposal would allow a Phlx member organization to aggregate its (and its affiliates under common ownership) customer volume in multiply-listed options that is electronically delivered and executed across Phlx and its two affiliated NASDAQ OMX exchanges, The NASDAQ Options Market LLC (“NOM”), and/or NASDAQ OMX BX, Inc. (“BX Options”) (collectively, the “NASDAQ OMX exchanges”), for purposes of determining whether it meets the volume tiers on Phlx. Second, the Proposal would increase the customer rebates offered for these transactions executed on Phlx by \$0.02 per contract,¹⁷ provided the member organization, together with any affiliate under common ownership, transacts customer volume on the NASDAQ OMX exchanges in multiply-listed options that is electronically delivered and executed equal to or greater than 2.5% of national customer volume in multiply-listed options in a month.

The Exchange believes the additional rebate would lower costs to transact business on Phlx and increase the volume of customer orders directed to and executed on Phlx, to the benefit of all market participants on Phlx.¹⁸ According to Phlx, the aspect of the Proposal under which a member organization’s eligibility for the volume tiers is determined by taking into account

¹⁶ To determine the applicable rebate, the Exchange totals customer volume in multiply-listed options (including options overlying the SPDR S&P 500) that are electronically-delivered and executed, except volume associated with electronically Qualified Contingent Cross Orders. Pursuant to the Phlx Pricing Schedule, the term “Customer” applies to any transaction that is identified by a member or member organization for clearing in the Customer range at The Options Clearing Corporation which is not for the account of a broker or dealer or for the account of a “Professional” (as that term is defined in Rule 1000(b)(14)).

¹⁷ Phlx would pay the additional \$0.02 per contract rebate, above and beyond other existing customer rebates, on all eligible orders transacted on Phlx by the qualifying member organization.

¹⁸ See Notice, supra note 4, at 69473.

customer volume executed on all of the NASDAQ OMX exchanges broadens the potential availability of a higher rebate to market participants that spread volume across multiple exchanges, rather than requiring a concentration of activity on Phlx.¹⁹ Phlx also argues that the Proposal would benefit investors and the national market system by reducing costs, increasing the incentives for exchanges to compete for order flow, and encouraging market participants to direct more liquidity to the Exchange.²⁰

III. Summary of Comments

As noted above, the Commission received thirteen comment letters on the proposed rule change,²¹ including five supplemental submissions from Phlx responding to comment letters.²² The Commission received seven comment letters opposing the proposed rule change,²³ and one comment letter supporting the proposed rule change.²⁴ Comments on the Proposal generally addressed four areas, namely 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) impacts market structure and efficiency.

¹⁹ See id. at 69477.

²⁰ See Phlx Response Letter, supra note 8, at 4.

²¹ See supra notes 5, 7 and 11.

²² See supra notes 8, 10, 12, 13 and 14.

²³ See ISE Letter; DirectEdge Letter; MIAX Letter; CBOE Letter; ISE Letter II; ISE Letter III; and Normann Letter, supra notes 5, 7 and 11.

²⁴ See Citadel Letter, supra note 7.

A. Equitable Allocation of Reasonable Dues, Fees, and other Charges among Members and Issuers using its Facility.

Several commenters who do not support the Proposal argue that it is inconsistent with the statutory language of Section 6(b)(4) of the Act, which requires that the rules of a registered national securities exchange provide for “the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities” (emphasis added).²⁵ One commenter asserts that such dues, fees, and other charges are intended to be allocated only with respect to the volume on the facilities of the exchange imposing such charges, not the volume executed on another exchange.²⁶ This commenter believes that imposing a fee or charge based on some activity other than use of the fee-imposing exchange’s own facilities would be impossible to allocate in an “equitable” way and could never be “reasonable.”²⁷ Another commenter believes that the Act’s focus on an equitable allocation of reasonable dues, fees, and other charges among its members using its facilities underscores the ArcaBook Order²⁸ conclusion that the Commission must analyze an exchange’s rules and fees on an exchange-by-exchange basis, and argues that imposing a cross-exchange fee, by its very nature, cannot be an equitable allocation of fees for the members of just one of the exchanges.²⁹ This commenter believes that exchange fees tied to activity conducted on competing exchanges

²⁵ See ISE Letter II, supra note 7, at 4; DirectEdge Letter, supra note 5, at 1; MIAX Letter, supra note 7, at 2; and CBOE Letter, supra note 7, at 2-3.

²⁶ See CBOE Letter, supra note 7, at 2.

²⁷ See id. at 3.

²⁸ See Securities Exchange Act Release No. 59039 (December 2, 2008), 73 FR 74770 (December 9, 2008) (SR-NYSEArca-2006-21) (Order Setting Aside Action by Delegated Authority and Approving Proposed Rule Change Relating to NYSE Arca Data), vacated and remanded sub nom by NetCoalition v. SEC, 615 F.3d 525 (D.C. Cir. 2010) but on other grounds (the “ArcaBook Order”).

²⁹ See ISE Letter II, supra note 7, at 4.

are impermissible regardless of whether they increase or lower the overall fees that joint exchange members may pay.³⁰

The commenter that supports the Proposal believes that if an exchange is subject to significant competitive forces in setting the terms of its proposed fees, the exchange's fees are presumed to be equitable, fair, reasonable and not unfairly discriminatory.³¹ This commenter states that reduced fees and rebates based on volume, in general, have been accepted by the Commission and have not been considered inequitable, despite the rebate benefits applying to one member class over another.³² The commenter also asserts that, while the direct benefits flow to only some members, the rebate tiers will benefit all members and customer orders by providing greater liquidity on the exchange and spreading other fees across a larger number of transactions and members.³³ Furthermore, this commenter states that the Commission has approved a proposal in which rebate volume tiers are calculated based on a market participant's aggregate activity on two markets operated by the same SRO.³⁴ In this regard, the commenter

³⁰ See id. at 5. ISE states that the Commission has always required a self-regulatory organization ("SRO") to justify its fees by reference solely to that SRO's operation and governing documents. See id. at 2.

³¹ See Citadel Letter, supra note 7, at 3.

³² See id. at 4.

³³ See id. at 4.

³⁴ See id. at 7 (citing Securities Exchange Act Release No. 50787 (December 2, 2004), 69 FR 71459 (December 9, 2004) (SR-NASD-2004-170)) (approving a National Association of Securities Dealers, Inc. ("NASD") proposed rule change, through its subsidiary The Nasdaq Stock Market ("Nasdaq"), to establish a price and rebate schedule for non-NASD members based on multiple volume-based usage tiers that takes into account the non-NASD member's combined volume activity on the Nasdaq Market Center and Nasdaq's BRUT facility). See also Phlx Response Letter IV, supra note 13, at 3. The Commission believes that the proposed rule change regarding the Brut ECN involved unique circumstances in which the Nasdaq Market Center and Brut were facilities of one SRO, a national securities association. See Securities Exchange Act Release No. 50311 (September 3, 2004), 69 FR 54818 (September 10, 2004) (Order

believes that there is no distinction in differentiating between separately affiliated markets operated by the same SRO, on the one hand, and separate affiliated exchanges operated by affiliated SROs, on the other hand.³⁵

Phlx also responds to the commenters opposing the Proposal by arguing that the phrase “persons using its facilities” in Section 6(b)(4) of the Act only refers to one category of market participant that is bound by an exchange’s rules.³⁶ Phlx asserts that the phrase does not describe the basis on which exchange fees may be determined, or restrict the right of an exchange to offer market participants a discount that is based in part on their trading activity on an affiliated exchange.³⁷ Moreover, Phlx argues that the proposed rebate is consistent with Section 6(b)(4) of the Act because the proposed rebate is limited to market participants who transact business on Phlx and only applies to orders executed on Phlx.³⁸ Phlx also states its view that the Proposal should be considered “presumptively reasonable” because it provides an opportunity for market participants to receive enhanced rebates and to lower the costs passed on to investors.³⁹

Granting Application for a Temporary Conditional Exemption Pursuant To Section 36(a) of the Exchange Act by the National Association of Securities Dealers, Inc. Relating to the Acquisition of an ECN By The NASDAQ Stock Market, Inc.). The Commission also notes that the proposed rule change was a temporary conditional exemption and, after Nasdaq’s acquisition of the Brut ECN, the Nasdaq Market Center, the Brut ECN, and the Nasdaq INET system were fully integrated into a single pool of liquidity. See also Securities Exchange Act Release No. 54155 (July 14, 2006), 71 FR 41291 (July 20, 2006) (SR-NASDAQ-2006-001) (order approving NASDAQ’s proposed rule change to combine the operations of the existing Nasdaq Market Center with NASDAQ’s Brut and INET facilities into one single integrated system).

³⁵ See id.

³⁶ See Phlx Response Letter, supra note 8, at 14.

³⁷ See id.

³⁸ See id.

³⁹ See id.

B. Unfair Discrimination between Customer, Issuers, Brokers, or Dealers.

Several commenters believe the Proposal is inconsistent with Section 6(b)(5) of the Act, which requires the rules of a national securities exchange to, among other things, not be “designed to permit unfair discrimination between customers, issuers, brokers, or dealers.”⁴⁰ In particular, these commenters believe that the Proposal unfairly discriminates between Phlx members because it advantages Phlx members that are also members of NOM and/or BX Options, while disadvantaging Phlx members who are otherwise similarly situated, but who do not have such memberships.⁴¹ As a result, several commenters believe that the Proposal could trigger relatively higher costs for the Phlx members who are not members on NOM and/or BX Options, but who otherwise have the same purchasing profile on Phlx as members who do hold such memberships.⁴²

⁴⁰ See ISE Letter II, supra note 7, at 2-3; MIAX Letter, supra note 7, at 2; and CBOE Letter, supra note 7, at 3.

⁴¹ See ISE Letter II, supra note 7, at 2-3; ISE Letter III, supra note 11, at 2; MIAX Letter, supra note 7, at 2; CBOE Letter, supra note 7, at 3; and Normann Letter, supra note 11, at 5. One commenter states that maintaining multiple exchange memberships requires significant one-time and continuing costs, which include membership and regulatory fees, and connectivity and line charges. See ISE Letter III, supra note 11, at 2. This commenter states its view that requiring members to absorb these additional costs to qualify for the rebate is not reasonable and is discriminatory, as the requirement adds significant costs to the member, but benefits Phlx and its affiliates. See id.

⁴² See CBOE Letter, supra note 7, at 3; and Normann Letter, supra note 11, at 5-6 (noting that a likely result of the Phlx proposal would be that “two otherwise identical customers with identical volume on Phlx, using identical services, will pay different net fees due to differences in purchasing patterns at exchanges other than Phlx.”). See id. at 6. One commenter also believes that the Proposal does not comport with rebate practices that the Commission has allowed in the past as an acceptable means of seeking to attract additional order flow. See CBOE Letter, supra note 7, at 3. Specifically, this commenter states its view that the discriminatory nature of the proposed rebate could distort a brokers’ best execution responsibilities and “present a new threat to public confidence in brokerage services and market integrity” contrary to the public interest and inconsistent with the protection of investors. Id. at 3-4.

The commenter that supports the Proposal argues that the Proposal is not unfairly discriminatory, noting that the Proposal does not require a Phlx member to become a member of NOM or BX Options to meet the rebate eligibility threshold.⁴³ In addition, this commenter believes that most Phlx members with sufficient customer order flow to reach the eligibility threshold are already members of NOM and BX Options.⁴⁴ The commenter further believes that becoming a member of Phlx affiliate exchanges is not an unreasonably discriminatory burden in exchange for the greater ability to meet the volume threshold under the Proposal.⁴⁵

In response to commenters opposing the Proposal, Phlx asserts that the Proposal is not unfairly discriminatory because the proposed rebate is available on equal terms to any market participant that may qualify for the rebate by executing the required volume on Phlx alone.⁴⁶ Phlx argues that members have an incentive to transact volume on Phlx alone because only qualifying customer orders executed on Phlx are entitled to the proposed rebate.⁴⁷ Phlx also argues that the Proposal cannot be unfairly discriminatory because it will extend the availability

⁴³ See Citadel Letter, supra note 7, at 5. The commenter notes that a Phlx member may meet the eligibility threshold by transacting sufficient volume on Phlx alone. See id.

⁴⁴ See id.

⁴⁵ See id. This commenter states that, for example, the Commission has approved fees as not unfairly discriminatory where the fee is tied to a service made available to all members on the same terms, even if only some voluntarily elect to use the service and pay the fee. See id.

⁴⁶ See Phlx Response Letter, supra note 8, at 5; and Phlx Response Letter V, supra note 14, at 2 and 6.

⁴⁷ See Phlx Response Letter, supra note 8, at 6; and Phlx Response Letter V, supra note 14, at 2. One commenter notes that there could be situations where customers earn rebates on Phlx due to purchases on NOM and/or BX Options because the Proposal aggregates volume from Phlx, NOM and BX Options. As a result, a customer may see its net pricing change from incremental purchases on NOM or BX Options and not on Phlx. See Normann Letter, supra note 11, at 8-9.

of an exchange rebate to more market participants.⁴⁸ Additionally, Phlx asserts that there are no significant barriers for market participants to participate in the proposed rebate program because market participants can easily register as members of Phlx and its affiliated exchanges.⁴⁹ Given these results, Phlx believes the Proposal would benefit not only market participants receiving the proposed rebate, but all other Phlx market participants as well.⁵⁰

One commenter, MIAX, believes that the Proposal would cause “disparate treatment” between two similarly positioned market participants on Phlx.⁵¹ MIAX offers the following example to demonstrate how it believes the Proposal would unfairly discriminate against similarly positioned market participants on Phlx: BD1 and BD2 are both the same class of market participant and execute 2% of the national customer volume on Phlx.⁵² However, BD1 sends the balance of their customer order flow of 1% to MIAX while BD2 sends the balance of their customer order flow of 1% to NOM.⁵³ MIAX believes that an equitable allocation of reasonable fees and dues that was not unfairly discriminatory would result in charging BD1 and BD2 the exact same fees for the identical trading activity on Phlx.⁵⁴ In contrast, MIAX argues

⁴⁸ See Phlx Response Letter, supra note 8, at 4.

⁴⁹ See id. at 5; and Phlx Response Letter V, supra note 14, at 2. Phlx asserts that most of its members are already members of its two affiliated NASDAQ OMX exchanges. See Phlx Response Letter V, supra note 14, at 2. Additionally, Phlx states that of the Phlx members that directed electronic customer orders to Phlx for execution in May 2014, 100% are members of NOM, and 88.6% are members of all of the NASDAQ OMX exchanges. See id.

⁵⁰ See id. at 4-5.

⁵¹ See MIAX Letter, supra note 7, at 2.

⁵² See id.

⁵³ See id.

⁵⁴ See id. and see also Norman Letter, supra note 11, at 6.

that the Proposal would result in BD1 and BD2 being charged different fees even though BD1 and BD2 are performing the same activity on Phlx.⁵⁵

Phlx does not directly respond to MIAX's example, but asserts that the MIAX example of price differentiation between two market participants who trade the same volume on Phlx does not mean that a rebate is unfairly discriminatory because "all rebates predicated on volume or some other condition differentiate between customers who meet the condition and those who do not."⁵⁶

Two commenters also note that the ArcaBook Order⁵⁷ provides precedent to disapprove the proposed rule change.⁵⁸ One commenter argues that the Proposal is inconsistent with the Act because, according to the ArcaBook Order, "the Exchange Act precludes anti-competitive tying of the liquidity pools of separately registered securities exchanges even if they are under common control."⁵⁹ Another commenter argues that Phlx misreads the ArcaBook Order to incorrectly stand for the proposition that "as long as exchanges are subject to competitive forces,

⁵⁵ See MIAX Letter, supra note 7, at 2. In the MIAX example, under the Proposal, BD1 would be eligible for a \$0.14 rebate, while BD2 would be eligible for a \$0.17 rebate for executing the identical 2% of the national customer volume on Phlx. See id.

⁵⁶ Phlx Response Letter, supra note 8, at 5. For example, Phlx points to several pricing structures that the Commission has historically approved that result in differential pricing, including, among others, volume tiers and fee caps. See id. at 5-6. However, two commenters respond that the services and/or products cited by Phlx refer to product types or offerings only on a single exchange. See Normann Letter, supra note 11, at 5-6; and ISE Letter III, supra note 11, at 7-8. See also ISE Letter II, supra note 7, at 5-6.

⁵⁷ See ArcaBook Order, supra note 28.

⁵⁸ See CBOE Letter, supra note 7, at 4-5; and ISE Letter III, supra note 11, at 4-7.

⁵⁹ CBOE Letter, supra note 7, at 5 (citing ArcaBook Order at 74790).

any fee is acceptable.”⁶⁰ This commenter states its view that, in the ArcaBook Order, the Commission determined that it must apply the Act’s provision regarding rule and fee changes to individual exchanges, and not to exchanges as a group.⁶¹ The commenter asserts that “[s]ince the Commission has held that the Act requires exchanges to compete at the individual level, Phlx unfairly discriminates by favoring members that route order flow to its affiliated exchanges rather than to other exchanges that also offer differing market and fee structures.”⁶² As a result, this commenter argues that, while Phlx can attempt to attract order flow by adjusting the market structure and fees on Phlx, Phlx cannot base its fees on factors related to other markets.⁶³

Phlx disagrees with commenters who assert that the ArcaBook Order demonstrates that exchanges cannot cooperate with each other on fees.⁶⁴ Phlx states that the ArcaBook Order “presupposes that affiliated exchanges will at times act jointly and that they will not violate the requirements of the Exchange Act by doing so.”⁶⁵ Phlx argues that because market participants on Phlx will benefit from the proposed rebate by achieving lower costs and because more

⁶⁰ ISE Letter II, supra note 7, at 4. The commenter believes that the ArcaBook Order “deals solely with the pricing of a monopoly or unique service ... by one exchange of its own market data,” which is distinguishable from the context of the proposed rebate. Id. at 5.

⁶¹ See ISE Letter III, supra note 11, at 6.

⁶² ISE Letter II, supra note 7, at 3. This commenter also asserts that the Proposal would create confusion for investors because Phlx’s fee schedule would not fully encompass the costs of trading on Phlx, because the fees are dependent on trading on different exchanges. See id. at 4.

⁶³ See id. at 3.

⁶⁴ Phlx asserts that the ArcaBook Order “at most stands for the proposition that an exchange cannot justify a harm imposed on a market participant on one exchange by referring to an offsetting benefit that the market participant will receive on another exchange.” Phlx Response Letter, supra note 8, at 13.

⁶⁵ Id. at 12; and Phlx Response Letter V, supra note 14, at 4. One commenter argues that this statement is irrelevant because the primary issue is whether the proposed rebate violates the Act, not whether there are theoretical situations in which such actions would not violate the Act. See ISE Letter III, supra note 11, at 6 n.18.

liquidity will be directed to the Exchange, nothing in the ArcaBook Order calls the proposed rebate into question.⁶⁶ Furthermore, even if the Commission accepts the interpretation of the ArcaBook Order explained by commenters, Phlx believes that the Proposal meets all relevant requirements of the Act.⁶⁷ Phlx states that the Act does not forbid Phlx from preferring its own affiliated exchanges over other competing exchanges.⁶⁸ Phlx also believes that the Proposal does not unfairly discriminate against other exchanges that compete with Phlx and its affiliated exchanges for liquidity because single exchanges could match Phlx's proposed rebate or employ lower prices without establishing a new exchange to compete.⁶⁹ Phlx also argues that the Commission has previously permitted "materially similar pricing arrangements."⁷⁰ However, several commenters argue that the fee precedents Phlx cites are distinguishable from the current

⁶⁶ See Phlx Response Letter, supra note 8, at 13. In response, one commenter argues that Phlx is improperly attempting to condone its discrimination by citing commercial reasons for favoring its affiliates. See ISE Letter III, supra note 11, at 6. This commenter argues that while there may be valid commercial reasons for an exchange to want to favor its own affiliated exchanges, that does not mean that such proposals are consistent with the Act. See id.

⁶⁷ See Phlx Response Letter V, supra note 14, at 4. One commenter states that Phlx has failed to justify the discriminatory proposal on an individual exchange basis regarding the effects of proposed rebate. See ISE Letter III, supra note 11, at 6-7.

⁶⁸ See Phlx Response Letter V, supra note 14, at 5. Phlx states that Section 6(b)(5) of the Act "prohibits an exchange from 'unfair[ly] discriminat[ing] between customers, issuers, brokers, or dealers' – not other exchanges." Id.

⁶⁹ See Phlx Response Letter, supra note 8, at 7. Phlx also makes a similar argument in response to comments received on whether the Proposal would not impose any burden on competition not necessary or appropriate in furtherance of the Act. See infra Section III.C. Phlx also believes that there are no significant barriers to creating affiliated exchanges. See id. However, one commenter states that Phlx provides no support for this assertion. See ISE Letter III, supra note 11, at 3.

⁷⁰ Phlx Response Letter, supra note 8, at 15. See also Notice, supra note 4 at 69480.

Proposal because, among other things, those fees are not based on an affiliated group of exchanges.⁷¹

One commenter argues that Phlx has not provided any support that additional volume transacted at either NOM or BX Options generates efficiencies at Phlx that would justify, on efficiency grounds, the enhanced rebates.⁷² Additionally, the commenter states that it would expect Phlx to include “substantive analysis of efficiencies generated for Phlx that would warrant passing these efficiencies down to Phlx customers.”⁷³ The absence of such analysis suggests to this commenter that the Proposal is “motivated by a form of price discrimination based on preferences for purchasing volume on a particular exchange, and not on efficiency grounds.”⁷⁴

The commenter believes that the Proposal is likely a form of price discrimination which would

⁷¹ See CBOE Letter, *supra* note 7, at 3; ISE Letter II, *supra* note 7, at 5-6; and ISE Letter III, *supra* note 11, at 7-8. ISE Letter II lists the following exchange fee structures from the Notice: (1) The NASDAQ Stock Market LLC basing fees on combined equity and options volume; (2) the options regulatory fee (“ORF”) that some options exchanges charge; (3) listing exchanges providing discounts on listing fees for companies moving from one listed exchange to an affiliated listed exchange; and (4) exchanges treating specific products, such as options on the S&P 500 ETF, differently for volume and rebate purposes. See ISE Letter II, *supra* note 7, at 5-6. ISE explains that, of the four fees that Phlx cites in support of its proposed rebate, only the ORF is relevant as it relates to activity on multiple exchanges. ISE, however, believes that the ORF structure is distinguishable from the proposed rebate. Specifically, ISE states that “the ORF structure is almost an exact opposite of the Phlx fee” because the purpose of the ORF is “to remove any incentive by members to avoid the fee by trading off that exchange,” whereas the purpose of the proposed rebate is “to encourage trading on the Phlx, the exchange collecting the fee.” *Id.* at 6. Furthermore, ISE states that the ORF “is not a fee based on an affiliated group of exchanges, it is not a variable fee based on the volume of transactions across exchanges, and most importantly, the choice of exchange or exchanges to which a broker-dealer sends its order flow has absolutely no effect on the level of fee the broker-dealer pays.” ISE Letter III, *supra* note 11, at 8.

⁷² See Normann Letter, *supra* note 11, at 7. This commenter states that “an economic justification for quantity discounting can be based on factors such as high fixed costs, scale economies or better scheduling of order flow.” *Id.*

⁷³ *Id.*

⁷⁴ *Id.* at 8.

result in otherwise identical Phlx customers paying different relative prices for substantially the same use of Phlx’s facilities.⁷⁵

Phlx disagrees with the commenter’s conclusion that the enhanced rebate is not an efficiency-based volume discount and believes that the commenter does not contend that the Proposal constitutes unfair discrimination under the Act.⁷⁶ Phlx states that the commenter’s efficiency discussion is based on the “misguided assumption that differential pricing is only justified where it results in ‘efficiencies related to the customer or transaction.’”⁷⁷ However, Phlx states that the Proposal will allow Phlx to increase its trading volume and spread its substantial fixed and common costs over more trades, which will help Phlx cover its fixed and common costs to the benefit of market participants.⁷⁸ Furthermore, Phlx states that the Commission has previously approved a number of similar forms of efficiency-based volume discounts that price discriminate, including cross-exchange pricing on equities exchanges,⁷⁹ discounted fees for proprietary trading products linked to volume in multiply-listed products, fee caps and enterprise licenses that favor heavy users of a system over other users, and differentiated pricing for data fees.⁸⁰

⁷⁵ See id. at 9. This commenter states its view that the effect of the Proposal likely would be to pay rebates to Phlx customers based on purchases made at other exchanges. See id.

⁷⁶ See Phlx Response Letter IV, supra note 13, at 1. Phlx notes that the commenter “does not offer an opinion that the [p]roposal will be harmful in any way.” Id.

⁷⁷ Id.

⁷⁸ See id. at 2.

⁷⁹ See supra note 34.

⁸⁰ See Phlx Response Letter IV, supra note 13, at 3.

C. Burden on Competition Not Necessary or Appropriate

Several commenters oppose the proposed rebate because they believe it is inconsistent with Section 6(b)(8) of the Act, which requires that the rules of a national securities exchange “not impose any burden on competition not necessary or appropriate” in furtherance of the Act.⁸¹ The commenters opposing the Proposal believe that an exchange with a single market structure and fee schedule cannot fairly compete against a fee structure that leverages the execution volume and fees across affiliated options exchanges.⁸² One commenter asserts that the Proposal would establish a precedent that would allow existing affiliated exchange groups to leverage the execution volume across their multiple independent SROs to the detriment of options exchanges that do not have such affiliated options exchanges.⁸³ Another commenter argues that exchange operators with multiple exchanges will be able to operate their exchanges with a single, integrated fee structure, cross-subsidizing various offerings in a way that exchanges with only one market will not be able to match.⁸⁴

In response, Phlx states its belief that a single-exchange operator can compete by increasing its own volume-based rebate or offering its own differentiated products, even if those services do not precisely match those offered by Phlx or any other exchange.⁸⁵ Phlx also asserts

⁸¹ See ISE Letter II, supra note 7, at 3; MIAX Letter, supra note 7, at 3; and CBOE Letter, supra note 7, at 4.

⁸² See id. Two commenters argue that the Proposal is an undue burden on competition among market participants on Phlx because Phlx members that do not have the capacity to be members of multiple options exchanges will be unable to leverage additional customer trading volume on a Phlx affiliate exchange to lower their fees. See CBOE Letter, supra note 7, at 4; and MIAX Letter, supra note 7, at 3.

⁸³ See MIAX Letter, supra note 7, at 3.

⁸⁴ See ISE Letter III, supra note 11, at 9.

⁸⁵ See Phlx Response Letter II, supra note 10, at 9-10. Phlx asserts, for example, that CBOE offers larger rebates for trades for proprietary options contracts to members who

that CBOE, ISE, and NYSE each operate two options exchanges,⁸⁶ and can adopt pricing mechanisms similar to the proposed rebate.⁸⁷ Thus, Phlx argues that, even if one of the current single-exchange operators were unable to match the proposed discount, Phlx would still face competition from five other exchange operators and eight other exchanges, including three exchange operators that themselves operate multiple exchanges.⁸⁸ As a result, Phlx argues that the price competition from the Proposal would benefit consumers and would itself outweigh any purported harm to competing exchanges that could result from the proposed rebate.⁸⁹

Phlx also argues that single market exchanges can compete with the Proposal by registering multiple exchanges and offering competing multi-exchange fees.⁹⁰ However, one commenter argues that the overall cost of initiating operation of an exchange “runs into the multiple millions of dollars.”⁹¹

meet certain volume thresholds for multiply-listed options contracts. See id. at 10. Phlx states that it cannot offer a similar pricing Proposal, since it does not execute trades for CBOE’s proprietary contracts. See id.

⁸⁶ The Commission notes that CBOE, ISE, and NYSE do not themselves operate two exchanges, but are each part of separate affiliated groups of exchanges operating under common holding companies. The Commission assumes that Phlx is arguing that the parent holding companies could offer pricing mechanisms similar to the pricing mechanism in the Proposal.

⁸⁷ See Phlx Response Letter II, supra note 10, at 10.

⁸⁸ See Phlx Response Letter, supra note 8, at 10. Phlx states that seven exchanges have commenced operation since 2003, and all have been able to increase their market share due to the competitive nature of the options exchange marketplace. See Phlx Response Letter II, supra note 10, at 2. Phlx asserts that exchanges have proven viable even at a small scale. See id.

⁸⁹ See Phlx Response Letter, supra note 8, at 10-11.

⁹⁰ See Notice, supra note 4, at 69482.

⁹¹ ISE Letter II, supra note 7, at 3. This commenter also states that allowing an exchange to combine trading volume with competitors removes incentives for that exchange to broaden its offerings to attract more order flow, which leads to “greater Balkanization of the exchange community.” ISE Letter II, supra note 7, at 4.

Furthermore, this commenter states that the cost and timing of such registrations impose “unacceptable competitive impediments.”⁹²

The commenter that supports the Proposal believes that the Proposal would not place any undue burden on competition.⁹³ This commenter reasons that the Proposal should be presumed to be pro-competitive because the proposed rebate lowers fees and forces competing exchanges to “innovate to maintain customers and market share.”⁹⁴ The commenter notes that “not all exchanges have affiliated exchanges through which they could structure a program similar to the [p]roposal.”⁹⁵ The commenter further states its belief that not having an affiliated exchange “does not constitute an undue burden on competition, but rather a potential for its enhancement.”⁹⁶

Phlx argues that the Proposal does not constitute anti-competitive tying because Phlx member organizations are not required to use NOM or BX Options to receive the enhanced rebate.⁹⁷ One commenter argues that the antitrust “tying” arguments by Phlx are irrelevant to provide a basis for approval of the Proposal because tying would be dispositive in this context only if there was a combination in the pricing of a competitive product and a monopoly product,

⁹² ISE Letter III, supra note 11, at 11. In response, Phlx states the fact that ISE recently registered a new exchange demonstrates that the barriers to entry are not prohibitively high. See Phlx Response Letter V, supra note 14, at 4.

⁹³ See Citadel Letter, supra note 7, at 5.

⁹⁴ Id. at 5.

⁹⁵ Id. at 6.

⁹⁶ Id. at 6.

⁹⁷ See Notice, supra note 4, at 69476-77.

which is not present in the Proposal.⁹⁸ In response, Phlx states that the Commission routinely cites and discusses antitrust cases in support of its orders approving proposed rule changes.⁹⁹ For example, Phlx points to the ArcaBook Order, where the Commission cited to an economic analysis of monopolies and pricing.¹⁰⁰

In its response, Phlx argues that the Proposal is simply a price cut and there is no evidence that low prices harm competition.¹⁰¹ Phlx asserts that the Proposal will benefit all Phlx market participants, including those who do not obtain the proposed rebates, through increased customer liquidity and tighter spreads.¹⁰² In addition, Phlx believes that market participants and investors will benefit under the Proposal because it is designed to attract Directed Orders (*i.e.*, customer orders directed to particular market makers for execution).¹⁰³ Phlx also states that members who choose to qualify for the enhanced rebates by maintaining volume on NOM or BX Options (as opposed to shifting their volume to Phlx, as would be required to qualify for a Phlx-

⁹⁸ See ISE Letter II, *supra* note 7, at 5. ISE notes that “[i]n basing fees on trading volume on multiple venues, Phlx argues that it will not be illegally tying services because there is no requirement that the ‘purchaser’ buy any two products together.” *Id.*

⁹⁹ See Phlx Response Letter V, *supra* note 14, at 2.

¹⁰⁰ See *id.* at 3.

¹⁰¹ See Phlx Response Letter, *supra* note 8, at 7-8. Phlx anticipates that the Proposal will increase its trading volume, decrease the transaction fee revenue per contract, and improve its competitive position. See Phlx Response Letter II, *supra* note 10, at 4.

¹⁰² See *id.* at 5; Phlx Response Letter III, *supra* note 12, at 1-2; Phlx Response Letter IV, *supra* note 13, at 2; and Phlx Response Letter V, *supra* note 14, at 4-5. One commenter asserts that firms that do not also trade on NOM or BX Options may lose order flow to larger firms that consolidate order flow to meet the rebate thresholds. See ISE Letter III, *supra* note 11, at 10. In response, Phlx states that this possibility exists today under any rebate program based on volume tiers. See Phlx Response Letter V, *supra* note 14, at 6.

¹⁰³ See Phlx Response Letter II, *supra* note 10, at 5. According to Phlx, under Phlx trading rules, a particular market maker (the “Directed Participant”) can execute as much as 40% of the Directed Order. See *id.* In practice, however, Phlx states that Directed Participants only execute around 9% of Directed Orders on average. See *id.* Phlx states that the remainder of the order is executed by other market participants. See *id.*

only rebate) will have the flexibility to route their orders to NOM or BX Options without reducing the rebates that they accrue on Phlx.¹⁰⁴ Additionally, Phlx explains that the Proposal offers several benefits beyond those available from a Phlx-only rebate, most notably, a significant price cut to members, additional volume, and increased flexibility for market participants.¹⁰⁵ Moreover, Phlx believes that employing bundled pricing in this manner can induce new trading and prompt members to shift volume from competing exchanges.¹⁰⁶

D. Impact on Options Market Structure

In its response to the request for additional comment in the Extension Notice, Phlx states that it does not believe the Proposal will have a material effect on the structure of the options or equities markets or lead to a change in the total number of options exchanges.¹⁰⁷ Phlx believes that its competitors can respond to the Proposal in several ways, including by offering better pricing on a single exchange, which would reduce the incentive for exchanges or new entities to create additional options exchanges.¹⁰⁸ Phlx also believes that the decision to open a new

¹⁰⁴ See id. at 6 and 9; and Phlx Response Letter IV, supra note 13, at 2.

¹⁰⁵ See Phlx Response Letter II, supra note 10, at 8; and Phlx Response Letter IV, supra note 13, at 2.

¹⁰⁶ See Phlx Response Letter II, supra note 10, at 6. Phlx has not made projections as to the amount of volume that might shift as a result of the Proposal or the effect that the Proposal would have on overall options industry volume. See id. at 7. However, Phlx expects that “the [p]roposal could lead to an increase in total options exchange industry volume, but the belief is pricing alone will not have a material impact on industry volume.” Id.

¹⁰⁷ See Phlx Response Letter III, supra note 12, at 2, 4 and 6. Thus, Phlx believes the Proposal should not generate any costs or benefits associated with a change in the number of exchanges. See id. at 7. Phlx also believes that the Proposal will not materially affect order interaction, liquidity, volatility, or execution. See id. at 6.

¹⁰⁸ See id. at 7. Phlx believes that its competitors can match the enhanced rebates by increasing the rebates on a single exchange or developing other strategies for offering differentiated pricing, products, or services that could appeal to market participants. See

exchange is influenced by other factors, primarily by whether “opening a new exchange will allow them to offer a new market model that will provide a different value proposition to market participants than is available through their existing exchanges.”¹⁰⁹ Phlx notes that in the past five years, as the number of exchanges have increased, the revenue per contract of CBOE, NASDAQ and NYSE has decreased or remained relatively flat, which suggests that trading costs do not necessarily increase when additional markets open.¹¹⁰ Furthermore, Phlx believes that the enhanced rebate will not create a sufficient incentive to prompt existing exchanges or exchange groups to consolidate due to the significant transaction costs involved.¹¹¹ Phlx argues that the decision whether to consolidate entities is driven by considerations other than those raised by the Proposal, including whether consolidation would help exchanges better serve the interest of market participants.¹¹²

Moreover, Phlx believes that the Proposal should not be held to violate the Act merely because it creates an incentive for another market operator to open a new exchange.¹¹³ Phlx notes that the Commission has expressed concern in the past that a multiplicity of trading venues could lead to fragmentation if market participants are unable to interact with order flow on each

Phlx Response Letter III, supra note 12, at 4; and Phlx Response Letter V, supra note 14, at 3.

¹⁰⁹ Phlx Response Letter III, supra note 12, at 4-5. See also Phlx Response Letter V, supra note 14, at 4.

¹¹⁰ See id. at 5.

¹¹¹ See id. at 7.

¹¹² See id.

¹¹³ See id. at 2. Phlx cites to prior Commission rulemaking to argue that the “Commission historically has praised the increase in securities exchanges in the United States as critical to enhancing competition for order flow and promoting consumer choice.” Id.

exchange to ensure that they are obtaining the best available price.¹¹⁴ However, Phlx does not believe the Commission has ever expressed an opinion that the possibility of future order fragmentation is a sufficient reason to discourage the creation of new exchanges.¹¹⁵

Finally, Phlx argues that the Commission's concern over the expansion of the number of exchanges presupposes that the Proposal will be successful and encourage other exchanges to respond by offering similar enhanced rebates to investors.¹¹⁶ Phlx believes that the Proposal should not be disapproved based on the presumption that investors will respond favorably to it and encourage other exchanges to offer additional market-based incentives.¹¹⁷ Phlx reiterates its view that because the Proposal enhances competition and offers a price cut to Phlx members, it is presumptively valid under the Act and "[t]here would need to be significant countervailing evidence supporting any conclusion that the [p]roposal conflicts with the purposes underlying the Act."¹¹⁸ Phlx believes that no such evidence exists in the Proposal and the Commission

¹¹⁴ See id.

¹¹⁵ See id.

¹¹⁶ See id. at 3. Phlx anticipates that the Proposal will increase its trading volume, decrease transaction fee revenue per contract, and improve its competitive position. See Phlx Response Letter II, supra note 10, at 4. Furthermore, Phlx does not expect the Proposal to result in substantial total cost savings in the near term. See id. at 6. Phlx explains that most of its costs are fixed and are not affected by modest changes in volume. See id. While large increases in volume may require Phlx, NOM, or BX Options to incur significant expenses to increase capacity, Phlx does not expect the Proposal to result in volume increases sufficient to require such expenditures. See id.

¹¹⁷ See Phlx Response Letter III, supra note 12, at 3. Phlx states that one firm would have qualified for the enhanced rebate at the time the Proposal was first implemented based on its pre-existing trading volume. See Phlx Response Letter II, supra note 10, at 2-3. Phlx also states that during the month in which the Proposal was in effect prior to the Order Instituting Proceedings, there was a modest increase in Phlx's customer volume. See id. at 3. In addition to the one firm that qualified for the enhanced rebate based on its pre-existing trading volume, two firms qualified for the enhanced rebate by shifting volume to NOM from rival exchanges. See id.

¹¹⁸ Phlx Response Letter III, supra note 12, at 3.

therefore should “permit market forces to determine both the optimal number of exchanges and the manner in which exchanges offer and respond to pro-competitive price discounts.”¹¹⁹

One commenter responded to the request for additional comment in the Extension Notice arguing that the Proposal will lead to an increase in the number of exchange registrations resulting in unnecessary market fragmentation.¹²⁰ The commenter believes that the options market structure currently reflects an appropriate balance between competition and fragmentation.¹²¹ The commenter believes that if the Proposal is approved, single exchange operators will view exchange registration as a defensive measure against exchange operators with multiple markets, rather than register exchanges to offer value to the market.¹²² This commenter concludes that exchange operators will register multiple exchanges just to match competitive offerings, “rather than providing any real benefit to the market,” leading to increased fragmentation without any corresponding benefit.¹²³

Furthermore, two commenters raised concern about the potential impact of the Proposal on a market-wide basis. One commenter believes that the Proposal imposes obstacles to the development of a national market system for securities and that ignoring the precedent in the ArcaBook Order would require a major change to the underlying assumptions regarding a

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Id.

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See ISE Letter III, supra note 11, at 8-9.

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See id. at 8.

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See id. at 9. This commenter notes that such value could be new order types, a new fee structure, enhanced technology, or services complementary to the exchange operator’s other offerings. See id.

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Id.

national market system, a change that could have significant unintended consequences.¹²⁴ This commenter states its view that the Proposal raises important questions about the foundation of the national market system and competition in the securities markets¹²⁵ and suggests that if the Commission ever determines to make such a change, it should be addressed either through Commission rulemaking or Congressional action – not through an individual exchange’s rule proposal.¹²⁶ Similarly, another commenter believes that the Proposal raises significant legal and policy issues and suggests that – if a reconsideration of policy must be undertaken – such reconsideration should be conducted on a market-wide basis and not in the context of a single proposed rule change.¹²⁷

IV. Discussion and Commission Findings

Under Section 19(b)(2)(C) of the Act, the Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable to such organization.¹²⁸ The Commission shall disapprove a proposed rule change if it does not make such a finding.¹²⁹ The Commission’s Rules of Practice, under Rule 700(b)(3), state that the “burden to demonstrate that a proposed rule change is consistent with the Exchange Act and

¹²⁴ See ISE Letter III, supra note 11, at 4. The commenter adds that each exchange competes for order flow through a variety of means, including execution quality, speed of execution, customer service, and fees. See id. Citing to the Act and the ArcaBook Order, this commenter explains its view that the national market system for options transactions has been built on the basis of competition between individual exchange markets, not groups of exchange markets. See id.

¹²⁵ See ISE Letter II, supra note 7, at 1-2.

¹²⁶ See ISE Letter III, supra note 11, at 4.

¹²⁷ See CBOE Letter, supra note 7, at 1 and 4.

¹²⁸ See 15 U.S.C. 78s(b)(2)(C)(i).

¹²⁹ See 15 U.S.C. 78s(b)(2)(C)(ii); and see also 17 CFR 201.700(b)(3).

the rules and regulations issued thereunder ... is on the self-regulatory organization that proposed the rule change” and that a “mere assertion that the proposed rule change is consistent with those requirements ... is not sufficient.”¹³⁰

After careful consideration, the Commission does not find 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. In particular, the Commission does not find that the proposed rule change is consistent with: (1) Section 6(b)(4) of the Act, which requires that the rules of a national securities exchange “provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities;”¹³¹ and (2) Section 6(b)(5) of the Act, which, among other things, requires that the rules of a national securities exchange not be “designed to permit unfair discrimination between customers, issuers, brokers, or dealers[.]”¹³² Because either of these determinations under the Act independently necessitates disapproving the Proposal, the Commission does so.

In the Order Instituting Proceedings, the Commission highlighted the statutory provisions referenced above, and noted that the Commission intended to further assess whether this additional customer rebate on Phlx, which is based on execution volume across the NASDAQ OMX exchanges, is consistent with the statutory requirements applicable to a national securities

¹³⁰ See 17 CFR 201.700(b)(3). “The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding. Any failure of a self-regulatory organization to provide the information elicited by Form 19b-4 may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder that are applicable to the self-regulatory organization.” Id.

¹³¹ 15 U.S.C. 78f(b)(4).

¹³² 15 U.S.C. 78f(b)(5).

exchange under the Act.¹³³ The Commission invited interested persons to submit written views with respect to these concerns. The Commission received eleven comment letters in response to the Order Instituting Proceedings, of which five were from Phlx.

To evaluate whether a fee, such as Phlx’s proposed rebate, is consistent with the Act, the Commission applies a “market-based approach.”¹³⁴ The Commission examines whether the exchange making the proposal is subject to significant competitive forces in setting the terms of its proposal, including the level of any fee.¹³⁵ If the exchange is subject to significant competitive forces in setting the terms of a proposal, the Commission will approve the proposal unless it determines that there is a substantial countervailing basis to find that the proposal nevertheless fails to meet an applicable requirement of the Act or the rules thereunder.¹³⁶ If the exchange is not subject to significant competitive forces in setting the terms of the proposal, the Commission will require the exchange to provide a substantial basis, other than competitive forces, to demonstrate that the terms of the proposal are equitable, fair, reasonable, and not unreasonably discriminatory.¹³⁷ For reasons discussed below, although we base our analysis on

¹³³ See Order Instituting Proceedings, supra note 6, at 71701-02.

¹³⁴ See ArcaBook Order, supra note 28, at 74781-82. See also Securities Exchange Act Release No. 68202 (November 9, 2012), 77 FR 68856, 68858-61 (November 16, 2012) (SR-Phlx-2012-27 and SR-Phlx-2012-54) (“Phlx Fees Order”) (applying the market-based approach analysis in connection with a Phlx transaction fee proposal. The Commission found, pursuant to delegated authority, that the proposed rule changes were consistent with the requirements of the Act and rules and regulations thereunder applicable to a national securities exchange.). Notably, one commenter on this Proposal applied the Commission’s market-based approach to analyzing the Proposal. See Citadel Letter, supra note 7, at 3.

¹³⁵ See ArcaBook Order, supra note 28, at 74781. See also Phlx Fees Order, supra note 134, at 68858.

¹³⁶ See ArcaBook Order, supra note 28, at 74781. See also Phlx Fees Order, supra note 134, at 68858.

¹³⁷ See ArcaBook Order, supra note 28, at 74781.

the assumption that Phlx is subject to significant competitive forces in setting the terms of the Proposal, there is a substantial countervailing basis to find that those 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.

As discussed more fully below and as explained in the ArcaBook Order, 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 – that is, an exchange's proposed rule change is analyzed at the individual level of the registered securities exchange and not at the group level of exchanges.¹³⁸ With respect to the first part of a market-based approach, the Commission previously has found and continues to believe that there is significant competition for order flow in the options market at the individual exchange level.¹³⁹ This Proposal adds

¹³⁸ See id. at 74793; and infra notes 143-145. Specifically, in the ArcaBook Order, the Commission stated:

Section 6 of the Exchange Act ... prohibits a national securities exchange from adopting rules that are designed to permit unfair discrimination among its customers or that would impose an unnecessary or inappropriate burden on competition. All of these requirements are applied at the level of the individual registered securities exchange, not at the group level of exchanges that are under common control. In particular, a proposed exchange rule must stand or fall based, among other things, on the interests of customers, issuers, broker-dealers, and other persons using the facility of that exchange.

¹³⁹ See Securities Exchange Act Release No. 61317 (January 8, 2010), 75 FR 2915 (January 19, 2010) (SR-ISE-2009-103). The Commission found, pursuant to delegated authority, that the exchange was subject to significant competitive forces in setting the terms of its proposal, including fees, and noting that “the Exchange has a compelling need to attract order flow to maintain its share of trading volume, imposing pressure on the Exchange to act reasonably in establishing fees for these data offerings.” Id. at 2917. With respect to

complexity to the first part of a market-based approach analysis because it raises a question of whether we also should analyze competition at the group level of exchanges in addition to the individual exchange level.¹⁴⁰ The Commission does not believe it is necessary to resolve that issue here because, even assuming that the Exchange were subject to significant competitive forces at the group level under the first part of a market-based approach, the Commission believes that, under the second part of the market-based analysis, there is a substantial countervailing basis to find that the terms of the proposed rebate fail to meet the requirements of the Act.

Specifically, the Commission believes that providing a rebate for transactions on Phlx based on the aggregate amount of customer volume transacted across all three of the NASDAQ OMX exchanges would be inconsistent with Section 6(b)(4) of the Act¹⁴¹ because it would not provide for the equitable allocation of reasonable dues, fees, and other charges among Phlx members and issuers and other persons using Phlx facilities. The Commission also believes that

this Proposal, commenters and the Exchange have both provided representations and data regarding the existence of competition for order flow among options exchanges. See Notice, supra note 4, at 69474; Phlx Response Letter, supra note 8, at 10 and 12; Phlx Response Letter II, supra note 10, at 2; Citadel Letter, supra note 7, at 3 (stating that “it is clear that Phlx and all options exchanges are subject to significant competitive forces in setting their fees” and “the Commission recently found that there is significant competition for order flow in the options markets”); and ISE Letter II, supra note 7, at 3 (stating that “every exchange operates in a competitive environment, seeking to maximize the order flow on that exchange”). In particular, the Exchange has stated that the trading of options is a highly competitive environment and the ability to attract order flow is driven largely by price competition. See Notice, supra note 4, at 69474; Phlx Response Letter, supra note 8, at 12; and Phlx Response Letter II, supra note 10, at 2. The Exchange also stated that member firms control the order flow that options markets compete to attract, and that exchange members, rather than the exchanges, drive competition. See Notice, supra note 4, at 69474.

¹⁴⁰ See Notice, supra note 4, at 69481-82.

¹⁴¹ 15 U.S.C. 78f(b)(4).

the Proposal would be inconsistent with Section 6(b)(5) of the Act¹⁴² because it would permit unfair discrimination between customers, issuers, brokers, or dealers.

As outlined above, the Proposal would allow market participants to aggregate volume across Phlx, NOM, and BX Options for purposes of determining whether they meet the volume tiers on Phlx. However, 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.¹⁴³ As the Commission articulated in the ArcaBook Order, the regulatory structure of Section 6 “limits the potential for related exchanges to act jointly[.]”¹⁴⁴ and reading the statute to require the application of (and assessment of compliance with) the requirements of Section 6 of the Act on an exchange-by-exchange basis is consistent with that purpose. While the Commission recognizes that there are other plausible approaches to the interpretation of the Act, we do not believe a sufficiently compelling case has been made for the Commission to alter its historical position at this time.

Thus, as articulated by the Commission in the ArcaBook Order, the Commission has analyzed whether this proposed rule change is consistent with the Act at the level of the individual registered securities exchange – not the group level. In applying this principle, it is notable that the Proposal could result in the Exchange charging different fees to Phlx members that are similarly situated and transact the same amount and type (electronically delivered) of customer volume on the Phlx exchange. For example, a Phlx member who transacts 2.3% of national customer volume in multiply-listed options in a month on Phlx would not qualify for the

¹⁴² 15 U.S.C. 78f(b)(5).

¹⁴³ See ArcaBook Order, supra note 28, at 74793.

¹⁴⁴ Id.

additional rebate. However, another Phlx member who also transacts 2.3% of national customer volume in multiply-listed options in a month on Phlx and who transacts an additional 0.5% of national customer volume in multiply-listed options in a month on NOM would qualify for the rebate. Further, given the second Phlx member's customer volume transacted on NOM, this second Phlx member need only transact 2.0% of national customer volume in multiply-listed options in that month on Phlx to qualify for the enhanced rebate.¹⁴⁵

Thus, under the Proposal, a Phlx member that transacts less national customer volume in multiply-listed options in a month on Phlx than other members would qualify for the additional proposed rebate while those other Phlx members with higher national customer volume percentages on Phlx – the exchange proposing the rebate – would not qualify. The Commission does not believe that the arguments put forth by Phlx provide a basis consistent with the Act as to why this disparity is equitable or not unfairly discriminatory when analyzing the treatment of Phlx members using the Phlx exchange.

Phlx argues that the Proposal provides for the equitable allocations of fees because the proposed rebate is limited to market participants who transact business on Phlx and only applies to orders actually executed on the Phlx exchange.¹⁴⁶ But this ignores the effect of the proposed

¹⁴⁵ Several commenters also raised this concern and argued that it renders the Proposal inequitable. *See, e.g.,* Normann Letter, *supra* note 11, at 6-9; and MIAX Letter, *supra* note 7, at 2. *See also* CBOE Letter, *supra* note 7, at 3 (noting that “imposition of a fee or charge by an exchange based on some activity other than use of the fee-imposing exchange’s own facilities necessarily would be impossible to allocate in an ‘equitable’ way and could never be ‘reasonable.’”); and ISE Letter II, *supra* note 7, at 2-3.

¹⁴⁶ Phlx Response Letter, *supra* note 8, at 14; and Section III.A, *supra*. In addition, Phlx argues that the proposed rebate should be considered “presumptively reasonable” because it would reduce transaction costs of doing business on the Exchange, which the Exchange believes would ultimately reduce the costs passed on to investors. *See* Phlx Response Letter, *supra* note 8, at 14. *See also* Notice, *supra* note 4 at 69477. The Commission notes that it is not making a finding as to whether the proposed rebate is reasonable

rebate on those market participants. Because the Proposal is based in part on the activity of Phlx members outside the Phlx exchange, the Proposal could result in the Exchange charging different fees to members that are similarly situated and execute the same amount and type of customer orders on the Phlx exchange. Further, Phlx has not shown that, when analyzed at the level of the individual exchange, such differential treatment is equitable.

Phlx believes that the resulting lower costs will incentivize market participants to increase the amount of customer orders sent to the Exchange, thereby enhancing the quality of its markets by narrowing quote spreads and further increasing customer volume to Phlx.¹⁴⁷ The Commission does not believe that any of the potential benefits of the Proposal cure its inequitable effect because, when analyzing the activity of members on the Phlx exchange alone, the Proposal could result in two Phlx members that are similarly situated and transact the same amount and type of customer volume on Phlx being charged different fees.

Finally, Phlx argues that the proposed rebate is structured as a volume-based discount and is similar to the existing rebate tiers in Section B of the Pricing Schedule, which the Commission has previously accepted.¹⁴⁸ But the Commission believes that the Proposal is distinguishable from the volume-based tiers and discounts that currently exist on Phlx and other registered securities exchanges. Current volume based discounts are based on the volume transacted on the registered securities exchange charging the fee and not volume transacted on a separate registered securities exchange. Thus, under current volume-based discounts, two similarly situated members executing the same amount and type of transaction volume on a registered

because the Commission finds that the Proposal is inconsistent with the Act on other grounds. See supra notes 138-143 and accompanying text.

¹⁴⁷ See Notice, supra note 4, at 69482.

¹⁴⁸ See Phlx Response Letter, supra note 8, at 15; and Notice, supra note 4 at 69480.

securities exchange should be charged the same transaction fee (or given the same transaction rebate).¹⁴⁹

Given the principle articulated by the Commission in its ArcaBook Order, and based on the record, the Commission therefore does not believe that the proposed fee structure, which as commenters noted, would allow the Exchange to charge different fees to Phlx members that are similarly situated and transact the same amount and type of customer volume on Phlx, is consistent with Section 6(b)(4) of the Act which, requires that the rules of a registered national securities exchange “provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities.”

Phlx also argues that the Proposal is not unfairly discriminatory under Section 6(b)(5) of the Act, asserting that because any market participant could qualify for the proposed rebate by transacting the required amount of customer volume on Phlx alone and thus market participants are not required to become members of NASDAQ OMX exchanges to qualify for the proposed rebate.¹⁵⁰ The Commission believes that this argument fails to address, when analyzing the activity of members on the Phlx exchange alone, the result of two Phlx members that are similarly situated and transact the same amount and type of customer volume on Phlx but could be charged different fees.¹⁵¹

¹⁴⁹ See, e.g., the existing Phlx Pricing Schedule B, Customer Rebate Program. In the Notice, Phlx also discusses other examples of differences in fees and rebates for exchange services. See Notice, supra note 4, at 69477-80. The Proposal is similarly distinguishable from those examples because only under the Proposal could two similarly situated market participants who transact the same amount of the same type of volume on Phlx be charged differing levels of transaction fees by that exchange.

¹⁵⁰ See Phlx Response Letter, supra note 8, at 4-7; and Phlx Response Letter V, supra note 14, at 2. See also supra Section III.B.

¹⁵¹ See infra note 156.

Phlx argues that market participants can easily register as members of Phlx and its affiliated exchanges at minimal cost, which will expand the pool of market participants who can receive the rebate.¹⁵² Phlx also argues that the Proposal would reduce fees and benefit market participants by way of reduced transaction costs.¹⁵³ In addition, the Exchange argues that the Proposal would enhance efficient trading activity by allowing market participants to route customer orders to other NASDAQ OMX exchanges and count transactions as a result of those orders towards the proposed rebate on Phlx.¹⁵⁴ The Exchange believes that this efficiency would improve execution quality while at the same time potentially lowering the cost for their customers.¹⁵⁵ But the Commission does not believe that any of the potential benefits of the Proposal put forth by Phlx—such as to expand the rebate to more market participants resulting in lower costs to market participants without compromising their execution obligations, and improved market quality through increased liquidity to the Exchange¹⁵⁶—cures its unfair discriminatory effects on Phlx-only members, who could be charged a higher fee for the same

¹⁵² See Phlx Response Letter, supra note 8, at 4-5.

¹⁵³ See Notice, supra note 4, at 69473.

¹⁵⁴ See Phlx Response Letter II, supra note 10, at 6 and 9; and Phlx Response Letter IV, supra note 13, at 2.

¹⁵⁵ See Phlx Response Letter II, supra note 10, at 6 and 9; and Phlx Response Letter IV, supra note 13, at 2.

¹⁵⁶ The Proposal potentially could lead to order flow shifting away from the Phlx exchange to other options exchanges because a member could still qualify for the rebate by aggregating the amount of customer volume that it transacts across one or more of the exchanges in the NASDAQ OMX exchange group. According to the Exchange, during the month the proposed rebate was in effect on Phlx, customer volume on Phlx experienced a modest increase; however, two of the three firms that qualified for the proposed rebate did so by shifting customer volume from rival exchanges to NOM. See Phlx Response Letter II, supra note 10, at 3-4. Phlx data shows that Phlx Member A's customer volume on NOM increased from 0.59% on October 1, 2013 to 1.67% on November 1, 2013 and Phlx Member C's customer volume on NOM increased from 0.58% on October 1, 2013 to 1.44% on November 1, 2013. See id.

volume on Phlx than Phlx members that have multiple NASDAQ OMX exchange memberships. Thus, the Commission does not believe that Phlx has provided a sufficient basis to support the assertion that the potential discrimination among Phlx members resulting from the Proposal would not be unfair. Consequently, the Commission does not believe that the proposed fee structure is consistent with Section 6(b)(5) of the Act which, among other things, requires that the rules of a registered national securities exchange be “not designed to permit unfair discrimination between customers, issuers, brokers, or dealers[.]”

In analyzing this Proposal and in making its determination to disapprove the rule change, the Commission has considered whether the action will promote efficiency, competition, and capital formation.¹⁵⁷ As part of this consideration, the Commission has considered comments regarding efficiency and competition, including literature cited in those comments, and how any effects on competition or efficiency could affect capital formation. For example, some commenters assert that the Proposal does not provide efficiency gains on Phlx,¹⁵⁸ while Phlx contends that some market participants who transact customer orders on Phlx could experience efficiency gains from improved execution choices.¹⁵⁹ Phlx contends the following effects may result from the Proposal: more efficient allocation of order flow between Phlx and its affiliated exchanges;¹⁶⁰ more efficient use of the services associated with the substantial fixed, sunk costs

¹⁵⁷ Whenever pursuant to the Act the Commission is engaged in rulemaking or 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. See 15 U.S.C. 78c(f).

¹⁵⁸ See ISE Letter III, supra note 11, at 8-9; Normann Letter, supra note 11, at 7.

¹⁵⁹ See Phlx Response Letter, supra note 8, at 4.

¹⁶⁰ See id.; and Willig and Bamberger Statement, supra note 8, at 19. See also Citadel Letter, supra note 7, at 2-3, 7.

shared among the three exchanges in the Nasdaq OMX group;¹⁶¹ more efficient price discrimination;¹⁶² increased trading volume on Phlx;¹⁶³ and, in principle, a potential increase in total options exchange industry volume.¹⁶⁴ The Commission notes that these efficiency gains, if realized, could potentially promote capital formation.

Additionally, commenters assert that the Proposal would lead to adverse effects on competition by placing burdens on competing exchanges¹⁶⁵ that may face loss of business to Phlx and on competing market participants that are not entitled to the proposed rebate.¹⁶⁶ Phlx contends that the Proposal would have a beneficial effect on competition by providing competitors with incentives to match the proposed rebate – by developing their own pricing strategies or increasing the quality of their execution services, thereby creating a more efficient, less costly national market system.¹⁶⁷ Phlx anticipates such enhanced competition, with or without the launch of new exchanges, while a commenter asserts that barriers to the creation of new exchanges could affect the competitive response and that the Proposal will lead to the inefficient proliferation of new exchanges.¹⁶⁸

¹⁶¹ See Willig and Bamberger Reply, supra note 13, at 4.

¹⁶² See Willig and Bamberger Statement, supra note 8, at 15-20; Willig and Bamberger Reply, supra note 13, at 4.

¹⁶³ See Willig and Bamberger Statement, supra note 8, at 26; and Phlx Response Letter IV, supra note 13, at 2.

¹⁶⁴ See Phlx Response Letter II, supra note 10, at 7.

¹⁶⁵ See ISE Letter III, supra note 11, at 3, MIAX Letter, supra note 7, at 3; and CBOE Letter, supra note 7, at 4.

¹⁶⁶ See CBOE Letter, supra note 7, at 4; MIAX Letter, supra note 7, at 3..

¹⁶⁷ See Phlx Response Letter, supra note 8, at 2.

¹⁶⁸ See ISE Letter III, supra note 11, at 3, 8-9.

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.

V. Conclusion

For the foregoing reasons, the Commission does not find that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Sections 6(b)(4) and 6(b)(5) of the Act.

IT IS THEREFORE ORDERED, pursuant to section 19(b)(2) of the Act, that the proposed rule change (SR-Phlx-2013-113) be, and hereby is, disapproved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁶⁹

Kevin M. O'Neill
Deputy Secretary

¹⁶⁹ 17 CFR 200.30-3(a)(12).