

August 4, 2014

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Notice of Filing of Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1, Related to the Priority Afforded to In-Crowd Participants Respecting Crossing, Facilitation, and Solicited Orders in Open Outcry Trading

I. Introduction

On April 23, 2014, NASDAQ OMX PHLX LLC (“Exchange” or “Phlx”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to revise the priority afforded to in-crowd participants respecting crossing, facilitation, and solicited orders in open outcry trading (“Proposal”). The proposed rule change was published for comment in the Federal Register on May 13, 2014.<sup>3</sup> On June 23, 2014, the Commission extended the time period in which to either approve the Proposal, disapprove the Proposal, or institute proceedings to determine whether to approve or disapprove the Proposal to August 11, 2014.<sup>4</sup> The Commission received two comment letters from one commenter regarding the Proposal<sup>5</sup> and one response letter from Phlx.<sup>6</sup> On July 30, 2014, the Exchange filed Amendment

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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. 72119 (May 7, 2014), 79 FR 27351 (“Notice”).

<sup>4</sup> See Securities Exchange Act Release No. 72447 (June 23, 2014), 79 FR 36569 (June 27, 2014).

<sup>5</sup> See Letter from Michael J. Simon, Secretary and General Counsel, International Securities Exchange, LLC, dated June 3, 2014 (“ISE Letter I”); Letter from Michael J. Simon, Secretary and General Counsel, International Securities Exchange, LLC, dated July 8, 2014 (“ISE Letter II”).

<sup>6</sup> See Letter from Carla Behnfeldt, Associate General Counsel, The NASDAQ OMX Group, Inc., dated June 20, 2014 (“Phlx Response Letter”).

No. 1 to the Proposal.<sup>7</sup> The Commission is publishing this notice and order to solicit comments on the Proposal, as modified by Amendment No. 1, from interested persons and to institute proceedings under Section 19(b)(2)(B) of the Act<sup>8</sup> to determine whether to approve or disapprove the Proposal, as modified by Amendment No. 1.

## II. Description of the Proposal

The Exchange proposes to amend Phlx Rule 1014, Commentary .05(c)(ii), to afford priority in open outcry trading to in-crowd participants over out-of-crowd Streaming Quote Traders (“SQTs”)<sup>9</sup>, Remote Specialists<sup>10</sup>, and Remote Streaming Quote Traders (“RSQTs”)<sup>11</sup>

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<sup>7</sup> In Amendment No. 1, the Exchange clarifies a reference to a previous Phlx filing and an example. Amendment No. 1 has been placed in the public comment file for SR-Phlx-2014-23 at <http://www.sec.gov/comments/sr-phlx-2014-23/phlx201423.shtml> (see letter from Carla Behnfeldt, Associate General Counsel, The NASDAQ OMX Group, Inc., to Secretary, Commission, dated July 30, 2014) and also is available on the Exchange’s website at [http://nasdaqomxphlx.cchwallstreet.com/NASDAQOMXPHLX/pdf/phlx-filings/2014/SR-Phlx-2014-23\\_Amendment\\_1.pdf](http://nasdaqomxphlx.cchwallstreet.com/NASDAQOMXPHLX/pdf/phlx-filings/2014/SR-Phlx-2014-23_Amendment_1.pdf).

<sup>8</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>9</sup> An SQT is defined in Exchange Rule 1014(b)(ii)(A) as a Registered Options Trader (“ROT”) who has received permission from the Exchange to generate and submit option quotations electronically in options to which such SQT is assigned. Types of ROTs include SQTs, RSQTs and non-SQTs, which by definition are neither SQTs nor RSQTs. A Registered Options Trader is defined in Exchange Rule 1014(b)(i) as a regular member of the Exchange located on the trading floor who has received permission from the Exchange to trade in options for his own account. See Phlx Rules 1014(b)(i) and (ii).

<sup>10</sup> A Remote Specialist is a qualified RSQT approved by the Exchange to function as a specialist in one or more options if the Exchange determines that it cannot allocate such options to a floor based specialist. A Remote Specialist has all the rights and obligations of a specialist, unless Exchange rules provide otherwise. See Phlx Rules 501 and 1020.

<sup>11</sup> A RSQT is defined in Exchange Rule 1014(b)(ii)(B) as an ROT that is a member affiliated with a Remote Streaming Quote Trader Organization (“RSQTO”) with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically in options to which such RSQT has been assigned. A qualified RSQT may function as a Remote Specialist upon Exchange approval. An RSQT may only submit such quotations electronically from off the floor of the Exchange. An RSQT may not submit option quotations in eligible options to which such RSQT is assigned to the extent that the RSQT is also approved as a Remote Specialist in the same options. An RSQT may only trade in a market making capacity in

and over out-of-crowd broker-dealer limit orders on the limit order book (but not over public customer orders) in crossing<sup>12</sup>, facilitation<sup>13</sup>, and solicited<sup>14</sup> orders, regardless of order size.

Currently, Commentary .05(c)(i) to Phlx Rule 1014 provides that, in the event that a Floor Broker<sup>15</sup> or specialist<sup>16</sup> presents a non-electronic order in which an RSQT is assigned or which is allocated to a Remote Specialist, and/or in which an SQT assigned in such option is not a crowd participant (collectively, “Non-Crowd Participants”), such Non-Crowd Participant may not participate in trades stemming from such a non-electronic order unless the non-electronic order is executed at the price quoted by the Non-Crowd Participant at the time of execution. If the non-electronic order is executed at the price quoted by the Non-Crowd Participant, the Non-Crowd Participant may participate in the trade unless the order was a crossing, facilitation, or

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classes of options in which he is assigned or approved as a Remote Specialist. An RSQTO is a member organization in good standing that satisfies the RSQTO readiness requirements in Phlx Rule 507(a)(i).

<sup>12</sup> A crossing order occurs when an options Floor Broker holds orders (except for floor qualified contingent cross orders, as defined in Exchange Rule 1064(e)) to buy and sell the same option series. Such a Floor Broker may cross such orders, provided that the trading crowd is given an opportunity to bid and offer for such option series in accordance with Exchange rules. See Phlx Rule 1064(a).

<sup>13</sup> A facilitation order occurs when an options Floor Broker holds an options order (except for floor qualified contingent cross orders, as defined in Exchange Rule 1064(e)) for a public customer and a contra-side order. Such a Floor Broker may execute such orders as a facilitation order, provided that such Floor Broker proceeds in accordance with Exchange rules concerning facilitation orders. See Phlx Rule 1064(b).

<sup>14</sup> A solicitation occurs whenever an order (except for floor qualified contingent cross orders, as defined in Exchange Rule 1064(e)), other than a cross, is presented for execution in the trading crowd resulting from an away-from-the-crowd expression of interests to trade by one broker dealer to another. See Phlx Rule 1064(c).

<sup>15</sup> A “Floor Broker” is an individual who is registered with the Exchange for the purpose, while on the Exchange’s options floor, of accepting and handling options orders received from members and member organizations. See Phlx Rule 1060.

<sup>16</sup> A “Specialist” is an Exchange member who is registered as an options specialist pursuant to Rule 1020(a).

solicited order with a size of at least 500 contracts on each side.<sup>17</sup> If the order is a crossing, facilitation, or solicited order with a size of at least 500 contracts on each side, Commentary .05(c)(ii) gives priority to in-crowd participants (including, for purposes of Commentary .05(c)(ii) only, Floor Brokers) over Non-Crowd Participants and over out-of-crowd broker-dealer limit orders on the limit order book, but not over public customer orders.<sup>18</sup>

The Exchange proposes to eliminate the 500 contract minimum order size from Phlx Rule 1014, Commentary .05(c)(ii). As amended, the rule would afford priority to in-crowd participants over Non-Crowd Participants and out-of-crowd broker-dealer limit orders in crossing, facilitation, and solicited orders regardless of the size of those orders. The Exchange states that it initially permitted Non-Crowd Participants to participate in Floor Broker crosses to foster electronic options trading.<sup>19</sup> In 2006, the Exchange adopted the size requirement, which continued to permit Non-Crowd Participants to participate in smaller (under five hundred contracts) Floor Broker crosses.<sup>20</sup> According to the Exchange, electronic options trading is well-established and there is no longer a need for such special rules and incentives to develop electronic trading further.<sup>21</sup> The Exchange notes that another options exchange does not have the

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<sup>17</sup> This in-crowd priority applies only to crossing, facilitation, and solicited orders represented in open outcry, and does not apply to orders submitted electronically via the Exchange's electronic options trading platform, to which other priority rules apply. See, e.g., Phlx Rules 1014(g)(vii) and (viii).

<sup>18</sup> According to the Exchange, public customer limit orders represented in the trading crowd and resting on the limit order book have, and will continue to have, priority over all other participants and accordingly must be executed up to the aggregate size of such orders before any in-crowd participant is entitled to priority. Public customer orders on the limit order book that are eligible for execution are required to be executed before a Floor Broker may execute its order in the crowd and/or with a contra-side order it holds. See Phlx Rule 1014, Commentary .05(c)(ii).

<sup>19</sup> See Amendment No. 1, supra note 7.

<sup>20</sup> See Notice, 79 FR at 27352. See also Amendment No. 1, supra note 7.

<sup>21</sup> See Notice, 79 FR at 27352. See also Amendment No. 1, supra note 7.

same differentiation of priority for orders of fewer than 500 contracts.<sup>22</sup> The Exchange believes that its Proposal will encourage order flow providers to send additional crossing, facilitation, and solicited orders to the Exchange without concern that the order may not be completely executed by the trading crowd.<sup>23</sup> The Exchange also believes that affording priority to in-crowd participants regardless of size will attract additional smaller cross orders to the Exchange and allow in-crowd market makers to compete for smaller orders.<sup>24</sup>

### III. Comment Letters and Phlx's Response

As noted above, the Commission received two comment letters from one commenter<sup>25</sup> and one response letter from Phlx.<sup>26</sup>

In its first letter, the commenter opposes the Proposal and requests that the Commission institute proceedings to disapprove the Proposal. The commenter argues that the Proposal unfairly denies electronic participants the ability to participate in the execution of open outcry orders along with in-crowd participants at the same price.<sup>27</sup> The commenter states its view that the Exchange has not provided sufficient justification for allocating smaller trades negotiated on its floor to counterparties in the trading crowd ahead of same-priced orders from electronic participants.<sup>28</sup> The commenter believes that the Proposal will encourage Phlx participants to bring more orders to the floor, where they may receive a higher trade allocation and may be able

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<sup>22</sup> See Notice, 79 FR at 27352-53. See also Chicago Board Options Exchange (“CBOE”) Rule 6.74, Crossing Orders.

<sup>23</sup> See Notice, 79 FR at 27353.

<sup>24</sup> See Notice, 79 FR at 27353-54.

<sup>25</sup> See supra note 5.

<sup>26</sup> See supra note 6.

<sup>27</sup> See ISE Letter I.

<sup>28</sup> See ISE Letter I.

to internalize a trade, instead of executing those orders through electronic auction systems.<sup>29</sup> The commenter argues that, even with the current 500 contract minimum, Phlx's priority rules disadvantage orders being internalized to the benefit of the internalizing brokers, as these orders receive relatively little price competition.<sup>30</sup> The commenter suggests that giving priority to small orders on the floor will further skew participants' incentives to bring orders to the floor to achieve a frictionless "clean cross" and deprive customers of vigorous competition for these orders.<sup>31</sup> The commenter states that most electronic auctions require that orders be exposed to all other participants trading on the exchange, and orders that are not exposed, such as qualified contingent crosses, are required to be for a large size.<sup>32</sup>

The commenter also argues that, because no trade information is disseminated about orders executed on the floor to electronic participants, who may be willing to provide liquidity to orders executed on the Exchange floor, such orders will not benefit from potential price improvement built into electronic auctions.<sup>33</sup> The commenter believes that the Proposal will largely limit price competition for small orders to participants physically present in the crowd at the time a floor cross is announced and transacted.<sup>34</sup> The commenter further argues that the Proposal would ignore electronic orders and quotes, especially for small orders, and cause more

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<sup>29</sup> See ISE Letter I.

<sup>30</sup> See ISE Letter I at 1-2.

<sup>31</sup> See ISE Letter I at 2.

<sup>32</sup> See ISE Letter I at 2.

<sup>33</sup> See ISE Letter I at 2.

<sup>34</sup> See ISE Letter I at 2.

orders to be crossed at prices that have not been sufficiently vetted by the participants most likely to offer price improvement.<sup>35</sup>

In response to the commenter's concerns regarding in-crowd liquidity, Phlx states that on-floor liquidity on Phlx in many issues exceeds the displayed wider electronic markets.<sup>36</sup> Phlx argues that the Proposal merely removes the 500 contract minimum and that another options exchange does not have the same differentiation of priority for orders of fewer than 500 contracts.<sup>37</sup> Phlx believes that attracting smaller orders to the trading floor fosters an environment for on-floor liquidity providers to continue to provide price improvement and size improvement.<sup>38</sup> In response to the commenter's suggestion that the Proposal will facilitate internalization, Phlx states that priority will be afforded to all in-crowd participants, including market makers, not just floor brokers.<sup>39</sup> Phlx also believes that the Proposal should encourage small participants, such as floor-based market makers, to continue to make markets, which Phlx believes will improve the quality of execution for these smaller orders.<sup>40</sup>

In its second letter, the commenter replies to the Phlx Response Letter and reiterates its request that the Commission institute proceedings to disapprove the Proposal. In response to Phlx's statement that, based on Phlx's experience, on-floor liquidity on Phlx in many issues exceeds the displayed wider electronic markets,<sup>41</sup> the commenter requests that the Commission

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<sup>35</sup> See ISE Letter I at 2. The commenter expressed its view that it is inappropriate to ignore electronic quotes, especially for smaller orders where substantial capital commitment or efforts to find liquidity are not necessary. See id.

<sup>36</sup> See Phlx Response Letter.

<sup>37</sup> See Phlx Response Letter (citing CBOE Rule 6.74, Crossing Orders).

<sup>38</sup> See Phlx Response Letter at 2.

<sup>39</sup> See Phlx Response Letter at 2.

<sup>40</sup> See Phlx Response Letter at 2.

<sup>41</sup> See Phlx Response Letter.

require Phlx to provide data that would allow the Commission to gauge the level of participation of floor-based market makers against orders represented in open outcry, and price improvement provided by these participants.<sup>42</sup> The commenter questions whether Phlx needs to afford priority to in-crowd liquidity providers if they are offering active price improvement.<sup>43</sup> The commenter states its view that to the extent that in-crowd participants provide price improvement to orders represented in open outcry, their orders are already entitled to priority over other orders at a worse price, including electronic quotes.<sup>44</sup> The commenter asserts that the Proposal is intended to allow in-crowd participants to internalize orders without being subject to competition from active liquidity providers in the electronic markets.<sup>45</sup> The commenter argues that Phlx's reliance on the CBOE rule is irrelevant as the Phlx Proposal must stand on its own, and, in any event, believes that the in-crowd priority rules of Phlx and CBOE are not in the public interest.<sup>46</sup> The commenter argues that the proposed expansion of these rules would only foster internalization and curtail price improvement.<sup>47</sup>

IV. Proceedings to Determine Whether to Disapprove SR-Phlx-2014-23 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>48</sup> to determine whether the proposed rule change should be approved or disapproved.<sup>49</sup> Institution of

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<sup>42</sup> See ISE Letter II.

<sup>43</sup> See ISE Letter II.

<sup>44</sup> See ISE Letter II at 1-2.

<sup>45</sup> See ISE Letter II at 2.

<sup>46</sup> See ISE Letter II at 2.

<sup>47</sup> See ISE Letter II at 2.

<sup>48</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>49</sup> Section 19(b)(2)(B) of the Act provides that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. The time for conclusion



such proceedings is appropriate at this time in view of the legal and policy issues that are raised by the Proposal and are discussed below. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail below, the Commission seeks and encourages interested persons to comment on the Proposal, as modified by Amendment No. 1, and to provide the Commission with additional comment to inform the Commission's analysis whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.

Pursuant to Section 19(b)(2)(B) of the Act, the Commission is providing notice of the grounds for disapproval under consideration. In particular, Section 6(b)(5) of the Act<sup>50</sup> requires that the rules of an exchange be designed, among other things, to prevent fraudulent and manipulative acts and practices, 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 are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. In addition, Section 6(b)(8) of the Act<sup>51</sup> requires that rules of an exchange do not impose any burden on competition not necessary or appropriate in furtherance of the Act.

As discussed above, the Proposal, as modified by Amendment No. 1, would afford priority to in-crowd participants over Non-Crowd Participants and out-of-crowd broker-dealer limit orders on the limit order book in crossing, facilitation, and solicited orders regardless of order size. The Exchange's current rule affords priority to in-crowd participants over Non-

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of the proceedings may be extended for up to an additional 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding or if the self-regulatory organization consents to the extension.

<sup>50</sup> 15 U.S.C. 78f(b)(5).

<sup>51</sup> 15 U.S.C. 78f(b)(8).

Crowd Participants and out-of-crowd broker-dealer limit orders on the limit order book in crossing, facilitation, and solicited orders with a size of at least 500 contracts on each side. As noted above, the commenter opposing the Proposal raises concerns, among other things, as to whether the Proposal unfairly denies electronic participants the ability to participate in the execution of open outcry orders along with in-crowd participants at the same price. The commenter further believes that the Proposal will encourage Phlx participants to send orders to the floor where the Phlx participant may receive a higher trade allocation and be able to internalize the trade – rather than executing the order in the electronic market where the customer order may be subject to more intense price competition. The commenter further stated its belief that insulating small order customers brought to the floor from competition by electronic participants may cause more orders to be crossed at prices that have not been sufficiently vetted by the participants most likely to offer price improvement.<sup>52</sup> This commenter believes that Phlx has provided insufficient justification for allocating smaller trades negotiated on its floor to counterparties in the trading crowd ahead of same-priced orders from electronic participants.<sup>53</sup>

The Commission believes that questions are raised as to whether the Proposal, as modified by Amendment No. 1, is consistent with: (1) the requirements of Section 6(b)(5) of the Act, including whether the Exchange’s proposed revisions to its rules regarding the order of priority in open outcry are designed to prevent fraudulent and manipulative acts and practices, 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 are not designed to permit unfair discrimination between

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<sup>52</sup> See ISE Letter I. See also ISE Letter II.

<sup>53</sup> See ISE Letter I.

customers, issuers, brokers, or dealers; and (2) the requirements of Section 6(b)(8) of the Act, including whether the Exchange's proposed revisions to its rules regarding the order or priority in open outcry impose any unnecessary or inappropriate burden on competition. The Commission believes that the issues raised by the Proposal can benefit from additional consideration and evaluation.

V. Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the concerns identified above, as well as any others they may have with the Proposal, as modified by Amendment No. 1. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change, as modified by Amendment No. 1, is inconsistent with Sections 6(b)(5) and 6(b)(8) or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.<sup>54</sup>

Interested persons are invited to submit written views, data, and arguments concerning Amendment No. 1 and regarding whether the proposed rule change, as modified by Amendment No. 1, should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file

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<sup>54</sup> Section 19(b) (2) of the Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 30 (1975).

that rebuttal by [insert date 35 days from publication in the Federal Register]. 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-2014-23 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-Phlx-2014-23. 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

publicly available. All submissions should refer to File Number SR-Phlx-2014-23 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. If comments are received, any rebuttal comments should be submitted by [insert date 35 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>55</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>55</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(57).