

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-83826; File No. SR-Phlx-2018-55)

August 10, 2018

Self-Regulatory Organizations; Nasdaq PHLX LLC; Notice of Filing of Proposed Rule Change Relating to Anticipatory Hedging

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 3, 2018, Nasdaq PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III, below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to amend Rule 1064(d) related to Anticipatory Hedging.

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

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

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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

1. Purpose

The Exchange proposes to amend Rule 1064 entitled "Crossing, Facilitation and Solicited Orders." Specifically, the Exchange proposes to amend 1064(d)(iii)(A) to add a specific eligibility size when transacting options on the Nasdaq 100® Index including options with nonstandard expiration dates³ ("NDX" and "NDXP"). The Exchange also proposes to amend an incorrect cross-reference to Rule 1064 and replace certain references with a defined term.

Rule 1064(d) describes rules for anticipatory hedging on Phlx. The rule provides:

'no member organization or person associated with a member or member organization who has knowledge of the material terms and conditions of a solicited order, an order being facilitated, or orders being crossed, the execution of which are imminent, shall enter, based on such knowledge, an order to buy or sell an option for the same underlying security; an order to buy or sell the security underlying such class; or an order to buy or sell any related instrument until (i) or (ii) occur: (i) the terms and conditions of the order and any changes in the terms of the order of which the member, member organization or person associated with a member or member organization has knowledge are disclosed to the trading crowd, or (ii) the trade can no longer reasonably be considered imminent in view of the passage of time since the order was received. For purposes of this Rule, an order to buy or sell a "related instrument" means, in reference to an index option, an order to buy or sell securities comprising 10% or more of the component securities in the index or an order to buy or sell a futures contract on an economically equivalent index.'

Among other conditions, Rule 1064(d)(iii) provides that it does not prohibit a member or member organization from buying or selling a stock, security futures or futures position following receipt of an option order, including a complex order, but prior to announcing such order to the trading crowd, provided that the option order is in a class designated as eligible for

³ NDX represents A.M.-settled options on the Nasdaq 100® Index. NDXP represent P.M.-settled options on the Nasdaq 100® Index.

“tied hedge” transactions⁴ as determined by the Exchange and is within the designated tied hedge eligibility size parameters, which parameters shall be determined by the Exchange and may not be smaller than 500 contracts per order (there shall be no aggregation of multiple orders to satisfy the size parameter).

When Phlx originally adopted the anticipatory hedge rule in 2001,⁵ the Exchange believed that the prohibition on anticipatory hedging was necessary to prevent members and associated persons from using undisclosed non-public information about imminent solicited option transactions to trade the relevant option or any closely-related instrument in advance of persons represented in the relevant options crowd. The Exchange notes that the tied-hedge exception was designed to preserve the right to cross orders in advance of submitting a proposal to the trading crowd, while at the same time assuring that orders that are the subject of crossing are exposed to the auction market (trading crowd) in a meaningful way by prohibiting behavior such as anticipatory hedging.⁶

The Exchange notes that the primary purpose of the provision, “not smaller than 500 contracts” is to limit use of the tied hedge procedures to larger orders that might benefit from a member’s or member organization’s ability to execute a facilitating hedge.⁷ When adopting the tied hedge exception the Exchange stated that it believes that, given the decreased amount of liquidity available at the NBBO, the frequency with which quotes may flicker, and differing costs associated with accessing liquidity on various markets, as well as for ease of

⁴ A tied hedge transaction is described in Rule 1064(d)(iii)(C)-(H).

⁵ See Securities Exchange Act Release No. 44740 (August 23, 2001), 66 FR 45721 (August 29, 2001) (SR-Phlx-2001-61).

⁶ See Securities Exchange Act Release No. 61066 (November 25, 2009), 74 FR 63162 (December 2, 2009) (SR-Phlx-2009-98).

⁷ Id.

administration, the proposed 500 contract minimum should be sufficient to address these considerations.⁸

The Exchange is proposing to add an exception to the eligibility size parameters for options on the Nasdaq 100® Index including options with nonstandard expiration dates (“NDX” and “NDXP”) which lowers the size eligibility for this index to not smaller than 50 contracts per order. The Exchange believes that this smaller order eligibility size is appropriate for NDX and NDXP because the index value for NDX and NDXP is high as compared to other securities instruments. An index has a multiplier of 100. The Exchange believes that lowering the eligibility size for NDX and NDXP from 500 to 50 contracts is appropriate because it would reduce the minimal notional value of the trade.

For example NDX, as of July 19, 2018, had an Index Level of 7,356 and factoring in the contract multiplier of 100 provides a notional value of \$735,600 as compared to PowerShares QQQ (“QQQ”) which had an equity value of 179.03 with a notional value of \$17,903 (100 x underlying value) as of July 19, 2018. The premium value of NDX front month, at-the-money calls for August 17th midpoint was \$130.35. Utilizing this value with 500 contracts would equate to a total premium for NDX of \$6,517,500 and utilizing this value with 50 contracts would equate to a total premium for NDX of \$651,750. By comparison, the premium value of QQQ front month, at-the-money calls for August 17th midpoint was \$3.43. Utilizing this value with 500 contracts would equate to a total premium for QQQ of \$171,500 and utilizing this value with 50 contracts would equate to a total premium for QQQ of \$17,150. The example demonstrates the much larger size of NDX as compared to QQQ, a highly liquidity equity option. This

⁸ Id.

example reflects the size comparison against a large broad based index and demonstrates the size of NDX.

The Exchange notes that this smaller size carve out for NDX is in line with the original intent of the selection of the size of the contracts, to limit use of the tied hedge procedures to larger orders that might benefit from a member's or member organization's ability to execute a facilitating hedge. The Exchange notes that a size of 50 contracts for NDX is still considered a large size order given the higher notional value.

The Exchange notes that it conducts certain surveillances in connection with anticipatory hedging. Specifically, the Exchange conducts an on-floor surveillance to ensure both the stock and option component parts of the trade were exposed in open outcry and there was a reasonable opportunity for the trading crowd to participate in the transaction. Further, post-trade surveillance is conducted with respect to anticipatory hedging rules. The Exchange notes that pursuant to Phlx Rule 1064(d)(iii)(G), prior to entering tied hedge orders on behalf of customers, the member or member organization must deliver to the customer a written notification informing the customer that his order may be executed using the Exchange's tied hedge procedures. The written notification must disclose the terms and conditions contained herein and be in a form approved by the Exchange. The Exchange notes that tied hedge transactions does not occur with great frequency on the Exchange's trading floor.

Amend Cross Reference and Define Term

The Exchange proposes to amend Rule 1066(f)(4) entitled "Tied Hedge Order." Currently, the rule provides that a tied hedge order is an option order that is tied to a hedge transaction as defined in Commentary .04 to Rule 1064, following the receipt of an option order in a class determined by the Exchange as eligible for "tied hedge" transactions. The Exchange

proposes to replace Commentary .04 to Rule 1064 within Rule 1066(f)(4) to reference Rule 1064(d)(iii) to correct the cross-reference.

The Exchange also proposes to replace legacy references to the Exchange's trading platform in Rule 1066, namely "PHLX XL" and "PHLX XL II" with the term "System" which was recently defined by the Exchange.⁹

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act,¹⁰ in general, and furthers the objectives of Section 6(b)(5) of the Act,¹¹ in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general to protect investors and the public interest, by changing the size requirements to assist NDX and NDXP to meet the eligibility requirements for Rule 1064(d).

The Exchange's proposed amendment to Rule 1064(d) to permit lower size eligibility requirements for NDX and NDXP of not smaller than 50 contracts per order is consistent with the Act and the protection of investors and the public interest because this smaller order eligibility size is appropriate for NDX and NDXP. NDX is a broad based index that is designed to reflect the movement of a large segment of the market. Each of these options represents a notional value equal to 100 units of the index. NDX is a large-cap growth index with 105 components. As with other broad based indexes, NDX has a large notional value as compared to non-index options. The index value for NDX and NDXP is 6400. Based on the index multiplier of 100, an index option would equate to 640,000 in notional value, which is high. The Exchange

⁹ System is defined in Phlx Rule 1000(b)(45).

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

believes that lowering the eligibility size for NDX and NDXP from 500 to 50 contracts is appropriate because it would reduce the notional value of one contract to 64,000 in notional value. The proposed rule would permit an eligibility size for NDX and NDXP that takes into account the notional value for this index. The Exchange believes that permitting the lower eligibility size for NDX and NDXP does not substantively amend the eligible order size, rather it provides a more appropriate mathematical equivalent.

The Exchange notes that this smaller size carve out for NDX is in line with the original intent of the selection of the size of the contracts, to limit use of the tied hedge procedures to larger orders that might benefit from a member's or member organization's ability to execute a facilitating hedge. The Exchange notes that a size of 50 contracts for NDX is still considered a large size order and in fact, in the case of NDX, a larger size than 500 contracts for an option contract.

Amend Cross Reference and Define Term

The Exchange's proposal to replace Commentary .04 to Rule 1064 with Rule 1064(d)(iii) to correct the cross-reference and replace "PHLX XL" and "PHLX XL II" with the term "System" are consistent with the Act because they will provide more clarity as to the Exchange's Rules. The Exchange also proposes to replace the words "PHLX XL" in the title of Phlx Rule 1066 with the newly defined term System. The term PHLX XL is the name of the Exchange's trading platform. The term "System" is intended to define the electronic trading platform.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The Exchange believes that the proposed amendment to Rule 1064(d) to permit lower size eligibility

requirements for NDX and NDXP will apply uniformly to all market participants. The Exchange notes that this smaller size carve out for NDX is in line with the original intent of the selection of the size of the contracts, to limit use of the tied hedge procedures to larger orders that might benefit from a member's or member organization's ability to execute a facilitating hedge. The Exchange's proposal to replace Commentary .04 to Rule 1064 with Rule 1064(d)(iii) to correct the cross-reference and replace "PHLX XL" and "PHLX XL II" with the term "System" are non-substantive rule changes. The Exchange does not believe that this will impact inter-market competition because the smaller eligibility size will permit NDX and NDXP to be available to market participants for a tied hedge similar to other competing index options.

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

No written comments were either solicited or received.

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

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

IV. Solicitation of Comments

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2018-55 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-2018-55. 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 Web site (<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 the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change.

Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to

make available publicly. All submissions should refer to File Number SR-Phlx-2018-55 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹²

Robert W. Errett
Deputy Secretary

¹² 17 CFR 200.30-3(a)(12).