

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-68202; File Nos. SR-Phlx-2012-27; SR-Phlx-2012-54)

November 9, 2012

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Notice of Filing of Amendments No. 1, and Order Granting Accelerated Approval for Proposed Rule Changes as Modified by Amendments No. 1 Relating to Complex Order Fees and Rebates for Adding and Removing Liquidity in Select Symbols

I. Introduction

On March 1, 2012 and April 23, 2012, NASDAQ OMX PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> two proposed rule changes relating to the transaction fees for certain complex order (“Complex Order”) transactions.<sup>3</sup> The notice of filing of Phlx-2012-27 was published for comment in the Federal Register on March 15, 2012,<sup>4</sup> and the notice of filing of Phlx-2012-54 was published for comment in the Federal Register on May 4, 2012.<sup>5</sup>

On April 30, 2012, the Commission suspended the proposals and instituted proceedings

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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> A Complex Order is any order involving the simultaneous purchase and/or sale of two or more different options series in the same underlying security, priced at a net debit or credit based on the relative prices of the individual components, for the same account, for the purpose of executing a particular investment strategy. A Complex Order may also be a stock-option order, which is an order to buy or sell a stated number of units of an underlying stock or exchange-traded fund (“ETF”) coupled with the purchase or sale of options contract(s). See Exchange Rule 1080, Commentary .08(a)(i).

<sup>4</sup> See Securities Exchange Act Release No. 66551 (March 9, 2012), 77 FR 15400 (SR-Phlx-2012-27) (“Notice I”).

<sup>5</sup> See Securities Exchange Act Release No. 66883 (April 30, 2012), 77 FR 26591 (SR-Phlx-2012-54) (“Notice II”).

to determine whether to approve or disapprove the proposals.<sup>6</sup> Following the institution of the proceedings, the Commission received a letter from the Exchange in support of its proposals.<sup>7</sup> On September 11, 2012, the Commission issued a notice of designation of a longer period for Commission action on the proceedings to determine whether to disapprove the proposed rule changes.<sup>8</sup> On October 24, 2012, the Exchange filed Amendment No. 1 to each of the proposed rule changes. In the amendments, the Exchange proposed to put certain of the fees (for Complex Order executions by Directed Participants<sup>9</sup> and Market Makers)<sup>10</sup> on a one-year pilot program, and stated that the proposed fees would be operative on December 3, 2012. The Exchange committed to provide publicly available data and data analyses of those fees to the Commission during the pilot.<sup>11</sup> The Exchange also represented that, prior to and at the time of a complex order transaction, Market Makers, including Directed Participants, are unaware of the identity of the contra-party to the transaction. The Exchange stated that Rule 707 is intended to prohibit

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<sup>6</sup> See Securities Exchange Act Release No. 66884 (April 30, 2012), 77 FR 26595 (May 4, 2012) (“Order Instituting Proceedings”). The Order Instituting Proceedings suspended the fees adopted in SR-Phlx-2012-27 and SR-Phlx-2012-54. Consequently, these fees were in effect for only two months, from March 1, 2012 to April 30, 2012.

<sup>7</sup> See Letter from Joan C. Conley, Senior Vice President and Corporate Secretary, Nasdaq OMX, to Elizabeth M. Murphy, Secretary, Commission, dated July 26, 2012 (“Response”).

<sup>8</sup> See Securities Exchange Act Release No. 67825 (September 11, 2012), 77 FR 57168 (September 17, 2012).

<sup>9</sup> The term “Directed Participant” applies to transactions for the account of a Specialist, Streaming Quote Trader (“SQT”) or Remote Streaming Quote Trader (“RSQT”) resulting from a Customer order that is (1) directed to the Specialist, SQT or RSQT by an order flow provider, and (2) executed by that Specialist, SQT or RSQT electronically on Phlx XL II. See Phlx Fee Schedule at 3.

<sup>10</sup> A “Market Maker” includes Specialists (see Exchange Rule 1020) and Registered Options Traders (“ROTs”) (see Exchange Rule 1014(b)(i) and (ii), which includes SQTs (see Exchange Rule 1014(b)(ii)(A)) and RSQTs (see Exchange Rule 1014(b)(ii)(B)).

<sup>11</sup> See Amendment No. 1 to SR-Phlx-2012-27 and SR-Phlx-2012-54, filed October 24, 2012.

coordinated actions between Directed Participants and order flow providers (“OFPs”), and that the Exchange proactively conducts surveillance for, and enforces against, such violations.<sup>12</sup>

The Commission received no comment letters on the proposals. This order approves the proposed rule changes, as modified by Amendments No. 1, and approves, as a one-year pilot program, those fees which the Exchange proposes to implement on a pilot basis.

## II. Description of the Proposals

The Exchange’s first proposal amended Complex Order fees and rebates for adding and removing liquidity in its Select Symbols.<sup>13</sup> Specifically, Phlx’s proposal: (1) increased the customer rebate for adding liquidity from \$0.30 per contract to \$0.32 per contract; (2) created a new rebate for removing liquidity of \$0.06 per contract for each contract of liquidity removed by an order designated as a customer Complex Order; (3) amended the fee for removing liquidity for all participants who are assessed such a fee; and (4) created a volume incentive for certain market participants that transact significant volumes of Complex Orders on the Exchange.

Phlx’s proposal to amend the Fee for Removing Liquidity increased the Complex Order Fees for Removing Liquidity for the Directed Participant, Market Maker, Firm, Broker-Dealer, and Professional<sup>14</sup> categories of market participants. The fee for Directed Participant transactions increased from \$0.30 to \$0.32 per contract; the fee for Market Makers increased from \$0.32 to \$0.37 per contract; and the fee for Firms, Broker-Dealers, and Professionals increased from \$0.35 to \$0.38 per contract.

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<sup>12</sup> See Amendment No. 1 to each filing, supra note 11.

<sup>13</sup> The Select Symbols are listed in Section I of the Phlx Fee Schedule.

<sup>14</sup> The term “Professional” means any person or entity that (i) is not a broker or dealer in securities, and (ii) places more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s). See Exchange Rule 1000(b)(14).

The proposal also provided a new volume incentive to Market Makers. The Exchange has four categories of Market Makers – Specialists,<sup>15</sup> ROTs,<sup>16</sup> SQTs<sup>17</sup> and RSQTs<sup>18</sup> – that would all be eligible to receive the volume incentive. Under this proposal, if a Market Maker executes more than 25,000 contracts of Complex Orders each day in a given month, the fees charged for all of that Market Maker’s transactions in Complex Orders that remove liquidity, both as a Directed Participant and as a Market Maker, would be reduced by \$0.01 per contract for that month.

In its second proposal, the Exchange did not propose to amend any of the fees for the Complex Order Directed Participant and Market Maker Fees for Removing Liquidity in Select Symbols. Rather, the Exchange provided further justification for the differential between the fees paid by Directed Participants and Market Makers.

As discussed more fully below, in its proposals and in its subsequent letter in support of its proposals, the Exchange advanced several arguments as to why the proposal to increase the fee for removing liquidity for Complex Orders to \$0.32 per contract for Directed Participants,

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<sup>15</sup> A Specialist is an Exchange member who is registered as an options specialist pursuant to Exchange Rule 1020(a).

<sup>16</sup> A ROT includes a SQT, a RSQT and a Non-SQT ROT, which by definition is neither a SQT nor a RSQT, and therefore cannot generate and submit quotes electronically. A Registered Option Trader is defined in Rule 1014(b) 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 Exchange Rule 1014(b)(i) and (ii).

<sup>17</sup> An SQT is defined in Exchange Rule 1014(b)(ii)(A) as an ROT who has received permission from the Exchange to generate and submit option quotations electronically in options to which such SQT is assigned.

<sup>18</sup> An RSQT is defined Exchange Rule in 1014(b)(ii)(B) as an ROT that is a member or member organization 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. An RSQT may only submit such quotations electronically from off the floor of the Exchange.

and to \$0.37 per contract for non-directed Market Makers, and the corresponding increase in the differential between these two fees from \$0.02 to \$0.05 per contract, was not unreasonable or unfairly discriminatory. First, the Exchange stated that Directed Participants enter into payment for order flow agreements (“PFOF”) with OFPs so that OFPs will direct order flow to them to execute against.<sup>19</sup> According to the Exchange, the reduced fee for Directed Participants recognizes the cost that such Market Makers incur by entering into such PFOF agreements, and the fact that such arrangements bring additional order flow to the Exchange, to the benefit of all Exchange market participants. The Exchange also argued that Directed Participants have higher quoting obligations, and that unlike in the leg markets (i.e., the market for the individual orders that make up a complex order) they do not have a guaranteed allocation for Complex Orders, and that these facts justify the fees. Second, the Exchange stated that the frequency with which Directed Participants execute against orders that are directed to them is such that the effective fee actually paid by such Market Makers is closer to the higher Market Maker rate.<sup>20</sup> Third, the Exchange stated that the proposed increase in the fee differential from \$0.02 to \$0.05 per contract will have a negligible impact on Directed Participants and non-directed Market Makers, given the average level of price improvement for customer Complex Orders. Fourth, the Exchange argued that a higher fee differential currently exists on another options exchange that is directly comparable to the Directed Participant/Market Maker differential at issue here. Finally, the Exchange argued that, given the stated policies of the Commission and applicable

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<sup>19</sup> The PFOF agreements at issue here differ from PFOF fees charged pursuant to Exchange rules, in that the PFOF agreements here were entered into outside of the purview of the Exchange.

<sup>20</sup> A Market Maker that has order flow directed to it will be assessed the lower Directed Participant fee rate only if it actually executes against such order flow; otherwise, it will be assessed the higher Market Maker rate.

case law, the Commission should allow competition to determine whether the fees are fair and reasonable.

In its order suspending the two proposals and instituting proceedings to determine whether to approve or disapprove the proposals, the Commission noted several areas of concern. For example, the Commission questioned whether discrimination on the basis of whether a Market Maker has an off-exchange arrangement to pay an OFP to direct its orders to that Market Maker is a “fair” basis for discrimination among exchange members with respect to the fees charged by the Exchange, and whether a flat \$0.05 fee differential appropriately reflects potential differences that may exist in payment for order flow arrangements between Market Makers and OFPs.<sup>21</sup> The Commission also questioned whether the proposed fees and fee differential would have an impact on competition, especially as between Directed Participants and Market Makers.<sup>22</sup> Finally, the Commission questioned whether the proposed fee changes will affect the quality of execution of customer Complex Orders or broader market quality, and, if so, how and what type of impact will they have.<sup>23</sup>

During the course of the proceedings, the Exchange amended its filings to implement the fee for removing liquidity for Directed Participants and other Market Makers on a one-year pilot basis, and to state that the proposed fees would be operative on December 3, 2012. The Exchange also represented that it would provide the Commission with certain publicly available data and data analyses, on a monthly basis, over the course of the pilot program that would enable the Commission to better evaluate the effects of the fee proposals. As part of the

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<sup>21</sup> See Order Instituting Proceedings, supra note 6, 77 FR at 26598.

<sup>22</sup> Id.

<sup>23</sup> Id.

amendment, the Exchange also represented that, prior to and at the time of a complex order transaction, Market Makers, including Directed Participants, are unaware of the identity of the contra-party to the transaction. The Exchange stated that Rule 707 is intended to prohibit coordinated actions between Directed Participants and OFPs, and that the Exchange proactively conducts surveillance for, and enforces against, such violations.<sup>24</sup>

### III. Discussion and Commission Findings

After careful consideration, and as discussed below, the Commission finds that the proposed rule changes are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission finds that the proposals are consistent with 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;”<sup>25</sup> Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange not be “designed to permit unfair discrimination between customers, issuers, brokers, or dealers;”<sup>26</sup> and 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 purposes of [the Exchange Act].”<sup>27</sup> The Commission has also considered, pursuant to Section 3(f) of the Act, the proposals’ impact on efficiency, competition and capital formation.<sup>28</sup>

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<sup>24</sup> See Amendment No. 1 to each filing, supra note 11.

<sup>25</sup> 15 U.S.C. 78f(b)(4).

<sup>26</sup> 15 U.S.C. 78f(b)(5).

<sup>27</sup> 15 U.S.C. 78f(b)(8).

<sup>28</sup> See 15 U.S.C. 78c(f).

Phlx argues in part that the Commission should rely on competitive forces to determine whether the proposed fees are reasonable and not unfairly discriminatory. Phlx states that competition should determine fee changes, noting that the “Congress directed that exchanges’ fee changes be deemed immediately effective for the expressed purpose of promoting price competition between markets.”<sup>29</sup> In support of this argument, Phlx states that the Commission has “a statutory duty to promote competition, including price competition.”<sup>30</sup> Phlx also notes that the D.C. Circuit Court of Appeals has “blessed” the Commission practice of relying on competitive forces, where possible, to assess the reasonableness of proposed rules,<sup>31</sup> and that intervention here would contravene the Commission’s “stated policy” in this respect.<sup>32</sup>

Phlx represents that the options markets operate in an intensely competitive environment, and that it and the other options exchanges are engaged in an intense competition on price (and other dimensions of competition) to attract order flow from directed and other order flow providers.<sup>33</sup> As an example, the Exchange notes that it and the Nasdaq Options Market (“NOM,” a sister exchange) have modified options trading fees monthly or even bi-monthly to attract new order flow, retain existing order flow, and regain order flow lost to competitor’s price cuts.<sup>34</sup> Phlx further states that price incentives are the essence of competition, in that they encourage market participants to provide attractive offerings to consumers, they benefit market

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<sup>29</sup> See Response, supra note 7, at 12.

<sup>30</sup> Id. at 12.

<sup>31</sup> Id. at 11 (citing NetCoalition v. SEC, 615 F.3d 525 (D.C. Cir. 2010)).

<sup>32</sup> Id. at 10.

<sup>33</sup> Id. at 1, 2, 11.

<sup>34</sup> Id. at 11. The Exchange represents that in 2011 it and NOM filed 71 execution fee changes and all of the options exchanges together filed 173 fee changes (excluding market data, connectivity, colocation, and other fees). Id.

participants who trade on the Exchange, and, in turn, they benefit consumers who enjoy greater price transparency and execution at lower prices.<sup>35</sup>

Phlx asserts that, in vibrant markets such as the options markets, participants who view one pricing scheme as unpalatable are free to move to another market or markets with favorable pricing.<sup>36</sup> Phlx states that, given the competitive nature of the options markets, no one exchange has sufficient market power to “raise prices for competitively-traded options in an unreasonable or unfairly discriminatory manner in violation of the . . . Act.”<sup>37</sup> According to Phlx, it is the member firms that have market power, as these market participants control the order flow that the options markets compete to attract.<sup>38</sup>

The Commission disagrees with the Exchange’s assertion that the existence of competition alone is adequate to determine whether the fees are reasonable, not unfairly discriminatory, and an equitable allocation of fees among members under the Exchange Act. The Commission’s market-based approach to evaluating whether certain market data fees are consistent with the Exchange Act incorporates two parts.<sup>39</sup> First, the Commission examines whether the exchange making the proposal was subject to significant competitive forces in

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<sup>35</sup> Id. at 1-2.

<sup>36</sup> Id. at 12.

<sup>37</sup> Id. at 12.

<sup>38</sup> Id. at 12.

<sup>39</sup> See Securities Exchange Act Release No. 59039 (December 2, 2008), 73 FR 74770 (December 9, 2008) (SR-NYSEArca-2006-21); vacated and remanded, NetCoalition v. SEC, 615 F.3d 525 (D.C. Cir. 2010)). In the NetCoalition decision, the court held that the Commission’s market-based approach to the market data fees in question was consistent with the Exchange Act, but reversed because the Commission had not adequately explained how competition would adequately constrain pricing in the particular case before it and that the record in the case did not contain sufficient evidence to support the Commission’s conclusions.

setting the terms of its proposal, including the level of any fees. If the exchange was 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 terms nevertheless fail to meet an applicable requirement of the Exchange Act or the rules thereunder. The Commission has cited an unfair or unreasonably discriminatory proposal as an example of one such countervailing basis.

Applying this approach to the Exchange's proposal, the Commission finds under the first part of the analysis that the Exchange was subject to significant competitive forces in setting the terms of its proposal. There currently are ten registered national securities exchanges that trade listed options. The Commission has previously found that there is significant competition for order flow in the options markets.<sup>40</sup> The Exchange provided representations and data supporting the existence of intense competition for order flow among the options exchanges. In particular, the Exchange stated that the trading of options is a highly competitive environment, and that the ability to attract order flow is driven largely by price competition.<sup>41</sup> 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.<sup>42</sup> The Exchange produced data showing the market share, based on contract volume, among the options exchanges, which,

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<sup>40</sup> See Securities Exchange Act Release No. 61317 (January 8, 2010), 75 FR 2915 (January 19, 2010) (SR-ISE-2009-103) (finding 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”).

<sup>41</sup> See Response, supra note 7, at 11.

<sup>42</sup> Id. at 12.

as of 2012, ranged from approximately less than 1% to 22% for equity options.<sup>43</sup> Similarly, monthly volume data published by the Options Clearing Corporation indicates that market share for equity options for September 2012 ranged from 0.70% (for NOBO) to 22.97% (for Phlx).<sup>44</sup> Further, six of the ten options exchanges have rules that provide for the trading of complex orders.<sup>45</sup> The Exchange produced data regarding market share among the options exchanges for complex orders on a monthly basis from November 2011 to June 2012. For June 1, 2012, the Exchange stated that the market share for complex orders ranged from 3.39% for NYSE Arca, which had 74,486 complex order trades, to 43.79% for ISE, which had 961,040 complex order trades.<sup>46</sup> Moreover, the volume for complex orders has been increasing over the past few years.<sup>47</sup> Further, the Commission's finding is based on the representation by the Exchange that the fees at issue apply only to the Select Symbols, which are all equity options that are able to be listed and traded on more than one options exchange, and are therefore subject to competition

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<sup>43</sup> See Response, *supra* note 7, at 12.

<sup>44</sup> See Options Clearing Corporation, Options Volume by Exchange, September 2012, at <http://www.optionsclearing.com/webapps/exchange-volume>.

<sup>45</sup> See C2 Rule 6.13; CBOE Rules 6.42, 6.45, 6.53C; ISE Rule 722; NYSE Arca Rules 6.62(e), 6.91; NYSE MKT Rules 900.3NY(e), 963NY, 980NY.

<sup>46</sup> See Phlx Supporting Data, at <http://www.sec.gov/comments/sr-phlx-2012-27/phlx201227-2.pdf>. Similarly, market share for complex orders in November 2011 ranged from 1.64% for C2, which had 33,406 trades, to 39.50% for ISE, which had 804,845 trades. Market share for complex orders in February 2012 ranged from 2.78% for NYSE Arca, which had 69,498 trades, to 37.97% for ISE, which had 950,368 trades.

<sup>47</sup> See Complex Orders Surge, Traders Magazine, March 2012 (noting increase in use of customer orders by customers at one broker-dealer in 2011); *see also* BATS February 2012 Options Market Update, at [http://www.batstrading.com/resources/fee\\_schedule/2012/BATS-February-2012-US-Market-Update.pdf](http://www.batstrading.com/resources/fee_schedule/2012/BATS-February-2012-US-Market-Update.pdf) (noting that more volume is being done through complex strategies, and that volume in the complex order book has increased).

among the market for order flow.<sup>48</sup>

Under the second part of the analysis, the Commission does not at this time find that there is a substantial countervailing basis to find that the terms of the fees and fee differential fail to meet the requirements of the Exchange Act or the rules thereunder. The Commission notes that it received no comments in opposition to the proposed rule changes. The fees for removing liquidity as proposed distinguish between Directed Participants and all other Market Makers (or other members), and would provide the Directed Participants a lower fee than other Market Makers when the Directed Participants interact with order flow that has been directed to them. The Exchange argues in part that Directed Participants that execute against order flow in the complex market that has been directed to them do not have a 40% guaranteed allocation, unlike in the leg market,<sup>49</sup> and that the reduced fee for Directed Participants is an attempt to confer an additional benefit on Directed Participants for the value they provide in bringing order flow to

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<sup>48</sup> See Response, supra note 7, at 11.

<sup>49</sup> See Response, supra note 7, at 17. Orders in the leg market are allocated pursuant to Exchange Rule 1014. Specifically, Directed Orders that are executed electronically are allocated first to customer limit orders resting on the limit order book at the execution price. For orders involving Directed Specialists, the contracts remaining in the Directed Order, if any, shall be allocated automatically as follows: The Directed Specialist shall be allocated a number of contracts that is the greater of: (a) the proportion of the aggregate size at the NBBO associated with such Directed Specialist's quote, SQT and RSQT quotes, and non-SQT ROT limit orders entered on the book at the disseminated price represented by the size of the Directed Specialist's quote; (b) the Enhanced Specialist Participation as described in Rule 1014(g)(ii); or (c) 40% of the remaining contracts. See Exchange Rule 1014(g)(viii).

For orders involving Directed RSQTs or SQTs, the contracts remaining in the Directed Order, if any, shall be allocated automatically as follows: The Directed RSQT or SQT shall be allocated a number of contracts that is the greater of the proportion of the aggregate size at the NBBO associated with such Directed SQT or RSQT's quote, the specialist's quote, other SQT and RSQT quotes, and non-SQT ROT limit orders entered on the book via electronic interface at the disseminated price represented by the size of the Directed RSQT or SQT's quote at the NBBO, or 40% of the remaining contracts. See Exchange Rule 1014(g)(viii).

the Exchange. The Exchange also argues that increased order flow provides better execution quality on the Exchange because customers enjoy greater price transparency and executions at lower prices, and that Market Makers to whom order flow is directed still must compete with other Exchange participants to interact with that order flow to receive the benefits of such arrangements.<sup>50</sup> According to the Exchange, this increased order flow, and corresponding greater execution quality, benefits all market participants.<sup>51</sup>

The Commission has previously approved as consistent with the Act rules of exchanges that provide directed Market Makers a 40% guaranteed allocation when they interact with directed order flow, based upon their status as directed Market Makers.<sup>52</sup> Likewise, pursuant to the proposals at issue here, Directed Participants on Phlx would be charged a lower fee when they interact with order flow directed to them, based on their status as Directed Participants.

When approving the proposals that provided a guaranteed allocation to directed market makers, the Commission found that the guaranteed allocation for directed market makers would not affect the incentives of the trading crowd to compete aggressively for orders based on price.<sup>53</sup> Here, the Commission believes that the potential impact of a guaranteed allocation on competition may be distinguished from the potential impact of the reduced transaction fee on competition. Specifically, the guaranteed allocation does not provide directed market makers an

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<sup>50</sup> See Notice I, supra note 4, at 15404 and Response, supra at note 7, at 2.

<sup>51</sup> See Notice I, supra note 4, at 15404.

<sup>52</sup> See, e.g., Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (order approving SR-Phlx-2004-91). In that order, the Commission noted that the Directed Participant would have to be quoting at the NBBO at the time the directed order was received to capitalize on the guarantee, and that Directed Participants have greater quoting obligations than other Phlx Market Makers that cannot be Phlx Directed Participants. Id.

<sup>53</sup> Id. See also Securities Exchange Act Release No. 34606 (August 26, 1994), 59 FR 45741 (September 2, 1994) (SR-Phlx-94-12) (approving 40% specialist guarantee).

explicit subsidy – in the form of lesser per contract fees – over other market makers that are competing to execute against the same order flow. Rather, the guaranteed allocation scheme allocates portions of orders to other Market Makers who are at the same price as the directed market maker, thus protecting the incentive of other market makers to compete with directed market makers on price. In contrast, assessing a lesser transaction fee on Directed Participants than other Market Makers when the Directed Participants interact with order flow directed to them may allow Directed Participants to execute against Complex Orders at more aggressive prices than other market makers, which may reduce the incentive and ability of such other market makers to compete with Directed Participants on price.

The Commission has carefully considered the potential impact of the fees for removing liquidity on Directed Participants and other Market Makers and the \$0.05 fee differential on competition between Directed Participants and other Market Makers that are competing to execute against the same order flow, and on the extent of price improvement provided to directed customer Complex Orders. The data provided by Phlx does not show any statistical significant adverse impact of the proposed fee and fee differential on the competitiveness of the market for directed customer Complex Orders on Phlx, or the extent of price improvement for directed customer Complex Orders.<sup>54</sup>

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<sup>54</sup> For purposes of studying the competitive impact of the fees for Directed Participants and other Market Makers, Phlx provided data on the rate of interaction with directed customer Complex Orders by both Directed Participants and non-directed Market Makers. This data was provided, on a weekly basis, for the twelve months prior to the time the suspended fees were in effect, in addition to the two months the suspended fees were in place. Phlx also provided data on rates of price improvement for directed customer Complex Orders that received price improvement by both Directed Participants and non-directed markers. This data was provided for the four months prior to the time the suspended fees were in effect, in addition to the two months the suspended fees were in place. Phlx also produced data on the percentage of directed and non-directed customer

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Complex Orders that received price improvement, and the average price improvement for such orders. This data was provided for the four months prior to the time the suspended fees were in effect, in addition to the two months the suspended fees were in place.

With respect to rates of customer Complex Order interaction, for the period prior to the introduction of the new fees (March 2011-February 2012), the average order interaction by Directed Participants was 14.98%. For March and April 2012, when the lower Directed Participant (as compared to the fee assessed to other Market Makers) fee was in effect, the statistics show that order interaction by Directed Participants averaged 14.02% and 15.64%, respectively. These figures reflect the rates of Complex Order interaction as averaged among Directed Participants, i.e., the rate of Complex Order interaction for any given Directed Participant could, in fact, be much higher.

With respect to price improvement data, Phlx produced data for directed customer Complex Orders receiving price improvement, showing the breakdown by contra side participant type, and the average amount of price improvement for such order flow, also by contra side participant type. This data was produced for November 2011 to May 2012, using the week before the standard expirations in each month. The data that has been submitted shows that, for directed customer Complex Orders that received price improvement, Directed Participants interacted with those orders 7.8% of the time, and provided average price improvement of \$7.90 per contract, during the time that the suspended fees were not in effect (November 2011 – February 2012, and May 2012), and 11.8% of the time, with an average price improvement amount of \$4.70 per contract, during the time that the suspended fees were in effect (March – April 2012). For directed customer Complex Orders that received price improvement, other Market Makers interacted with those orders 86.74% during the time that the suspended fees were not in effect (November 2011 – February 2012, and May 2012) and 7.8% of the time during the time that the suspended fees were in effect (March – April 2012), and provided average price improvement of \$6.14 and \$5.15 per contract, respectively, for the same respective time periods.

Phlx also produced data showing the percentage of directed and non-directed customer Complex Orders that received price improvement, and the average amount of price improvement. This data was produced for November 2011 to May 2012, using the week before the standard expirations in each month. The data that has been submitted shows that non-directed customer Complex Orders received price improvement 17.2% of the time while the suspended fees were not in effect (November 2011 – February 2012, and May 2012), with an average price improvement of \$3.29 per contract. During the time the suspended fees were in effect (March – April 2012), non-directed Customer Complex orders received price improvement 13% of the time, with an average price improvement of \$3.39 per contract. Directed customer Complex Orders received price improvement 29.6% of the time while the suspended fees were not in effect (November 2011 – February 2012, and May 2012), with an average price improvement of \$6.26 per contract. During the time the suspended fees were in effect (March – April 2012), directed Customer Complex orders received price improvement 30.5% of the time, with an average price improvement of \$5.10 per contract.

However, the suspended fees that are at issue were only in place for two months and thus were only analyzed over that period.<sup>55</sup> Phlx has filed an amendment to its filing to, among other things, specify that the portion of the proposed rule change relating to execution fees for Complex Orders for Directed Participants and other Market Makers, and the accompanying \$0.05 fee differential, will be operative on a one-year pilot basis, and that such fees will be operative on December 3, 2012. Phlx also has committed to provide the Commission, on a monthly basis, with publicly available data and data analyses studying the impact of the fees for removing liquidity for complex orders for Directed Participants and other Market Makers upon inter and intra-market competition, and upon market quality. The Exchange has represented that it would provide such information as the Commission may request regarding this fee pilot, including information with respect to rates of order interaction by Directed Participants and Market Makers with Customer Complex Orders and rates of price improvement for Complex Orders.

This data and analysis will allow the Exchange and the Commission to further evaluate during the course of the pilot program the impact of the fees for removing liquidity for Directed Participants and other Market Makers and the \$0.05 fee differential on competition between Directed Participants and other Market Makers and the extent of price improvement for Complex Orders over a longer time period with a larger data set.<sup>56</sup> For these reasons, the Commission

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In providing this data, Phlx used a definition of price improvement that compared the execution price with the limit price of the incoming order. In the data to be provided by Phlx as part of the pilot, Phlx will measure price improvement by comparing the Phlx best bid or offer at the time of the incoming order to the execution price of the order.

<sup>55</sup> See supra note 6.

<sup>56</sup> See Securities Exchange Act Release No. 66278 (January 30, 2012), 77 FR 5590 (SR-BX-2011-046) (approving a fee change to the BX Price Improvement Period (“PIP”) upon finding, in part, that the data provided by the exchange did not “suggest any

finds that the proposed rule changes, each as modified by Amendment No. 1, are consistent with the Act. The Commission's finding takes into account that Directed Participants are subject to heightened quoting obligations compared to other Market Makers that are not Directed Participants,<sup>57</sup> and that the fact that whether a customer Complex Order is a directed order or not is not known to any Market Maker, including Directed Participants, prior to execution.<sup>58</sup>

In its original filing, the Exchange also pointed to the existence of non-exchange sponsored PFOF arrangements as a basis for the fees and fee differential. Specifically, Phlx argued that the fee differential is fair, equitable and not unfairly discriminatory because it is intended "to . . . reflect the increased costs that are incurred by such Market Makers that enter into order flow arrangements at a cost and without the benefit of a guaranteed allocation."<sup>59</sup>

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significant adverse impact of the proposed PIP fee change on the competitiveness of the PIP auction or the extent of price improvement for orders executed in the PIP in those series.").

<sup>57</sup> The Commission recognizes that, given the structure of the Complex Order market on Phlx, there currently are no quoting obligations on Phlx specific to Complex Orders. However, quotations in the leg markets are relevant to the Complex Order market, as Complex Orders are priced based on the leg markets, and executions on the Complex Order market must take into account the prices in the leg markets. Additionally, Directed Participants must be at the best price for a complex order to execute against the Complex Order.

<sup>58</sup> Phlx Rule 707 prohibits Directed Participants and order flow providers from coordinating actions involving Directed Orders. See also Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 (June 6, 2005) (SR-Phlx-2004-91) (noting the applicability of Rule 707 to this scenario). Thus, an order flow provider cannot let a Directed Participant know when it is sending a directed customer Complex Order to Phlx, or that it has such an order resting on Phlx's Complex Order book. In Amendment No. 1 to the proposals, Phlx noted that Rule 707 is intended to prohibit coordinated actions between Directed Participants and OFPs, and that the Exchange proactively conducts surveillance for, and enforces against, such violations. See Amendment No. 1 to SR-Phlx-2012-27 and SR-Phlx-2012-54, supra note 11.

<sup>59</sup> See Notice I, 77 FR at 15402.

In support of its argument, Phlx has represented that it is aware that non-exchange-sponsored PFOF arrangements exist, and that the rates paid by Market Makers under these arrangements, in many cases, “exceed [Phlx’s] own exchange-sponsored payment for order flow fee and also exceed the rebates that [Phlx] provides for adding or removing liquidity from the exchange.”<sup>60</sup> However, Phlx also represented that it “does not compile data on the exact prices that Market Makers pay third-party order flow providers for directed order flow . . . .”<sup>61</sup> Phlx has not produced any data with respect to non-exchange-sponsored payment for order flow arrangements, and has represented to Commission staff that it does not have such data.<sup>62</sup>

The Commission does not believe that this argument provides a reasonable basis to find that the fees and fee differential are consistent with the Act. As outlined above, pursuant to this argument, Phlx would be setting its fees, and discriminating among market participants, based on the existence of non-exchange sponsored PFOF arrangements. The record, however, does not contain any representations regarding the amounts of payments made by Directed Participants pursuant to such arrangements or whether such payments are made, whether these off-exchange PFOF arrangements are standardized, and whether the terms and amounts are the same between different OFPs and Directed Participants. As such, the Exchange has not substantiated the details of such off-exchange PFOF arrangements. The Commission believes it is likely that the

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<sup>60</sup> See Response, *supra* note 7, at 14.

<sup>61</sup> *Id.*

<sup>62</sup> Phlx did provide links to the websites of two order flow providers, Interactive Brokers and Wedbush. The Interactive Brokers link generally describes its PFOF practices, and states that it receives PFOF payments from Timber Hill “consistent with SEC-approved” PFOF plans. Since the Commission does not approve non-exchange-sponsored PFOF arrangements, this sentence presumably refers to exchange-sponsored PFOF payments, which are not relevant here. The Wedbush link notes that PFOF payments with respect to the options exchanges range from \$0 - \$0.75 per contract.

terms of such arrangements could vary considerably between different Directed Participants and OFPs. Essentially, pursuant to this argument, Phlx could be discriminating in its fees for a specified amount based on payments potentially made off-exchange that may vary widely. The Commission therefore does not believe that this argument provides a basis to support a finding that the fees and fee differential are reasonable, equitably allocated, and not unfairly discriminatory. Nevertheless, for the reasons discussed above, the Commission finds that the proposed rule changes are consistent with the Act.

#### IV. Solicitation of Comments

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

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>);  
or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Numbers SR-Phlx-2012-27 and SR-Phlx-2012-54 on the subject line.

##### Paper Comments:

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

All submissions should refer to File Numbers SR-Phlx-2012-27 and SR-Phlx-2012-54. 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 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; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Numbers SR-Phlx-2012-27 and SR-Phlx-2012-54 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Accelerated Approval of Proposed Rule Changes, as Modified by Amendments No. 1

Amendments No. 1 revised the proposed rule changes to, among other things, specify that the portion of the proposed rule change relating to fees for removing liquidity for Complex Orders for Directed Participants and other Market Makers, and the accompanying \$0.05 fee differential, will be operative on a one-year pilot basis, and that such fees would be operative on December 3, 2012. Phlx also committed to provide the Commission, on a monthly basis, with publicly available data and data analyses studying the impact of the fees for removing liquidity for complex orders for Directed Participants and other Market Makers upon inter and intra-market competition, and upon market quality. The Exchange represented that it would provide such information as the Commission may request regarding this fee pilot, including information with respect to rates of order interaction with Customer Complex Orders and rates of price

improvement. Receiving data and analysis from the Exchange during the duration of the pilot period will allow the Commission (and the Exchange) to continue to assess the impact, if any, of the proposed rule changes during the pilot period. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>63</sup> for approving the proposed rule changes, as modified by Amendments No. 1, prior to the 30<sup>th</sup> day after the date of publication of notice in the Federal Register.

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule changes, as modified by Amendments No. 1, are consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Sections 6(b)(4), 6(b)(5), and 6(b)(8) of the Act.

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<sup>63</sup> 15 U.S.C. 78s(b)(2).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>64</sup> that the proposed rule changes (SR-Phlx-2012-27 and SR-Phlx-2012-54), as modified by Amendments No.1, be, and hereby are, approved. With respect to the fees for executions of Complex Orders by Directed Participants and Market Makers, such fees are approved on a one-year pilot basis, with such fees being operative on December 3, 2012.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>65</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>64</sup> 15 U.S.C. 78s(b)(2).

<sup>65</sup> 17 CFR 200.30-3(a)(12).