

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68393; File No. SR-Phlx-2012-134)

December 10, 2012

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Notice of Filing and Immediate Effectiveness of a Proposal with Respect to the Authority of the Exchange or Nasdaq Options Services LLC (“NOS”) to Cancel Options Orders when a Technical or System Issue Occurs and to Describe the Operation of an Error Account for NOS

Pursuant to Section 19(b)(1)¹ of the Securities Exchange Act of 1934 (the “Act”)² and Rule 19b-4 thereunder,³ notice is hereby given that, on November 30, 2012, NASDAQ OMX PHLX LLC (“PHLX” or “Exchange”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the self-regulatory organization. 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 is filing a proposal with respect to the authority of the Exchange or NOS to cancel options orders when a technical or system issue occurs and to describe the operation of an error account for NOS. The text of the proposed rule change is available at <http://nasdaqomxphlx.cchwallstreet.com>, at PHLX’s principal office, 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

¹ 15 U.S.C.78s(b)(1).

² 15 U.S.C. 78a.

³ 17 CFR 240.19b-4.

the proposed rule change. The text of those 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 parts of such statements.

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 1080(m) by adding a new subparagraph (v) that addresses the authority of the Exchange or NOS to cancel options orders when a technical or systems issue occurs and to describe the operation of an error account for NOS.⁴

NOS is the approved routing broker of the Exchange, subject to the conditions listed in Rule 1080(m). The Exchange relies on NOS to provide outbound routing services from itself to

⁴ NOS is a facility of the Exchange. Accordingly, under Rule 1080(m), the Exchange is responsible for filing with the Commission rule changes and fees relating to NOS's functions. In addition, the Exchange is using the phrase "NOS or the Exchange" in this rule filing to reflect the fact that a decision to take action with respect to orders affected by a technical or systems issue may be made in the capacity of NOS or the Exchange depending on where those orders are located at the time of that decision.

From time to time, the Exchange may use non-affiliate third-party broker-dealers to provide outbound routing services (i.e., third-party Routing Brokers). In those cases, orders are submitted to the third-party Routing Broker through NOS, the third-party Routing Broker routes the orders to the routing destination in its name, and any executions are submitted for clearance and settlement in the name of NOS so that any resulting positions are delivered to NOS upon settlement. As described above, NOS normally arranges for any resulting securities positions to be delivered to the member that submitted the corresponding order to the Exchange. If error positions (as defined in proposed Rule 1080(m)(v)(2)) result in connection with the Exchange's use of a third-party Routing Broker for outbound routing, and those positions are delivered to NOS through the clearance and settlement process, NOS would be permitted to resolve those positions in accordance with proposed Rule 1080(m)(v). If the third-party Routing Broker received error positions in connection with its role as a routing broker for the Exchange, and the error positions were not delivered to NOS through the clearance and settlement process, then the third-party Routing Broker would resolve the error positions itself, and NOS would not be permitted to accept the error positions, as set forth in proposed Rule 1080(m)(v)(2)(B).

routing destinations of NOS (“routing destinations”).⁵ When NOS routes orders to a routing destination, it does so by sending a corresponding order in its own name to the routing destination. In the normal course, routed orders that are executed at routing destinations are submitted for clearance and settlement in the name of NOS, and NOS arranges for any resulting securities positions to be delivered to the member that submitted the corresponding order to the Exchange. From time to time, however, the Exchange and NOS encounter situations in which it becomes necessary to cancel orders and resolve error positions.⁶

Examples of Circumstances That May Lead to Canceled Orders

A technical or systems issue may arise at NOS, a routing destination, or the Exchange that may cause the Exchange or NOS to take steps to cancel orders if the Exchange or NOS determines that such action is necessary to maintain a fair and orderly market. The examples set forth below describe some of the circumstances in which the Exchange or NOS may decide to cancel orders.

Example 1. If NOS or a routing destination experiences a technical or systems issue that results in NOS not receiving responses to immediate or cancel (“IOC”) orders that it sent to the routing destination, and that issue is not resolved in a timely manner, NOS or the Exchange

⁵ The Exchange has authority to receive inbound routes of options orders by NOS from NASDAQ OMX BX (on a one year pilot basis) and The NASDAQ Options Market. See Securities Exchange Act Release Nos. 67294 (June 28, 2012), 77 FR 39771 (July 5, 2012)(SR-Phlx-2012-68); 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (SR-Phlx-2008-31); and 65399 (September 26, 2011), 76 FR 60955 (September 30, 2011)(SR-Phlx-2011-111).

⁶ The examples described in this filing are not intended to be exclusive. Proposed Rule 1080(m)(v) would provide general authority for the Exchange or NOS to cancel orders in order to maintain fair and orderly markets when technical and systems issues are occurring, and Rule 1080(m)(v) also would set forth the manner in which error positions may be handled by the Exchange or NOS. The proposed rule change is not limited to addressing order cancellation or error positions resulting only from the specific examples described in this filing.

would seek to cancel the routed orders affected by the issue.⁷ For instance, if NOS experiences a connectivity issue affecting the manner in which it sends or receives order messages to or from routing destinations, it may be unable to receive timely execution or cancellation reports from the routing destinations, and NOS or the Exchange may consequently seek to cancel the affected routed orders. Once the decision is made to cancel those routed orders, any cancellation that a member submitted to the Exchange on its initial order during such a situation would be honored.⁸

Example 2. If the Exchange experiences a systems issue, the Exchange may take steps to cancel all outstanding orders affected by that issue and notify affected members of the cancellations. In those cases, the Exchange would seek to cancel any routed orders related to the members' initial orders.

Examples of Circumstances That May Lead to Error Positions

In some instances, the technical or systems issue at NOS, a routing destination, the Exchange, or a non-affiliate third party Routing Broker may also result in NOS acquiring an error position that it must resolve. The examples set forth below describe some of the circumstances in which error positions may arise.

Example A. Error positions may result from routed orders that the Exchange or NOS attempts to cancel but that are executed before the routing destination receives the cancellation

⁷ In a normal situation (i.e., one in which a technical or systems issue does not exist), NOS should receive an immediate response to an IOC order from a routing destination, and would pass the resulting fill or cancellation on to the Exchange member. After submitting an order that is routed to a routing destination, if a member sends an instruction to cancel that order, the cancellation is held by the Exchange until a response is received from the routing destination. For instance, if the routing destination executes that order, the execution would be passed on to the member and the cancellation instruction would be disregarded.

⁸ If a member did not submit a cancellation to the Exchange, however, that initial order would remain "live" and thus be eligible for execution or posting on the Exchange, and neither the Exchange nor NOS would treat any execution of that initial order or any subsequent routed order related to that initial order as an error.

message or that are executed because the routing destination is unable to process the cancellation message. Using the situation described in Example 1 above, assume that the Exchange seeks to cancel orders routed to a routing destination because it is not receiving timely execution or cancellation reports from the routing destination. In such a situation, NOS may still receive executions from the routing destination after connectivity is restored, which it would not then allocate to members because of the earlier decision to cancel the affected routed orders. Instead, NOS would post those positions into its error account and resolve the positions in the manner described below.

Example B. Error positions may result from an order processing issue at a routing destination. For instance, if a routing destination experienced a systems problem that affects its order processing, it may transmit back a message purporting to cancel a routed order, but then subsequently submit an execution of that same order (i.e., a locked-in trade) to The Options Clearing Corporation (“OCC”) for clearance and settlement. In such a situation, the Exchange would not then allocate the execution to the member because of the earlier cancellation message from the routing destination. Instead, NOS would post those positions into its error account and resolve the positions in the manner described below.

Example C. Error positions may result if NOS receives an execution report from a routing destination but does not receive clearing instructions for the execution from the routing destination. For instance, assume that a member sends the Exchange an order to buy 100 contracts overlying ABC stock, which causes NOS to send an order to a routing destination that is subsequently executed, cleared, and closed out by that routing destination, and the execution is ultimately communicated back to that member. On the next trading day (T+1), if the routing destination does not provide clearing instructions for that execution, NOS would still be

responsible for settling that member's purchase, but would be left with a short position in its error account.⁹ NOS would resolve the position in the manner described below.

Example D. Error positions may result from a technical or systems issue that causes orders to be executed in the name of NOS that are not related to NOS's function as the Exchange's routing broker and are not related to any corresponding orders of members. As a result, NOS would not be able to assign any positions resulting from such an issue to members. Instead, NOS would post those positions into its error account and resolve the positions in the manner described below.

Example E. Error positions may result from a technical or systems issue through which the Exchange does not receive sufficient notice that a member that has executed trades on the Exchange has lost the ability to clear trades through OCC. In such a situation, the Exchange would not have valid clearing information, which would prevent the trade from being automatically processed for clearance and settlement on a locked-in basis. Accordingly, NOS would assume that member's side of the trades so that the counterparties can settle the trades. NOS would post those positions into its error account and resolve the positions in the manner described below.

Example F. Error positions may result from a technical or systems issue at the Exchange that does not involve routing of orders through NOS. For example, a situation may arise in which a posted quote/order was validly cancelled but the system erroneously matched that quote/order with an order that was seeking to access it. In such a situation, NOS would have to assume the side of the trade opposite the order seeking to access the cancelled quote/order. NOS

⁹ To the extent that NOS incurred a loss in covering its short position, it would submit a reimbursement claim to that routing destination.

would post the position in its error account and resolve the position in the manner described below.

In the circumstances described above, neither the Exchange nor NOS may learn about an error position until T+1, either: (1) during the clearing process when a routing destination has submitted to OCC a transaction for clearance and settlement for which NOS never received an execution confirmation; or (2) when a routing destination does not recognize a transaction submitted to OCC for clearance and settlement. Moreover, the affected members' trade may not be nullified absent express authority under Exchange rules.¹⁰

Proposed Amendments to Rule 1080(m)

The Exchange proposes to amend Rule 1080(m) to add new subparagraph (v) to address the cancellation of orders due to technical or systems issues and the use of an error account by NOS.

Specifically, under subparagraph (v)(1) of the proposed rule, the Exchange or NOS would be expressly authorized to cancel orders as may be necessary to maintain fair and orderly markets if a technical or systems issue occurred at the Exchange, NOS, or a routing destination.¹¹ The Exchange or NOS would be required to provide notice of the cancellation to affected members as soon as practicable.

Subparagraph (v)(2) of the proposed rule would permit NOS to maintain an error account for the purpose of addressing positions that result from a technical or systems issue at NOS, the

¹⁰ See, e.g., Rule 1092.

¹¹ Such a situation may not cause the Exchange to declare self-help against the routing destination pursuant to Rule 1084(b)(i). If the Exchange or NOS determines to cancel orders routed to a routing destination under proposed Rule 1080(m)(v), but does not declare self-help against that routing destination, the Exchange would continue to be subject to the trade-through requirements in the Options Order Protection and Locked/Crossed Markets Plan and Rule 1084 with respect to that routing destination.

Exchange, a routing destination, or a non-affiliate third-party Routing Broker that affects one or more orders (“error positions”). By definition, an error position would not include any position that results from an order submitted by a member to the Exchange that is executed on the Exchange and automatically processed for clearance and settlement on a locked-in basis. NOS also would not be permitted to accept any positions in its error account from an account of a member and could not permit any member to transfer any positions from the member’s account to NOS’s error account under the proposed rule.¹² However, if a technical or systems issue results in the Exchange not having valid clearing instructions for a member to a trade, NOS may assume that member’s side of the trade so that the trade can be processed for clearance and settlement on a locked-in basis.¹³

Under subparagraph (v)(3), in connection with a particular technical or systems issue, NOS or the Exchange would be permitted to either (i) assign all resulting error positions to members, or (ii) have all resulting error positions liquidated, as described below. Any determination to assign or liquidate error positions, as well as any resulting assignments, would be required to be made in a nondiscriminatory fashion.

¹² The purpose of this provision is to clarify that NOS may address error positions under the proposed rule that are caused by a technical or systems issue, but that NOS may not accept from a member positions that are delivered to the member through the clearance and settlement process, even if those positions may have been related to a technical or systems issue at NOS, the Exchange, a routing destination of NOS, or a non-affiliate third-party Routing Broker. This provision would not apply, however, to situations like the one described in Example C in which NOS incurred a short position to settle a member’s purchase, as the member did not yet have a position in its account as a result of the purchase at the time of NOS’s action (i.e., NOS’s action was necessary for the purchase to settle into the member’s account). Similarly, the provision would not apply to situations like the one described in Example F, where a system issue caused one member to receive an execution for which there was not an available contraparty, in which case action by NOS would be necessary for the position to settle into that member’s account.

¹³ See Example E above.

NOS or the Exchange would be required to assign all error positions resulting from a particular technical or systems issue to the applicable members affected by that technical or systems issue if NOS or the Exchange:

- Determined that it has accurate and sufficient information (including valid clearing information) to assign the positions to all of the applicable members affected by that technical or systems issue;
- Determined that it has sufficient time pursuant to normal clearance and settlement deadlines to evaluate the information necessary to assign the positions to all of the applicable members affected by that technical or systems issue; and
- Had not determined to cancel all orders affected by that technical or systems issue.

For example, a technical or systems issue of limited scope or duration may occur at a routing destination, and the resulting trades may be submitted for clearance and settlement by such routing destination to OCC. If there were a small number of trades, there may be sufficient time to match positions with member orders and avoid using the error account.

There may be scenarios, however, where NOS determines that it is unable to assign all error positions resulting from a particular technical or systems issue to all of the affected members, or determines to cancel all affected routed orders. For example, in some cases, the volume of questionable executions and positions resulting from a technical or systems issue might be such that the research necessary to determine which members to assign those executions to could be expected to extend past the normal settlement cycle for such executions. Furthermore, if a routing destination experiences a technical or systems issue after NOS has transmitted IOC orders to it that prevents NOS from receiving responses to those orders, NOS or

the Exchange may determine to cancel all routed orders affected by that issue. In such a situation, NOS or the Exchange would not pass on to the members any executions on the routed orders received from the routing destination.

The proposed rule also would require NOS to liquidate error positions as soon as practicable.¹⁴ In liquidating error positions, NOS would be required to provide complete time and price discretion for the trading to liquidate the error positions to a third-party broker-dealer and could not attempt to exercise any influence or control over the timing or methods of trading to liquidate the error positions.¹⁵ NOS also would be required to establish and enforce policies and procedures reasonably designed to restrict the flow of confidential and proprietary information between the third-party broker-dealer and NOS/the Exchange associated with the liquidation of the error positions.

Under proposed subparagraph (v)(4), NOS and the Exchange would be required to make and keep records to document all determinations to treat positions as error positions and all determinations for the assignment of error positions to members or the liquidation of error positions, as well as records associated with the liquidation of error positions through the third-party broker-dealer.

¹⁴ If NOS determines in connection with a particular technical or systems issue that some error positions can be assigned to some affected members but other error positions cannot be assigned, NOS would be required under the proposed rule to liquidate all such error positions (including those positions that could be assigned to the affected members).

¹⁵ This provision is not intended to preclude NOS from providing the third-party broker with standing instructions with respect to the manner in which it should handle all error account transactions. For example, NOS might instruct the broker to treat all orders as “not held” and to attempt to minimize any market impact on the price of the stock being traded.

2. Statutory Basis

The proposed rule change is consistent with Section 6(b)¹⁶ of the Securities Exchange Act of 1934 (the “Act”), in general, and furthers the objectives of Section 6(b)(5),¹⁷ in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and it is not designed to permit unfair discrimination among customers, brokers, or dealers. The Exchange believes that this proposal is in keeping with those principles because NOS’s or the Exchange’s ability to cancel orders during a technical or systems issue and to maintain an error account facilitates the smooth and efficient operations of the market. Specifically, the Exchange believes that allowing NOS or the Exchange to cancel orders during a technical or systems issue would allow the Exchange to maintain fair and orderly markets. Moreover, the Exchange believes that allowing NOS to assume error positions in an error account and to liquidate those positions, subject to the conditions set forth in the proposed amendments to Rule 1080(m), would be the least disruptive means to correct these errors, except in cases where NOS can assign all such error positions to all affected members of the Exchange. Overall, the proposed amendments are designed to ensure full trade certainty for market participants and to avoid disrupting the clearance and settlement process. The proposed amendments are also designed to provide a consistent methodology for handling error positions in a manner that does not discriminate among members. The proposed amendments are also consistent with Section 6 of the Act insofar as they would require NOS to establish controls to

¹⁶ 15 U.S.C. 78f(b).

¹⁷ 15 U.S.C. 78f(b)(5).

restrict the flow of any confidential information between the third-party broker and NOS/the Exchange associated with the liquidation of error positions.

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.

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

Written comments were neither solicited nor received.

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

Because the foregoing proposed rule change does not: (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁸ and Rule 19b-4(f)(6)¹⁹ thereunder.

Phlx has requested that the Commission waive the 30-day operative delay.²⁰ The Commission believes that waiver of the operative delay is consistent with the protection of investors and the public interest. Such waiver would allow the Exchange, without delay, to implement the proposed rule change, which is designed to provide a consistent methodology for handling error positions in a manner that does not discriminate among members. The

¹⁸ 15 U.S.C. 78s(b)(3)(A).

¹⁹ 17 CFR 240.19b-4(f)(6). In addition, Rule 19b-4(f)(6) requires a self-regulatory organization to give the Commission written notice of its intent to file the proposed rule change at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

²⁰ 17 CFR 240.19b-4(f)(6)(iii).

Commission also notes that the proposed rule change is based on, and substantially similar to, Phlx Rule 3315(d), which the Commission recently approved.²¹ Accordingly, the Commission designates the proposal operative upon filing.²²

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of 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. Please include File Number SR-Phlx-2012-134 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 Number SR-Phlx-2012-134. This file number should be included on the subject line if e-mail is used. To help the Commission process and review

²¹ See Securities Exchange Act Release No. 67654 (August 14, 2012), 77 FR 50187 (August 20, 2012) (SR-Phlx-2012-81).

²² For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule change's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

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 Number SR-Phlx-2012-134 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.²³

Kevin M. O'Neill
Deputy Secretary

²³ 17 CFR 200.30-3(a)(12).