

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73291; File No. SR-Phlx-2014-23)

October 2, 2014

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Related to the Priority Afforded to In-Crowd Participants Respecting Crossing, Facilitation, and Solicited Orders in Open Outcry Trading

I. Introduction

On April 23, 2014, NASDAQ OMX PHLX LLC (“Exchange” or “Phlx”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to revise the priority afforded to in-crowd participants respecting crossing, facilitation, and solicited orders in open outcry trading (“Proposal”). The proposed rule change was published for comment in the Federal Register on May 13, 2014.³ On June 23, 2014, the Commission extended the time period in which to either approve the Proposal, disapprove the Proposal, or institute proceedings to determine whether to approve or disapprove the Proposal to August 11, 2014.⁴ The Commission received two comment letters from one commenter regarding the Proposal⁵ and one response letter from Phlx.⁶ On July 30, 2014, the Exchange filed Amendment

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 72119 (May 7, 2014), 79 FR 27351 (“Notice”).

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

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

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

No. 1 to the Proposal (“Amendment No. 1”).⁷ On August 4, 2014, the Commission instituted proceedings pursuant to Section 19(b)(2)(B) of the Act⁸ to determine whether to approve or disapprove the proposed rule change and published Amendment No. 1 for comment.⁹ The Order Instituting Proceedings was published for comment in the Federal Register on August 8, 2014.¹⁰ In response to the Order Instituting Proceedings, the Commission received no comment letters on the Proposal. This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposal

The Exchange proposes to amend Phlx Rule 1014, Commentary .05(c)(ii), to afford priority in open outcry trading to in-crowd participants over out-of-crowd Streaming Quote Traders (“SQTs”)¹¹, Remote Specialists¹², and Remote Streaming Quote Traders (“RSQTs”)¹³

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

⁸ 15 U.S.C. 78s(b)(2)(B).

⁹ See Securities Exchange Act Release No. 72751, (August 4, 2014), 79 FR 46474 (August 8, 2014) (“Order Instituting Proceedings”).

¹⁰ See Order Instituting Proceedings. The comment period closed on August 29, 2014, and the rebuttal period closed on September 12, 2014.

¹¹ An SQT is defined in Exchange Rule 1014(b)(ii)(A) as a Registered Options Trader (“ROT”) who has received permission from the Exchange to generate and submit option quotations electronically in options to which such SQT is assigned. Types of ROTs include SQTs, RSQTs and non-SQTs, which by definition are neither SQTs nor RSQTs. A Registered Options Trader is defined in Exchange Rule 1014(b)(i) as a regular member of the Exchange located on the trading floor who has received permission from the Exchange to trade in options for his own account. See Phlx Rules 1014(b)(i) and (ii).

¹² A Remote Specialist is a qualified RSQT approved by the Exchange to function as a specialist in one or more options if the Exchange determines that it cannot allocate such options to a floor based specialist. A Remote Specialist has all the rights and obligations of a specialist, unless Exchange rules provide otherwise. See Phlx Rules 501 and 1020.

and over out-of-crowd broker-dealer limit orders on the limit order book (but not over public customer orders) in crossing¹⁴, facilitation¹⁵, and solicited¹⁶ orders, regardless of order size.

Currently, Commentary .05(c)(i) to Phlx Rule 1014 provides that, in the event that a Floor Broker¹⁷ or specialist¹⁸ presents a non-electronic order in which an RSQT is assigned or which is allocated to a Remote Specialist, and/or in which an SQT assigned in such option is not a crowd participant (collectively, “Non-Crowd Participants”), such Non-Crowd Participant may

¹³ A RSQT is defined in Exchange Rule 1014(b)(ii)(B) as an ROT that is a member affiliated with a Remote Streaming Quote Trader Organization (“RSQTO”) with no physical trading floor presence who has received permission from the Exchange to generate and submit option quotations electronically in options to which such RSQT has been assigned. A qualified RSQT may function as a Remote Specialist upon Exchange approval. An RSQT may only submit such quotations electronically from off the floor of the Exchange. An RSQT may not submit option quotations in eligible options to which such RSQT is assigned to the extent that the RSQT is also approved as a Remote Specialist in the same options. An RSQT may only trade in a market making capacity in classes of options in which he is assigned or approved as a Remote Specialist. An RSQTO is a member organization in good standing that satisfies the RSQTO readiness requirements in Phlx Rule 507(a)(i).

¹⁴ A crossing order occurs when an options Floor Broker holds orders (except for floor qualified contingent cross orders, as defined in Exchange Rule 1064(e)) to buy and sell the same option series. Such a Floor Broker may cross such orders, provided that the trading crowd is given an opportunity to bid and offer for such option series in accordance with Exchange rules. See Phlx Rule 1064(a).

¹⁵ A facilitation order occurs when an options Floor Broker holds an options order (except for floor qualified contingent cross orders, as defined in Exchange Rule 1064(e)) for a public customer and a contra-side order. Such a Floor Broker may execute such orders as a facilitation order, provided that such Floor Broker proceeds in accordance with Exchange rules concerning facilitation orders. See Phlx Rule 1064(b).

¹⁶ A solicitation occurs whenever an order (except for floor qualified contingent cross orders, as defined in Exchange Rule 1064(e)), other than a cross, is presented for execution in the trading crowd resulting from an away-from-the-crowd expression of interests to trade by one broker dealer to another. See Phlx Rule 1064(c).

¹⁷ A “Floor Broker” is an individual who is registered with the Exchange for the purpose, while on the Exchange’s options floor, of accepting and handling options orders received from members and member organizations. See Phlx Rule 1060.

¹⁸ A “Specialist” is an Exchange member who is registered as an options specialist pursuant to Rule 1020(a).

not participate in trades stemming from such a non-electronic order unless the non-electronic order is executed at the price quoted by the Non-Crowd Participant at the time of execution. If the non-electronic order is executed at the price quoted by the Non-Crowd Participant, the Non-Crowd Participant may participate in the trade unless the order was a crossing, facilitation, or solicited order with a size of at least 500 contracts on each side.¹⁹ If the order is a crossing, facilitation, or solicited order with a size of at least 500 contracts on each side, Commentary .05(c)(ii) gives priority to in-crowd participants (including, for purposes of Commentary .05(c)(ii) only, Floor Brokers) over Non-Crowd Participants and over out-of-crowd broker-dealer limit orders on the limit order book, but not over public customer orders.²⁰

The Exchange proposes to eliminate the 500 contract minimum order size from Phlx Rule 1014, Commentary .05(c)(ii). As amended, the rule would afford priority to in-crowd participants over Non-Crowd Participants and out-of-crowd broker-dealer limit orders in crossing, facilitation, and solicited orders regardless of the size of those orders. The Exchange states that it initially permitted Non-Crowd Participants to participate in Floor Broker crosses to foster electronic options trading.²¹ In 2006, the Exchange adopted the size requirement, which continued to permit Non-Crowd Participants to participate in smaller (under five hundred

¹⁹ This in-crowd priority applies only to crossing, facilitation, and solicited orders represented in open outcry, and does not apply to orders submitted electronically via the Exchange's electronic options trading platform, to which other priority rules apply. See, e.g., Phlx Rules 1014(g)(vii) and (viii).

²⁰ According to the Exchange, public customer limit orders represented in the trading crowd and resting on the limit order book have, and will continue to have, priority over all other participants and accordingly must be executed up to the aggregate size of such orders before any in-crowd participant is entitled to priority. Public customer orders on the limit order book that are eligible for execution are required to be executed before a Floor Broker may execute its order in the crowd and/or with a contra-side order it holds. See Phlx Rule 1014, Commentary .05(c)(ii).

²¹ See Amendment No. 1, supra note 7.

contracts) Floor Broker crosses.²² According to the Exchange, electronic options trading is well-established and there is no longer a need for such special rules and incentives to develop electronic trading further.²³ The Exchange notes that another options exchange does not have the same differentiation of priority for orders of fewer than 500 contracts.²⁴ The Exchange believes that its Proposal will encourage order flow providers to send additional crossing, facilitation, and solicited orders to the Exchange without concern that the order may not be completely executed by the trading crowd.²⁵ The Exchange also believes that affording priority to in-crowd participants regardless of size will attract additional smaller cross orders to the Exchange and allow in-crowd market makers to compete for smaller orders.²⁶

III. Comment Letters and Phlx's Response

As noted above, the Commission received two comment letters from one commenter²⁷ and one response letter from Phlx.²⁸

In its first letter, the commenter opposes the Proposal and requests that the Commission institute proceedings to disapprove the Proposal. The commenter argues that the Proposal unfairly denies electronic participants the ability to participate in the execution of open outcry orders along with in-crowd participants at the same price.²⁹ The commenter states its view that

²² See Notice, 79 FR at 27352. See also Amendment No. 1, supra note 7.

²³ See Notice, 79 FR at 27352. See also Amendment No. 1, supra note 7.

²⁴ See Notice, 79 FR at 27352-53. See also Chicago Board Options Exchange (“CBOE”) Rule 6.74, Crossing Orders.

²⁵ See Notice, 79 FR at 27353.

²⁶ See Notice, 79 FR at 27353-54.

²⁷ See supra note 5.

²⁸ See supra note 6.

²⁹ See ISE Letter I.

the Exchange has not provided sufficient justification for allocating smaller trades negotiated on its floor to counterparties in the trading crowd ahead of same-priced orders from electronic participants.³⁰ The commenter believes that the Proposal will encourage Phlx participants to bring more orders to the floor, where they may receive a higher trade allocation and may be able to internalize a trade, instead of executing those orders through electronic auction systems.³¹ The commenter argues that, even with the current 500 contract minimum, Phlx’s priority rules disadvantage orders being internalized to the benefit of the internalizing brokers, as these orders receive relatively little price competition.³² The commenter suggests that giving priority to small orders on the floor will further skew participants’ incentives to bring orders to the floor to achieve a frictionless “clean cross” and deprive customers of vigorous competition for these orders.³³ The commenter states that most electronic auctions require that orders be exposed to all other participants trading on the exchange, and orders that are not exposed, such as qualified contingent crosses, are required to be for a large size.³⁴

The commenter also argues that, because no trade information is disseminated about orders executed on the floor to electronic participants, who may be willing to provide liquidity to orders executed on the Exchange floor, such orders will not benefit from potential price improvement built into electronic auctions.³⁵ The commenter believes that the Proposal will largely limit price competition for small orders to participants physically present in the crowd at

³⁰ See ISE Letter I.

³¹ See ISE Letter I.

³² See ISE Letter I at 1-2.

³³ See ISE Letter I at 2.

³⁴ See ISE Letter I at 2.

³⁵ See ISE Letter I at 2.

the time a floor cross is announced and transacted.³⁶ The commenter further argues that the Proposal would ignore electronic orders and quotes, especially for small orders, and cause more orders to be crossed at prices that have not been sufficiently vetted by the participants most likely to offer price improvement.³⁷

In response to the commenter's concerns regarding in-crowd liquidity, Phlx states that on-floor liquidity on Phlx in many issues exceeds the displayed wider electronic markets.³⁸ Phlx argues that the Proposal merely removes the 500 contract minimum and that another options exchange, CBOE, does not have the same differentiation of priority for orders of fewer than 500 contracts.³⁹ Phlx believes that attracting smaller orders to the trading floor fosters an environment for on-floor liquidity providers to continue to provide price improvement and size improvement.⁴⁰ In response to the commenter's suggestion that the Proposal will facilitate internalization, Phlx states that priority will be afforded to all in-crowd participants, including market makers, not just Floor Brokers.⁴¹ Phlx also believes that the Proposal should encourage small participants, such as floor-based market makers, to continue to make markets, which Phlx believes will improve the quality of execution for these smaller orders.⁴²

In its second letter, the commenter replies to the Phlx Response Letter and reiterates its request that the Commission institute proceedings to disapprove the Proposal. In response to

³⁶ See ISE Letter I at 2.

³⁷ See ISE Letter I at 2. The commenter expressed its view that it is inappropriate to ignore electronic quotes, especially for smaller orders where substantial capital commitment or efforts to find liquidity are not necessary. See id.

³⁸ See Phlx Response Letter.

³⁹ See Phlx Response Letter (citing CBOE Rule 6.74, Crossing Orders).

⁴⁰ See Phlx Response Letter at 2.

⁴¹ See Phlx Response Letter at 2.

⁴² See Phlx Response Letter at 2.

Phlx's statement that, based on Phlx's experience, on-floor liquidity on Phlx in many issues exceeds the displayed wider electronic markets,⁴³ the commenter requests that the Commission require Phlx to provide data that would allow the Commission to gauge the level of participation of floor-based market makers against orders represented in open outcry, and price improvement provided by these participants.⁴⁴ The commenter questions whether Phlx needs to afford priority to in-crowd liquidity providers if they are offering active price improvement.⁴⁵ The commenter states its view that to the extent that in-crowd participants provide price improvement to orders represented in open outcry, their orders are already entitled to priority over other orders at a worse price, including electronic quotes.⁴⁶ The commenter asserts that the Proposal is intended to allow in-crowd participants to internalize orders without being subject to competition from active liquidity providers in the electronic markets.⁴⁷ The commenter argues that Phlx's reliance on the CBOE rule is irrelevant as the Phlx Proposal must stand on its own, and, in any event, believes that the in-crowd priority rules of Phlx and CBOE are not in the public interest.⁴⁸ The commenter argues that the proposed expansion of these rules would only foster internalization and curtail price improvement.⁴⁹

IV. Discussion and Commission Findings

After careful review of the proposed rule change as well as the comment letters and the Phlx response letter received on the Proposal, the Commission finds that the proposed rule

⁴³ See Phlx Response Letter.

⁴⁴ See ISE Letter II.

⁴⁵ See ISE Letter II.

⁴⁶ See ISE Letter II at 1-2.

⁴⁷ See ISE Letter II at 2.

⁴⁸ See ISE Letter II at 2.

⁴⁹ See ISE Letter II at 2.

change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, with Section 6(b) of the Act.⁵⁰ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁵¹ which requires, among other things, that the rules of a national securities exchange be 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 regulating, clearing, settling, processing information with respect to, and 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 not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

As noted above, the Commission received two comment letters from one commenter in response to the proposed rule change.⁵² The commenter raised concerns about whether the Exchange's proposed revisions to its rules governing priority during open outcry were appropriate, as more fully described above.⁵³ In its review of the proposal, the Commission has carefully considered all of the comments received. The Commission acknowledges the concerns raised by the commenter, as detailed above,⁵⁴ about the potential impact on competition resulting from the Proposal in the Exchange's rules governing priority and order allocation for open outcry

⁵⁰ 15 U.S.C. 78f(b). In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁵¹ 15 U.S.C. 78f(b)(5).

⁵² See supra note 5.

⁵³ See ISE Letters I and II. See also notes 29-37 and 44-49 and accompanying text describing the issues and concerns raised by these comments.

⁵⁴ See supra notes 29-37 and 44-49 and accompanying text.

transactions. At the same time, the Commission also acknowledges the Exchange's belief that this Proposal will encourage order flow providers to send additional crossing, facilitation, and solicited orders to the Exchange,⁵⁵ as well as its belief that today, electronic options trading is well-established and no longer requires special rules and incentives to develop further.⁵⁶

Phlx Rule 1014, Commentary .05(c)(ii), as proposed to be revised, describes priority for crossing, facilitation, and solicited orders in open outcry transactions. The proposed rules governing open outcry during crossing, facilitation, and solicited transactions on the Exchange floor are similar to the rules governing priority in crossing transactions at other exchanges.⁵⁷ Given that other options exchanges currently have rules that provide lower priority to non-priority customer orders on the electronic book during crossing transactions on those exchanges, the Exchange's proposed revisions to its priority scheme for floor transactions will allow Phlx to compete with other floor-based exchanges that have substantially similar rules. Accordingly, the

⁵⁵ See Notice, 79 FR at 27353.

⁵⁶ See Amendment No. 1 at 4.

⁵⁷ See, e.g., CBOE Rule 6.74; NYSE MKT Rule 934NY; NYSE Arca Rule 6.47. CBOE Rule 6.74 provides that for purposes of establishing priority at the same price, bids and offers of In-Crowd Market Participants have first priority, except with respect to public customer orders resting in the electronic book; and all other bids and offers (including bids and offers of broker-dealer orders in the electronic book and electronic quotes of Market-Makers) have second priority. NYSE MKT Rule 934NY(b)(3) provides that, for a non-facilitation cross, if there are bids or offers in the Consolidated Book better than the proposed execution price or Customer Orders in the Consolidated Book priced at the proposed execution price, the Floor Broker must trade against such bids or offers in the Consolidated Book. Once bids or offers in the Book are satisfied, the Floor Broker may cross the balance of the orders, if any, to be crossed. NYSE Arca Rule 6.47 provides that, for crossing orders, the Floor Broker must trade against: (i) Customer bids or offers on the Consolidated Book priced equal or better than the proposed execution price; and (ii) better-priced non-Customer bids or offers on the Consolidated book along with any equal-priced non-Customer bids and offers that are ranked ahead of any equal-priced Customer bids and offers.

Commission believes that it would be appropriate and consistent with the Act to approve the Exchange's proposed rule change.⁵⁸

⁵⁸ As noted above, the Exchange's proposal is intended to bring its floor priority rules for crossing, facilitation, and solicited orders in line with the floor priority rules of certain other options exchanges. However, the Commission is aware of the concerns, as expressed by the commenter, that the rules of an options trading floor should allow for sufficient competition for orders. This concern is one that the Commission staff intends to continue to evaluate in the context of its ongoing empirical consideration of market structure. For example, there currently is relatively little information available about the extent and nature of floor crossing transactions. The Commission staff, however, expects that an exchange with a trading floor, as part of its regulatory obligations, will monitor the extent to which competition is maintained in floor crossing transactions. One way an exchange could do so would be to assess periodically the level of participation in such crossing transactions by market makers and other market participants, aside from the firm that initiated the cross, and review whether its rules appropriately allow for such competition. In addition, the Commission reminds broker-dealers that the duty of best execution requires them to assess periodically the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders. See, e.g., Order Execution Obligations, Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 at 48322-33 (September 12, 1996). Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices. See id. at 48323. In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities. See id.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act⁵⁹ that the proposed rule change, as modified by Amendment No. 1, (SR-Phlx-2014-23) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁶⁰

Kevin M. O'Neill
Deputy Secretary

⁵⁹ 15 U.S.C. 78s(b)(2).

⁶⁰ 17 CFR 200.30-3(a)(12).