

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-77449; File No. SR-Phlx-2016-10)

March 25, 2016

Self-Regulatory Organizations; NASDAQ PHLX LLC; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Professional Customer Definition

I. Introduction

On January 21, 2016, NASDAQ PHLX LLC (the “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend the methodology for counting average daily order submissions in listed options to determine whether a person or entity meets the definition of a Professional<sup>3</sup> (“Professional order counting”). The Commission published the proposed rule change for comment in the Federal Register on February 10, 2016.<sup>4</sup> The Exchange filed Amendment No. 1 to the proposed rule change on March 21, 2016.<sup>5</sup> The Commission received no comments on this proposal. This order provides

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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> 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 Phlx Rule 1000(b)(14); see also Securities Exchange Release 59287 (January 23, 2009), 74 FR 5694 (January 30, 2009) (ISE-2006-26) (“ISE Approval Order”).

<sup>4</sup> See Securities Exchange Act Release No. 77054 (February 4, 2016), 81 FR 7166 (“Notice”).

<sup>5</sup> In Amendment No. 1, the Exchange changed how complex orders will be counted with respect to Professional order counting. Amendment No. 1 modified the proposal to provide that a complex order compromised of nine legs or more will count as multiple orders with each option leg counting as its own separate order while complex orders with eight legs or less will count as a single order. The Exchange previously proposed that complex orders compromised of five legs or more count as multiple orders while complex orders with four legs or less count as a single order. In addition, any complex order with nine or more legs that is canceled and replaced would count as multiple new

notice of filing of Amendment No. 1 and approves the proposal, as modified by Amendment No. 1, on an accelerated basis.

## II. Description of the Proposal

The Exchange proposes to amend the definition of Professional in Rule 1000(b)(14) to clarify the calculation of certain types of orders for purposes of Professional order counting.<sup>6</sup>

### Background

On Phlx, public customers are granted certain marketplace advantages over other market participant orders, including non-customer orders and quotes from specialists and Registered Options Traders (“ROTs”).<sup>7</sup> These advantages include priority over other market participant orders at the same price as well as no transaction fees for order execution.<sup>8</sup> When representing orders on the Exchange, members must specify whether an order for the account of a non-broker-dealer is for the beneficial account of a Professional.<sup>9</sup>

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orders. The Exchange previously proposed that complex orders with five legs or more that were canceled and replaced would count as multiple new orders. Finally, Amendment No.1 also added clarifying rule text to make clear that single-strike algorithms are treated the same as cancel and replace orders and therefore each cancel and replace order will count as a new order when tracking the NBBO. Finally, the Exchange clarified that an order that cancels and replaces a subordinate order on the same side and series as the parent order will count as one order. To promote transparency of its proposed amendment, when Phlx filed Amendment No. 1 with the Commission, it also submitted Amendment No. 1 as a comment letter to the file, which the Commission posted on its website and placed in the public comment file for SR-Phlx-2016-10 (available at <http://www.sec.gov/comments/sr-phlx-2016-10/phlx201610-1.pdf>). The Exchange also posted a copy of its Amendment No. 1 on its website when it filed the amendment with the Commission.

<sup>6</sup> See Notice, supra note 4, at 7166.

<sup>7</sup> See id. at 7169.

<sup>8</sup> See id.

<sup>9</sup> See id. at 7166. Phlx rules require members to review their customers’ account activity on a quarterly basis to determine whether certain customers should be represented as Professionals. See id. at 7167. The Exchange also may conduct its own analysis and identify persons or entities that should be represented as Professionals. See id. at 7167,

## Proposal

The Exchange's proposal is intended to provide additional guidance regarding the counting methodology when calculating average daily orders for Professional order counting purposes. As a general rule, for Professional order counting, the Exchange required the counting of orders regardless of which exchange they are routed to with the exception of FLEX orders.<sup>10</sup>

## FLEX orders

Under new paragraph (a) of proposed Rule 1000(b)(14)(i), FLEX orders are not included in the Professional order counting methodology as they are non-electronic orders and not typically traded by retail customers.<sup>11</sup> Therefore, according to the Exchange, these orders are not relevant to the distinction that it seeks to make between public customers and professional traders.<sup>12</sup>

## Cancel and Replace/Complex Orders

Under new Paragraph (b) of proposed Rule 1000(b)(14)(i), the Exchange will count as a new order any order that cancels and replaces a prior order.<sup>13</sup> Additionally, single strike algorithms, which are a series of cancel and replace orders in an individual strike that tracks the NBBO, will also count as a new order for each cancel and replace order.<sup>14</sup>

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n.5.

<sup>10</sup> See id. at 7167. The term "FLEX option" means a FLEX option contract that is traded subject to Exchange Rule 1079.

<sup>11</sup> See id.

<sup>12</sup> See id.

<sup>13</sup> See id. A cancel and replace order is one that removes a preexisting order and replaces it with a new order. See id. The Exchange notes that a cancel message alone is not an order. See id. at 7167, n.11. Similarly, the rule would count as multiple new orders any cancel/replace of a complex order of nine options legs or more. See Amendment No. 1, supra note 5.

<sup>14</sup> See Notice, supra note 4, at 7167. In Amendment No. 1, the Exchange clarified that

Under new Paragraph (c) of proposed Rule 1000(b)(14)(i), a complex order of 9 legs<sup>15</sup> or more will count as a new order per leg whereas a complex order of 8 legs or less will count as a single order for all its legs combined.<sup>16</sup>

#### Parent/Child orders

Under new Paragraph (d) of proposed Rule 1000(b)(14)(i), an order that converts into multiple subordinate orders in order to achieve an execution strategy<sup>17</sup> will be counted as one order per side and per series.<sup>18</sup> Additionally, if one of those subordinate “child” orders is subsequently canceled and replaced by multiple orders on multiple sides/series, then each new replacement order is counted as a separate new order per each side and series.<sup>19</sup> However, if a subordinate “child” order is canceled and replaced by a new order(s) on the same side and series, then that new replacement order will not count as a separate new order.<sup>20</sup>

As the Exchange explained in its Notice, an order that is filled in parts by the Exchange’s matching engine, without any intervention by the customer, will not count as separate order for

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“single strike algorithms” are included in this provision. See supra note 5.

<sup>15</sup> See Amendment No. 1, supra note 5 (in which the Exchange increased the number of option legs from five to nine).

<sup>16</sup> For complex orders, stock orders do not count towards the number of legs. For example, a nine leg complex order with eight option legs and one stock leg will count as an eight leg complex order for the purposes of Professional order counting. See Notice, supra note 4, at 7167, n.10, as amended by Amendment No. 1, supra note 5.

<sup>17</sup> See id. at 7167 (noting that all strategies must comply with Rule 1080, Commentary .07(a)(ii)); see also id. at 7168 (for examples of cancel and replace, “parent/child” Professional order counting, and a chart detailing the rule).

<sup>18</sup> See id. For example, orders that are for a single side/series but are broken up by the broker will count as one order, even if part of the order is routed away. See Proposed Rule 1000(b)(14)(i)(d). If a member sends in multiple orders to the Exchange as separate orders then each will count as a separate order. See Notice, supra note 4, at 7167.

<sup>19</sup> See Notice, supra note 4, at 7167.

<sup>20</sup> See Amendment No.1, supra note 5 (adding a sentence to paragraph (d)).

each fill because the customer did not intervene to generate new orders.<sup>21</sup> Along similar lines, if an order is repriced to avoid locking or crossing the market, that action will not cause a “new” order for Professional order counting purposes because the customer did not intervene in that process.<sup>22</sup> The Exchange noted that the manner in which an order is ultimately executed, as one order or multiple orders, does not by itself determine whether the activity is that of a Professional.<sup>23</sup> Rather, the distinction is whether the member exercised control and discretion over the order to an extent that could be characterized as non-retail customer trading activity.<sup>24</sup>

### Implementation

The Exchange proposes to implement this rule on April 1, 2016, and will issue an Options Trader Alert in advance to inform market participants of such date.<sup>25</sup>

### III. Discussion and Commission Findings

After careful review of the proposed rule change, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>26</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>27</sup> 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,

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<sup>21</sup> See Notice, supra note 4, at 7167.

<sup>22</sup> See id.

<sup>23</sup> See id.

<sup>24</sup> See id.

<sup>25</sup> See id. at 7168.

<sup>26</sup> 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).

<sup>27</sup> 15 U.S.C. 78f(b)(5).

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. In addition, the Commission finds that the proposed rule change is consistent with Section 6(b)(8) of the Act, which requires the rules of the exchange not to impose any burden on competition not necessary or appropriate in furtherance of the Act.<sup>28</sup>

The Commission previously has articulated its position regarding the application of Section 6 of the Act in evaluating distinctions among market participants proposed by exchanges and the discretion available to an exchange to set an appropriate level of advantages and responsibilities of persons trading on its market.<sup>29</sup> In particular, the Commission previously indicated that it does not believe that priority for public customer orders is a statutorily-required attribute of an exchange and therefore the grant of such priority is within an exchange's prerogative and business judgement, as long as such provision is otherwise consistent with the requirements of the Act.<sup>30</sup>

The Commission notes that the Exchange is not amending the threshold of 390 orders in listed options per day but is revising the method for counting Professional orders in the context of multi-part orders and cancel/replace activity. The Commission believes that the proposal is designed to set forth a reasonable and objective approach to determine Professional customer status. Specifically, the proposal addresses how to account for complex orders, parent/child orders, and cancel/replace orders. The Commission believes that distinguishing between

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<sup>28</sup> 15 U.S.C. 78f(b)(8).

<sup>29</sup> See ISE Approval Order, supra note 3, at 5699, n.59.

<sup>30</sup> See id. at 5700.

complex orders with 9 or more options legs and those orders with 8 or fewer options legs is a reasonable and objective approach.

In addition, the Commission believes that PHLX's proposal appropriately distinguishes between parent/child orders that are generated by a broker's efforts to obtain an execution on a larger size order while minimizing market impact and multi-part orders that are used by more sophisticated market participants. Similarly, the Commission believes that the proposed rule change under which cancel/replace orders will count as separate orders with limited exceptions is a reasonable and objective approach to distinguish the orders of retail customers that are "worked" by a broker from orders generated by algorithms used by more sophisticated market participants. Similar to what it has noted in past Professional customer filings, the Commission believes that the line that Phlx now seeks to draw between "priority" customers and Professional customers reflects Phlx's belief that the orders of a person who submits, on average, more than one order every minute of the trading day need not (or should not) be granted the same benefit or incentive that is granted to customers who do not trade on such a scale.<sup>31</sup> The Commission believes that the grant of priority to certain participants over others, in a manner that is consistent with the Act is most reasonably viewed as within the discretion of the Exchange.<sup>32</sup> Thus, the Commission believes that PHLX's proposal, which establishes an objective methodology for counting average daily order submissions for Professional order counting purposes, is consistent with the Act.

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<sup>31</sup> See id. at 5701.

<sup>32</sup> See id. at 5700.

V. Solicitation of Comments on Amendment No. 1 to the Proposed Rule Change

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 1 to 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 No. SR-Phlx-2016-10 on the subject line.

Paper comments:

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

All submissions should refer to File No. SR-Phlx-2016-10. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also 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 No. SR-Phlx-2016-10 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1

The Commission finds good cause to approve the proposed rule change, as modified by Amendment No. 1, prior to the thirtieth day after the date of publication of notice of the amended proposal in the Federal Register. The revisions made to the proposal in Amendment No. 1 provided clarifying language for how cancel and replace orders will be counted in addition to changing how complex orders will be counted with respect to Professional order counting. In particular, Amendment No. 1 modified the proposal to provide that a complex order compromised of 9 legs or more will count as multiple orders with each option leg counting as its own separate order instead of 5 legs or more as previously proposed by the Exchange.<sup>33</sup> Amendment No. 1 effectively allows retail customers to use more advanced trading strategies (i.e., complex orders with up to 8 legs) without having that activity counted as multiple orders for purposes of Professional order counting. Thus, the Commission believes that the changes in Amendment No. 1 adopt a more permissive threshold for complex orders, and ultimately could decrease the number of persons or entities that will meet the definition of Professional under the new rule. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>34</sup> to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

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<sup>33</sup> See Amendment No. 1, supra note 5.

<sup>34</sup> 15 U.S.C. 78s(b)(2)

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>35</sup> that the proposed rule change (SR-Phlx-2016-10), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>36</sup>

Robert W. Errett  
Deputy Secretary

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<sup>35</sup> See id.

<sup>36</sup> 17 CFR 200.30-3(a)(12).