

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-79145; File No. SR-Phlx-2016-109)

October 24, 2016

Self-Regulatory Organizations; NASDAQ PHLX LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Adopt Phlx Rule 765 (Prohibition Against Trading Ahead of Customer Orders)

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> notice is hereby given that on October 20, 2016, NASDAQ PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III, below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to adopt Phlx Rule 765 (Prohibition Against Trading Ahead of Customer Orders). Phlx also proposes to amend Rule 3404 (Recording of Order Information) to include an additional order reporting requirement related to one of the exceptions in Rule 765.

The text of the proposed rule change is set forth below. Proposed new language is underlined; deleted text is in brackets.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

## **RULES OF THE EXCHANGE**

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### **Rule 765. Prohibition Against Trading Ahead of Customer Orders**

(a) Phlx members and persons associated with a member shall comply with FINRA Rule 5320 as if such Rule were part of Phlx's rules.

(b) For purposes of this Rule:

(1) References to FINRA Rules 5310, 5320 and 7440 shall be construed as references to Phlx Rules 764, 765 and 3404, respectively;

(2) The reference in FINRA Rule 5320 to an "institutional account", as defined in FINRA Rule 4512(c), shall be construed to apply to accounts of customers that do not meet the definition of "non-institutional customer", as defined in Phlx Rule 763(c);

(3) FINRA Rule 5320.02(b) and the reference to FINRA Rule 6420 therein shall be disregarded;

(4) References to "FINRA" shall be construed as references to "Phlx".

(c) Phlx members and persons associated with a member relying upon the exception set forth in FINRA Rule 5320.03 shall comply with the reporting requirements stated therein. Phlx and FINRA are parties to the Regulatory Contract pursuant to which FINRA has agreed to perform certain functions on behalf of Phlx. Therefore, Phlx members are complying with Phlx Rule 765 by complying with FINRA Rule 5320.03 as written, including, for example, reporting requirements and notifications. In addition, functions performed by FINRA, FINRA departments, and FINRA staff under Phlx Rule 765 are being performed by FINRA on behalf of Phlx.

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**Rule 3000. NASDAQ OMX PSX**

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**Rule 3404. Recording of Order Information**

With respect to orders for securities listed on the NASDAQ Stock Market or the Exchange, member organizations and persons associated with a member organization shall comply with the following Rule:

(a) No Change.

(b) Order Origination and Receipt

Unless otherwise indicated, the following order information must be recorded under this Rule when an order is received or originated. For purposes of this Rule, the order origination or receipt time is the time the order is received from the customer.

(1) through (16) No Change.

(17) an identification of the order as related to a Program Trade or an Index Arbitrage Trade;  
[and]

(18) the type of account, i.e., retail, wholesale, employee, proprietary, or any other type of account designated by the Exchange, for which the order is submitted[.]; and

(19) if the member is relying on the exception provided in FINRA Rule 5320.02 with respect to the order, the unique identification of any appropriate information barriers in place at the department within the member where the order was received or originated.

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

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the

proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

Phlx proposes to adopt Rule 765 (Prohibition Against Trading Ahead of Customer Orders). This rule will largely incorporate FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders), commonly known as the "Manning Rule", by reference. Phlx also proposes to adopt, as part of Rule 3404 (Recording of Order Information), language that specifies how members shall comply with the exception set forth in FINRA Rule 5320.02 (No-Knowledge Exception) if the member implements information barriers in reliance on that exception.

Phlx believes that Rule 765 will add important additional safeguards to the treatment of customer orders by members, and that the amendment to Rule 3404 will increase regulatory efficiency in conducting surveillance to ensure compliance with Rule 765. In addition, both The Nasdaq Stock Market LLC ("Nasdaq") and NASDAQ BX, Inc. ("BX") have previously adopted rules prohibiting the trading ahead of customer orders that reference FINRA Rule 5320, and so this proposal will further align the Phlx rules with Nasdaq and BX rules in this regard.<sup>3</sup>

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<sup>3</sup> FINRA Rule 5320 was previously codified as NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders). FINRA adopted FINRA Rule 5320 in 2011, which combined NASD IM-2110-2 and NASD Rule 2111 into one rule and made several changes. See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011) (SR-FINRA-2009-090). Nasdaq adopted IM-2110-2 as part of its Form 1 application that it submitted in 2001. See Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001) (File No. 10-131). Nasdaq subsequently amended that rule to reflect the adoption of FINRA Rule 5320. See Securities Exchange Act Release No.

Proposed Rule 765 contains three distinct elements. First, Rule 765 states that members shall be required to comply with FINRA Rule 5320 as if that rule were part of Phlx's rules. As part of incorporating FINRA Rule 5320 by reference, Rule 765 states that references to FINRA shall be construed as references to Phlx, and replaces cross-references to other FINRA rules with cross-references to corresponding Phlx rules. Second, Rule 765 exempts members from complying with FINRA Rule 5320.02(b) and the reference to FINRA Rule 6420 therein, as those provisions deal with trading in OTC equity securities, which Phlx does not regulate. Finally, Rule 765 addresses how members and persons associated with a member relying upon the exception set forth in FINRA Rule 5320.03 (relating to riskless principal transactions) shall comply with the reporting requirements stated therein. These elements are further discussed below.

#### Compliance with FINRA Rule 5320

Rule 765 states that Phlx members and persons associated with a member shall comply with FINRA Rule 5320 as if such Rule were part of Phlx's rules. As part of incorporating FINRA Rule 5320 by reference, Rule 765 states that references to "FINRA" shall be construed as references to "Phlx".

Rule 765 also changes cross-references from FINRA rules to Phlx rules. Specifically, FINRA Rule 5320 cross-references FINRA Rules 5310 (Best Execution and Interpositioning), 5320 (Prohibition Against Trading Ahead of Customer Orders) and 7440 (Recording of Order Information). Rule 765 changes those cross-references to references to Phlx Rules 764 (Best

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68153 (November 5, 2012), 77 FR 67409 (November 9, 2012) (SR-NASDAQ-2012-124). In 2008, BX adopted IM-2110-2 (Trading Ahead of Customer Limit Order), which incorporates NASD IM-2110-2 by reference, and Rule 2111 (Trading Ahead of Customer Market Orders), which incorporates NASD Rule 2111 by reference. See Securities and Exchange Act Release No. 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48).

Execution and Interpositioning), 765 (Prohibition Against Trading Ahead of Customer Orders) and 3404 (Recording of Order Information), respectively.

Finally, FINRA Rule 5320 contains an exception for large orders (10,000 shares or more, unless such orders are less than \$100,000 in value) and for orders for customers that meet the definition of an “institutional account”, as defined in FINRA Rule 4512(c). Phlx proposes to adopt a similar exception by cross-referencing Phlx Rule 763(c), which defines a “non-institutional customer” using the same criteria as FINRA Rule 4512(c).<sup>4</sup> Although the two definitions use the same criteria, those criteria are used to define opposite concepts (“institutional account” versus “non-institutional customer”). Since the same criteria is used to define opposite concepts, Rule 765 states that the reference in FINRA Rule 5320 to an “institutional account” as defined in FINRA Rule 4512(c) shall be construed to apply to accounts of customers that do not meet the definition of “non-institutional customer”, as defined in Rule 763(c).

Phlx believes that it is appropriate to adopt a Manning rule that is substantively the same as the current FINRA rule, including the various exceptions to that rule. First, Phlx believes that the rationale for initially adopting the Manning rule continues to apply today. In initially approving NASD IM-2110-2, the Commission found that the rule would enhance investor confidence by allowing more trade volume to be made available to customers by giving customer orders priority over the market maker’s proprietary trading, which would result in quicker and

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<sup>4</sup> Rule 763(c) defines a non-institutional customer as “a customer that is not (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.” FINRA Rule 4512(c) uses the same criteria to define an “institutional account”. See FINRA Rule 4512(c).

more frequent executions for customers.<sup>5</sup> The Commission also found that the rule would improve the price discovery process, as market makers would be encouraged to handle customer limit orders in a timely fashion, which would provide investors with a more accurate indication of the buy and sell interest at a given moment.<sup>6</sup> Phlx believes that the reasons justifying the proposal of the original NASD rule also apply here.

Second, as noted above, both Nasdaq and BX have adopted rules prohibiting the trading ahead of customer orders that largely adopt FINRA Rule 5320 by reference, and so this proposal will further align the Phlx rules with Nasdaq and BX rules in this regard.

Phlx also believes that it is appropriate to incorporate by reference the various exceptions set forth in the FINRA rule. With respect to incorporating FINRA's definition of an institutional account, and that rule's corresponding carve-out for institutional accounts, the SEC noted in originally approving NASD IM-2110-2 (which allowed members to set the specific terms and conditions for acceptance of institutional orders) that institutional orders may qualify for special treatment. The SEC found that, because most market makers cannot typically fill institutional-size orders out of inventory, institutions generally only hold market makers to a "best efforts" standard in return for the willingness of the market maker to put up substantial capital to provide liquidity for large orders.<sup>7</sup> Phlx believes that a similar rationale applies here, and that this rationale justifies incorporating this exception by reference.

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<sup>5</sup> See Securities Exchange Act Release No. 34279 (June 29, 1994), 59 FR 16369 (July 7, 1994) (SR-NASD-93-58).

<sup>6</sup> Id.

<sup>7</sup> See Securities Exchange Act Release No. 34279 (June 29, 1994), 59 FR 16369 (July 6, 1994) (SR-NASD-93-58).

Phlx also believes that it is appropriate to incorporate by reference the exception in FINRA Rule 5320 for riskless principal trades.<sup>8</sup> In initially proposing this exception, the NASD stated that it considered trades that met the standards of the riskless principal exception to be functionally equivalent to an agency trade and therefore did not materially implicate a market maker's proprietary trading.<sup>9</sup> According to NASD, this position was primarily based on the rule's requirement that only trades where a market maker gives the customer a trade price that reflects the market maker's actual cost in acquiring the stock would be eligible for the exception, as the requirement to "trade flat" effectively removed concerns that a member would breach its fiduciary duty to customer limit orders that it holds.<sup>10</sup> Phlx believes that the same rationale applies here, and that this rationale justifies incorporating this exception by reference.

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<sup>8</sup> FINRA Rule 5320.03 provides that the obligations under the rule "shall not apply to a member's proprietary trade if such proprietary trade is for the purposes of facilitating the execution, on a riskless principal basis, of an order from a customer (whether its own customer or the customer of another broker-dealer) (the "facilitated order"), provided that the member: (a) submits a report, contemporaneously with the execution of the facilitated order, identifying the trade as riskless principal to FINRA (or another self-regulatory organization if not required under FINRA rules); and (b) has written policies and procedures to ensure that riskless principal transactions for which the member is relying upon this exception comply with applicable FINRA rules. At a minimum these policies and procedures must require that the customer order was received prior to the offsetting principal transaction, and that the offsetting principal transaction is at the same price as the customer order exclusive of any markup or markdown, commission equivalent or other fee and is allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution. Members must have supervisory systems in place that produce records that enable the member and FINRA to reconstruct accurately, readily, and in a time-sequenced manner all facilitated orders for which the member relies on this exception."

<sup>9</sup> See Securities Exchange Act Release No. 46006 (May 30, 2002), 67 FR 39455 (June 7, 2002) (SR-NASD-2002-66). NASD extended this exception to NASD Rule 2111 (Trading Ahead of Customer Market Orders) when NASD adopted that rule in 2005. See Securities Exchange Act Release No. 52226 (August 9, 2005), 70 FR 48219 (August 16, 2005) (SR-NASD-2004-045).

<sup>10</sup> See Securities Exchange Act Release No. 46006 (May 30, 2002), 67 FR 39455 (June 7, 2002) (SR-NASD-2002-66).

### Exception from Requirement to Comply With FINRA Rule 5320.02(b)

Rule 765 excludes a provision of FINRA's Manning rule that relates to the over-the-counter market. Specifically, Rule 765 provides that FINRA Rule 5320.02(b) and its reference to FINRA Rule 6420 therein shall be disregarded. FINRA Rule 5320.02 applies the Manning rule to OTC equity securities, which are defined in FINRA Rule 6420.<sup>11</sup> Phlx is excluding FINRA Rule 5320.02(b) and its reference to FINRA Rule 6420 from Rule 765 because this provision relates to over-the-counter securities, and Phlx does not regulate the over-the-counter market.<sup>12</sup>

### Compliance with FINRA Rule 5320.03

Finally, Phlx proposes to adopt language governing how Phlx members may comply with one of the exceptions to FINRA's Manning rule; specifically, the exception for riskless principal trades.<sup>13</sup> If a member relies upon the riskless principal exception, FINRA Rule 5320.03 requires that the member, among other things, submit a report contemporaneous with the execution of the customer trade identifying the trade as riskless principal, and have written policies and procedures in place to ensure that the riskless principal trades for which the member is relying

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<sup>11</sup> FINRA Rule 5320.02 provides that, with respect to OTC equity securities, if a member implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent a non-market-making trading unit from obtaining knowledge of customer orders held by a separate trading unit, the non-market-making trading unit trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit. FINRA defines an OTC equity security as "any equity security that is not an 'NMS stock' as that term is defined in Rule 600(b)(47) of SEC Regulation NMS; provided, however, that the term 'OTC Equity Security' shall not include any Restricted Equity Security." See FINRA Rule 6420(f).

<sup>12</sup> Nasdaq proposed a similar exclusion when updating its Manning rule to reflect the adoption of FINRA Rule 5320. See Securities Exchange Act Release No. 68153 (November 5, 2012), 77 FR 67409 (November 9, 2012) (SR-NASDAQ-2012-124).

<sup>13</sup> That exception is discussed in note 8 above.

upon the exception comply with applicable FINRA rules. Rule 765(c) states that members and persons associated with a member relying upon the exception set forth in FINRA Rule 5320.03 shall comply with the reporting requirements stated therein. The Rule further states that Phlx and FINRA are parties to the Regulatory Contract pursuant to which FINRA has agreed to perform certain functions on behalf of Phlx. Therefore, Phlx members are complying with Phlx Rule 765 by complying with FINRA Rule 5320.03 as written, including, for example, reporting requirements and notifications. In addition, Rule 765 states that functions performed by FINRA, FINRA departments, and FINRA staff under Phlx Rule 765 are being performed by FINRA on behalf of Phlx. Phlx believes that this provision provides useful clarification as to how members may comply with the rule's riskless principal exception.

#### Rule 3404 and Compliance with the No-Knowledge Exception

Phlx also proposes to adopt, as part of Rule 3404 (Recording of Order Information) language that specifies how members shall comply with the exception set forth in FINRA Rule 5320.02 (No-Knowledge Exception) if the member implements information barriers in reliance on that exception. Under this exception, if a member implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent one trading unit from obtaining knowledge of customer orders held by a separate trading unit, those other trading units trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit.<sup>14</sup> FINRA Rule 5320.02 further specifies that, if a member implements and utilizes appropriate information barriers in reliance on this exception, the member must uniquely identify such information barriers as prescribed in

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<sup>14</sup> See FINRA Rule 5320.02. This exception applies to NMS stocks, as defined in Rule 600 of Regulation NMS. See 17 CFR 242.600(47).

FINRA Rule 7440(b)(19).<sup>15</sup> That rule states that, if the member is relying on the exception provided in FINRA Rule 5320.02 with respect to the order, the member must record the unique identification of any appropriate information barriers in place at the department within the member where the order was received or originated. Members must record this information when an order is received or originated, which means the time the order is received from the customer.<sup>16</sup>

As part of incorporating FINRA's Manning rule, Phlx proposes to adopt, as Rule 3404(b)(19), corresponding language that sets forth how members shall comply with the no-knowledge exception if members utilize information barriers in reliance on that exception. Just as FINRA Rule 5320.02 references the applicable requirement in FINRA Rule 7440(b) that members identify the appropriate information barriers in place in connection with the order that is subject to the no-knowledge exception, Rule 765 shall reference the corresponding requirement in Rule 3404.

Phlx believes that it is appropriate to adopt a corresponding requirement that a member identify, at the time of order receipt or origination, the appropriate information barriers in place if a member is utilizing information barriers in reliance on the no-knowledge exception. In initially proposing this requirement as part of FINRA Rule 7440, FINRA stated that it would enhance regulatory efficiency by allowing FINRA to ascertain, on an automated basis, those firms that are claiming the no-knowledge exception, thereby reducing the number of "false

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<sup>15</sup> FINRA Rule 7440(b)(19) has subsequently been re-numbered as Rule 7440(b)(20). See Securities Exchange Act Release No. 77523 (April 5, 2016), 81 FR 21427 (April 11, 2016) (SR-FINRA-2016-006).

<sup>16</sup> See FINRA Rule 7440(b)(20).

positives” where trading ahead may otherwise be indicated.<sup>17</sup> Phlx believes that the same rationale applies here. Phlx also notes that Nasdaq has incorporated the no-knowledge exception as part of its Manning rule and the corresponding language that sets forth how members shall comply with the no-knowledge exception if members utilize information barriers in reliance on that exception.<sup>18</sup>

## 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act,<sup>19</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>20</sup> in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general to protect investors and the public interest. Phlx believes that the proposed rule will add important additional safeguards to the treatment of customer orders by members, and notes that the SEC has previously found that the Manning rule may result in increased market quality for market participants. Phlx also notes that the SEC has previously approved the various exceptions to the rule, such as the exception for institutional accounts and the riskless principal exception, which Phlx proposes to incorporate by reference. Phlx believes that the proposed amendment to Rule 3404 will increase regulatory efficiency in conducting surveillance to ensure compliance with Rule 765. Finally, Nasdaq and BX already contain rules prohibiting trading ahead of customer orders that reference the applicable FINRA rule, and so this proposal will further align the Phlx rules with Nasdaq and BX rules in this regard.

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<sup>17</sup> See Securities Exchange Act Release No. 65692 (November 4, 2011), 76 FR 70195 (November 10, 2011) (Notice of filing of SR-FINRA-2011-063).

<sup>18</sup> See Nasdaq Rule 5320A and Rule 7440A.

<sup>19</sup> 15 U.S.C. 78f(b).

<sup>20</sup> 15 U.S.C. 78f(b)(5).

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

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule will apply equally to all similarly-situated members, i.e., members that handle customer market and limit orders. To the extent that the rule contains exceptions for certain kinds of accounts (such as trades for accounts of customers that do not meet the definition of “non-institutional customer”) and certain kinds of trades (such as riskless principal trades), and additional reporting requirements for firms that use information barriers pursuant to the no-knowledge exception, these exceptions and requirements will also apply equally to all similarly-situated market participants. In addition, the SEC has previously found that such exceptions and requirements are consistent with the Act.

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

No written comments were either solicited or received.

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

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 from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>21</sup> and subparagraph (f)(6) of Rule 19b-4 thereunder.<sup>22</sup>

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<sup>21</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>22</sup> 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.

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: (i) necessary or appropriate in the public interest; (ii) for the protection of investors; or (iii) otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

#### IV. Solicitation of Comments

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

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-Phlx-2016-109 on the subject line.

##### Paper comments:

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

All submissions should refer to File Number SR-Phlx-2016-109. 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 Number SR-Phlx-2016-109 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.<sup>23</sup>

Robert W. Errett  
Deputy Secretary

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<sup>23</sup> 17 CFR 200.30-3(a)(12).