

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-85136; File No. SR-Phlx-2018-72)

February 14, 2019

Self-Regulatory Organizations; Nasdaq PHLX LLC; Order Approving a Proposed Rule Change to Establish Rules Governing the Give Up of a Clearing Member by a Member Organization on Exchange Transactions

I. Introduction

On November 6, 2018, Nasdaq PHLX LLC (“Phlx” or “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 establish rules governing the “give up” process by which an Exchange member organization, in connection with executing a trade on the Exchange, indicates to the Exchange (i.e., “gives up”) the name of a Clearing Member<sup>3</sup> that will be responsible for the clearance of that transaction. The proposed rule change was published for comment in the Federal Register on November 26, 2018.<sup>4</sup> On January 9, 2019, pursuant to Section 19(b)(2) of the Act,<sup>5</sup> the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.<sup>6</sup>

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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> See Phlx Rule 1000(b)(3) (defining “Clearing Member” as a member organization that has been admitted to membership in the Options Clearing Corporation (“OCC”) pursuant to the provisions of the rules of the Options Clearing Corporation).

<sup>4</sup> See Securities Exchange Act Release No. 84624 (Nov. 19, 2018), 83 FR 60547 (“Notice”).

<sup>5</sup> 15 U.S.C. 78s(b)(2).

<sup>6</sup> See Securities Exchange Act Release No. 84981, 83 FR 837 (Jan. 31, 2019) (designating February 24, 2019 as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change).

The Commission received three comment letters on the proposed rule change, each in support of the proposal.<sup>7</sup> This order approves the proposed rule change.

## II. Description of the Proposed Rule Change

Exchange rules currently require that, in order to enter transactions on the Exchange, a member organization either must be a Clearing Member or have a Clearing Member agree to accept financial responsibility for the member organization's transactions via a clearing arrangement.<sup>8</sup> Further, Phlx Rule 1052 provides generally that Clearing Members are responsible for the clearing their own Exchange transactions as well as Exchange transactions of each member organization that gives up the Clearing Member's name provided that the Clearing Member has authorized such member organization to give up its name on Exchange transactions. Exchange rules do not, however, establish a framework for the give up authorization process. To address this, Phlx proposes to adopt Rule 1037 and amend Rule 1052 to establish requirements for the give up process, including specific procedures, in greater detail.

Specifically, proposed Rule 1037 will allow Clearing Members to "opt in" and request that the Exchange systematically restrict use of one or more of its OCC clearing numbers (each a "Restricted OCC Number"). Once restricted, Exchange member organizations will not be able to give up the Restricted OCC Number to clear an Exchange transaction unless the Clearing Member previously has submitted to the Exchange written authorization permitting that member organization to give up that Restricted OCC Number. If a Clearing Member does not "opt in" to

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<sup>7</sup> See Letters to Brent J. Fields, Secretary, Commission, from: (1) Matthew R. Scott, President, Merrill Lynch Professional Clearing Corp, dated December 7, 2018 ("Scott Letter"); (2) Ellen Greene, Managing Director, SIFMA, dated December 17, 2018 ("SIFMA Letter"); and (3) John P. Davidson, President and Chief Operating Officer, OCC, dated December 19, 2018 ("Davidson Letter"). The comment letters are available at <https://www.sec.gov/comments/sr-phlx-2018-72/srphlx201872.htm>.

<sup>8</sup> See Phlx Rule 1046 (Clearing Arrangements).

this process for a particular OCC number (a “Non-Restricted OCC Number”), that number would be available to be given up by any Exchange member organization.

#### Give Up Process for Restricted OCC Numbers

A Clearing Member that requests the Exchange to restrict use of one or more of its OCC clearing numbers would “opt in” by sending to the Exchange a completed “Clearing Member Restriction Form”<sup>9</sup> that identifies the requested Restricted OCC Numbers.<sup>10</sup> At the same time, the Clearing Member would list on the form the Exchange member organizations that it authorizes to give up that Restricted OCC Number (each an “Authorized Member Organization”).<sup>11</sup> For newly Restricted OCC Numbers, the Exchange will require 90 days before the restriction becomes effective within the Exchange’s system.<sup>12</sup>

Thereafter, a member organization may only give up a Restricted OCC Number if the member organization has previously been identified and processed by the Exchange as an Authorized Member Organization, except that a member organization may give up the Restricted OCC Number of its guarantor with whom it has a letter of guarantee without being identified as an Authorized Member Organization.<sup>13</sup>

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<sup>9</sup> The Exchange represented in its filing that it will maintain this form and a list of the Restricted OCC Numbers on its website, which it will update on a regular basis, along with the Clearing Member’s contact information to assist member organizations with requesting authorization for a Restricted OCC Number. See Notice, supra note 4 at n.7.

<sup>10</sup> See Proposed Phlx Rule 1037(b)(i). The restriction would remain in effect until terminated by the Clearing Member. See id. The Exchange also proposes to amend Rule 1052 regarding financial responsibility of Exchange options transactions cleared through Clearing Members to clarify that Rule 1052 applies to all Clearing Members regardless of whether they “opt in” pursuant to Phlx Rule 1037.

<sup>11</sup> See id.

<sup>12</sup> See id.

<sup>13</sup> See Proposed Phlx Rule 1037(d).

Once a Restricted OCC Number is effective, a Clearing Member will be able to submit a new Clearing Member Restriction Form to authorize, or remove from authorization, a member organization from its list of Authorized Member Organizations approved to give up its Restricted OCC Number(s), as well as amend its list of Restricted OCC Numbers.<sup>14</sup> The Exchange will promptly notify member organizations if they are no longer authorized to give up a Clearing Member's Restricted OCC Number.<sup>15</sup>

The Exchange will ensure the authorized use of Restricted OCC Numbers through its systems and will not allow an unauthorized member organization to give up a Restricted OCC Number. Specifically, for orders that are executed on the trading floor in open outcry using the Options Floor Based Management System ("FBMS"), the Exchange will reject the clearing portion of the trade if an unauthorized member organization enters a Restricted OCC Number.<sup>16</sup> The member organization will receive notification of the rejected clearing information, and will be required to modify the clearing information by contacting the Exchange.<sup>17</sup> For all other orders (i.e., orders that are submitted directly to the exchange's system), the Exchange will not

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<sup>14</sup> See Proposed Phlx Rule 1037(b)(iii). Such changes will be effective on the next business day under regular circumstances, but could be effective intra-day in unusual circumstances. See id.

<sup>15</sup> See id.

<sup>16</sup> See Proposed Phlx Rule 1037(c).

<sup>17</sup> See id. According to the Exchange, the FBMS order will be executed, provided the terms of the trade comply with the relevant Exchange rules, and the execution reported to the consolidated tape. The System will, however, reject the clearing portion, and the member organization will have to amend the clearing information by contacting the Exchange. See Notice, supra note 4 at n. 11.

allow an unauthorized member organization to give up a Restricted OCC Number at the firm mnemonic level at the point of order entry.<sup>18</sup>

### Misuse of the Rule

Finally, Phlx Rule 1037(e) provides that an intentional misuse of the Rule by any party is impermissible and may be treated as a violation of Rule 707 (“Conduct Inconsistent with Just and Equitable Principles of Trade”) or Rule 708 (“Acts Detrimental to the Interest or Welfare of the Exchange”).<sup>19</sup>

### III. Discussion and Commission Findings

After careful consideration of the proposal, the Commission finds that the Exchange’s proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>20</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>21</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating,

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<sup>18</sup> See Proposed Phlx Rule 1037(c). Specifically, the Exchange states that its system will block the entry of the order from the outset. See Notice, supra note 4 at n. 13. The Exchange notes that a valid mnemonic will be required for any order to be submitted directly to the system, and a mnemonic will only be set up for a member organization if there is already a clearing arrangement in place for that firm either through a letter of guarantee (as is the case today) or as proposed in the case of a Restricted OCC Number, the member organization must be an Authorized Member Organization for that Restricted OCC Number. See id. As proposed, the system also will now restrict any post-trade allocation changes if the member organization is not authorized to use a Restricted OCC Number. See id.

<sup>19</sup> See Proposed Phlx Rule 1037(e). See also Notice, supra note 4 at 60549 (providing one example of intentional misuse where a member organization sends orders to a Restricted OCC Number without authorization to do so).

<sup>20</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>21</sup> 15 U.S.C. 78f(b)(5).

clearing, settling, processing information with respect to, and facilitating transactions in securities and, in general, to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission received three comment letters on the proposed rule change, each supporting it.<sup>22</sup> One commenter argues that the proposal “is a critical first step to reduce risk in listed-options clearing,” and will facilitate the ability of Clearing Members “to properly assess and enforce credit limits for authorized executing brokers and their clients.”<sup>23</sup> Another commenter notes that the Exchange’s proposal is the culmination of efforts among industry participants to address and ultimately reduce clearing member risks.<sup>24</sup> Further, one commenter believes that the proposal “strikes the right balance across all participants.”<sup>25</sup>

The Commission believes that the proposal is designed to foster cooperation and coordination among the parties engaged in facilitating transactions in securities by setting forth a basic framework within which a Clearing Member can exercise greater control over the use of its clearing services by customers using the services of third party executing brokers in a manner that is not intended to allow for or impose a burden on competition that is not necessary or appropriate in furtherance of the Act. In particular, the Exchange’s proposal will implement a defined and standardized process through which a Clearing Member can “opt in” to limit the use of one or more of its OCC clearing numbers to member organizations that it pre-authorizes in writing, which the Exchange will then enforce through its systems. These provisions are designed to help assure the orderly clearance and settlement of Exchange trades and should, for

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<sup>22</sup> See supra note 7.

<sup>23</sup> SIFMA Letter, supra note 7, at 2.

<sup>24</sup> Davidson Letter, supra note 7, at 2.

<sup>25</sup> Scott Letter, supra note 7, at 1. See also SIFMA Letter, supra note 7, at 2.

example, reduce the chance for keypunch errors and may assist Clearing Members in enforcing the provisions of their clearing arrangements with customers.

As an integral and important part of this process, the Exchange will provide notice to affected member organizations, including by providing a 90-day delayed effectiveness on newly restricted OCC numbers, by providing notice to affected member organizations whose authorized status changes, and by providing publicly available information on all Restricted OCC Numbers and the corresponding Clearing Member contact information. In so doing, the proposed rule is designed to promote transparency and provide an orderly process by which third party executing brokers can make arrangements for clearing services to facilitate transactions on the Exchange.

Further, requiring Clearing Members to use standardized forms to designate all Restricted OCC Numbers and Authorized Member Organizations, and to make amendments to those items, should enhance Phlx's ability to monitor and enforce compliance with its proposed rule relating to the give up process. Use of standardized forms also may make it easier for Clearing Members and member organizations to comply with the proposed rule, and should benefit all members by providing written confirmation of a member organization's authorized status with respect to a specific Restricted OCC Number for a particular Clearing Member.

The Commission believes that the proposal seeks to address the needs of different parties involved in facilitating transactions in securities and does so in a balanced manner that provides a reasonable framework for the authorization process. Moreover, the proposal recognizes the need for a member organization to be able to give up its guarantor, and minimizes burdens on the member organization and Clearing Member by allowing such give ups to occur without the need to obtain any further authorization through use of the Clearing

Member Restriction Form. In this manner, the proposed rule change recognizes that there will always be a Clearing Member that will be financially responsible for a trade, which should foster operational certainty and facilitate cooperation and coordination with persons engaged in clearing transactions.

For the foregoing reason, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act<sup>26</sup> and the rules and regulations thereunder applicable to national securities exchanges.

#### IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,<sup>27</sup> that the proposed rule change (SR-Phlx-2018-72) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>28</sup>

Eduardo A. Aleman  
Deputy Secretary

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

<sup>27</sup> 15 U.S.C. 78s(b)(2).

<sup>28</sup> 17 CFR 200.30-3(a)(12).