

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67294; File No. SR-PHLX-2012-68)

June 28, 2012

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, to Accept Inbound Orders from NASDAQ OMX BX's New Options Market

I. Introduction

On May 15, 2012, 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 accept inbound options orders routed by NASDAQ Options Services LLC ("NOS") from NASDAQ OMX BX ("BX") on a one year pilot basis in connection with the establishment of a new options market by BX. The proposed rule change was published for comment in the Federal Register on May 24, 2012.³ The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Background

PHLX Rule 985(b) prohibits the Exchange or any entity with which it is affiliated from, directly or indirectly, acquiring or maintaining an ownership interest in, or engaging in a business venture with, an Exchange member or an affiliate of an Exchange member in the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 67026 (May 18, 2012), 77 FR 31053 ("Notice"). The Commission notes that on May 17, 2012, the Exchange submitted Amendment No. 1 to the proposed rule change, to make technical amendments to Item 3.a of the Form 19b-4 and Item II of Exhibit 1.

absence of an effective filing under Section 19(b) of the Act.⁴ NOS is a registered broker-dealer that is a member of the Exchange, and currently provides to members of the Exchange optional routing services to other markets.⁵ NOS is owned by NASDAQ OMX Group, Inc. (“NASDAQ OMX”), which also owns three registered securities exchanges – the Exchange, BX, and the NASDAQ Stock Market LLC (“NASDAQ”).⁶ Thus, NOS is an affiliate of these exchanges.⁷ Absent an effective filing, PHLX Rule 985(b) would prohibit NOS from being a member of the Exchange. The Commission initially approved NOS’s affiliation with PHLX and its affiliated exchanges in connection with NASDAQ OMX’s acquisition of PHLX and BX,⁸ and NOS currently performs certain limited activities for each.⁹ With the current proposed rule change, the Exchange seeks approval to permit NOS to perform a new function.

⁴ 15 U.S.C. 78s(b). PHLX Rule 985 also prohibits a PHLX member from being or becoming an affiliate of PHLX, or an affiliate of an entity affiliated with PHLX, in the absence of an effective filing under Section 19(b). See PHLX Rule 958(b)(1)(B).

⁵ See PHLX Rule 1080(m)(iii). See also Notice, supra note 3, at 31054 n.5 and accompanying text.

⁶ See Securities Exchange Act Release No. 58324 (August 7, 2008), 73 FR 46936 (August 12, 2008) (SR-BSE-2008-02; SR-BSE-2008-23; SR-BSE-2008-25; SR-BSECC-2008-01) (order approving NASDAQ OMX’s acquisition of BX) (“BX Acquisition Order”); Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (SR-PHLX-2008-31) (order approving NASDAQ OMX’s acquisition of PHLX) (“PHLX Acquisition Order”).

⁷ See id. See also Notice, supra note 3, at 31054.

⁸ See PHLX Acquisition Order, supra note 6, at 42877; and BX Acquisition Order, supra note 6, at 46944. See also Securities Exchange Act Release No. 57478 (March 12, 2008), 73 FR 14521, 14532-14533 (March 18, 2008) (SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080) (initially approving NASDAQ’s affiliation with NOS in connection with the establishment of the NASDAQ Options Market (“NOM”) (“NOM Approval Order”).

⁹ See, e.g., PHLX Rule 1080(m) (governing order routing by PHLX); and Securities Exchange Act Release No. 65399 (September 26, 2011), 76 FR 60955 (September 30, 2011) (SR-PHLX-2011-111) (approving routing of orders by NOS inbound to PHLX from NOM) (“PHLX Routing Order”).

On May 1, 2012, BX filed a proposed rule change to establish a new BX options market (“BX Options”), which will be an electronic trading system that trades options.¹⁰ As part of its proposal, BX proposed that NOS provide BX with outbound options routing services to other markets, including its affiliate PHLX. On May 15, 2012, the Exchange filed the instant proposal to allow the Exchange to accept such options orders routed inbound by NOS from BX on a one year pilot basis subject to certain limitations and conditions.¹¹

III. Discussion and Commission Findings

After careful review, 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.¹² Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act,¹³ which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulation thereunder, and the rules of the Exchange. Further, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁴ 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

¹⁰ See Securities Exchange Act Release No. 66983 (May 14, 2012), 77 FR 29730 (May 18, 2012) (SR-BX-2012-030) (notice of propose rule change to adopt rules for the new BX options market) (“BX Options Proposal”) On June 26, 2012, the Commission approved the BX Options Proposal. See Securities Exchange Act Release No. 67256 (June 26, 2012) (“BX Options Approval”).

¹¹ See Notice, supra note 3.

¹² In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹³ 15 U.S.C. 78f(b)(1).

¹⁴ 15 U.S.C. 78f(b)(5).

principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and 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. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

NOS will operate as a facility of BX that provides outbound options routing from BX Options to other market centers, subject to certain conditions.¹⁵ The operation of NOS as a facility of BX providing outbound routing services from BX Options will be subject to BX oversight, as well as Commission oversight. BX will be responsible for ensuring that NOS's outbound options routing service is operated consistent with Section 6 of the Act and BX rules. In addition, BX must file with the Commission rule changes and fees relating to BX's outbound options routing services.

Recognizing that the Commission has previously expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange of which it is a member, the Exchange previously proposed, and the Commission approved, limitations and conditions on NOS's affiliation with the Exchange.¹⁶ Also recognizing that the Commission has previously expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange to which it is routing orders, the Exchange proposed the following limitations and conditions to NOS's affiliation with the Exchange to permit the Exchange to accept inbound options orders that NOS routes in its

¹⁵ See BX Options Approval, supra note 10, at Section II.D.

¹⁶ See PHLX Acquisition Order, supra note 6, at 42887. See also Notice, supra note 3, at 31054 n.10 and accompanying text. In addition, the Exchange has authority to accept inbound orders that NOS routes in its capacity as a facility of NASDAQ, subject to certain limitations and conditions. See PHLX Routing Order, supra note 9, at 60956.

capacity as a facility of BX:¹⁷

- First, the Exchange and the Financial Industry Regulatory Authority (“FINRA”) will maintain a Regulatory Contract, as well as an agreement pursuant to Rule 17d–2 under the Act (“17d–2 Agreement”).¹⁸ Pursuant to the Regulatory Contract and the 17d–2 Agreement, FINRA will be allocated regulatory responsibilities to review NOS’s compliance with certain PHLX rules.¹⁹ Pursuant to the Regulatory Contract, however, the Exchange retains ultimate responsibility for enforcing its rules with respect to NOS.
- Second, FINRA will monitor NOS for compliance with PHLX’s trading rules, and will collect and maintain certain related information.²⁰
- Third, FINRA will provide a report to the Exchange’s chief regulatory officer (“CRO”), on a quarterly basis, that: (i) quantifies all alerts (of which the Exchange or FINRA is aware) that identify NOS as a participant that has potentially violated Commission or Exchange rules, and (ii) lists all investigations that identify NOS as a participant that has potentially violated Commission or PHLX rules.
- Fourth, the Exchange has in place PHLX Rule 985, which requires NASDAQ OMX, as the holding company owning both the Exchange and NOS, to establish and maintain

¹⁷ See Notice, supra note 3, at 31054.

¹⁸ 17 CFR 240.17d-2.

¹⁹ NOS is also subject to independent oversight by FINRA, its designated examining authority, for compliance with financial responsibility requirements.

²⁰ Pursuant to the Regulatory Contract, both FINRA and the Exchange will collect and maintain all alerts, complaints, investigations and enforcement actions in which NOS (in its capacity as a facility of BX routing orders to the Exchange) is identified as a participant that has potentially violated applicable Commission or Exchange rules. The Exchange and FINRA will retain these records in an easily accessible manner in order to facilitate any potential review conducted by the Commission’s Office of Compliance Inspections and Examinations. See Notice, supra note 3, at 31054 n.14.

procedures and internal controls reasonably designed to ensure that NOS does not develop or implement changes to its system, based on non-public information obtained regarding planned changes to the Exchange's systems as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members, in connection with the provision of inbound options order routing to the Exchange.

- Fifth, the Exchange proposes that the routing of options orders from NOS to the Exchange, in NOS's capacity as a facility of BX be authorized for a pilot period of one year.

In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest, and the potential for unfair competitive advantage.²¹ Although the Commission continues to be concerned about potential unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, for the

²¹ See, e.g., Securities Exchange Act Release Nos. 54170 (July 18, 2006), 71 FR 42149 (July 25, 2006) (SR-NASDAQ-2006-006) (order approving NASDAQ's proposal to adopt NASDAQ Rule 2140, restricting affiliations between NASDAQ and its members); 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (order approving the combination of the New York Stock Exchange, Inc. and Archipelago Holdings, Inc.); 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008) (SR-Amex-2008-62 and SR-NYSE-2008-60) (order approving the combination of NYSE Euronext and the American Stock Exchange LLC); 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) (SR-ISE-2009-85) (order approving the purchase by ISE Holdings of an ownership interest in Direct Edge Holdings LLC); 59281 (January 22, 2009), 74 FR 5014 (January 28, 2009) (SR-NYSE-2008-120) (order approving a joint venture between NYSE and BIDS Holdings L.P.); 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (File No. 10-182) (order granting the exchange registration of BATS Exchange, Inc.); 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (File Nos. 10-194 and 10-196) (order granting the exchange registration of EDGX Exchange, Inc. and EDGA Exchange, Inc.); and 62716 (August 13, 2010), 75 FR 51295 (August 19, 2010) (File No. 10-198) (order granting the exchange registration of BATS-Y Exchange, Inc.).

reasons discussed below, the Commission believes that it is consistent with the Act to permit NOS, in its capacity as a facility of BX, to route options orders inbound to the Exchange on a pilot basis, subject to the limitations and conditions described above.²²

The Commission believes that these limitations and conditions enumerated above will mitigate its concerns about potential conflicts of interest and unfair competitive advantage. In particular, the Commission believes that a non-affiliated SRO's oversight of NOS,²³ combined with a non-affiliated SRO's monitoring of NOS's compliance with the Exchange's rules and quarterly reporting to the Exchange, will help to protect the independence of the Exchange's regulatory responsibilities with respect to NOS. The Commission also believes that the Exchange's proposed amendments to PHLX Rule 985(b) are designed to ensure that NOS cannot use any information advantage it may have because of its affiliation with the Exchange. Furthermore, the Commission believes that the Exchange's proposal to allow NOS to route options orders inbound to the Exchange from BX, on a pilot basis, will provide the Exchange and the Commission an opportunity to assess the impact of any conflicts of interest of allowing an affiliated member of the Exchange to route orders inbound to the Exchange and whether such affiliation provides an unfair competitive advantage.

²² The Commission notes that these limitations and conditions are consistent with those previously approved by the Commission for other exchanges. See, e.g., BX Options Approval, supra, note 10, at Section II.D.2.

²³ This oversight will be accomplished through the 17d-2 Agreement between FINRA and the Exchange and the Regulatory Contract. See Notice, supra note 3, at 31054 n.12 and accompanying text.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change, as modified by Amendment No. 1, (SR-PHLX-2012-68) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

Kevin M. O'Neill
Deputy Secretary

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).