

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67680; File No. SR-Phlx-2012-106)

August 17, 2012

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Notice of Filing of Proposed Rule Change to Modify Exchange Rule 3307 to Institute a Five Millisecond Delay in the Execution Time of Marketable Orders on NASDAQ OMX PSX

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 9, 2012, NASDAQ OMX PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“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 modify Exchange Rule 3307 to institute a five millisecond delay in the execution time of marketable orders on NASDAQ OMX PSX (“PSX”). The Exchange proposes to implement the proposed rule change within 30 days of Commission approval. The text of the proposed rule change is available at <http://nasdaqomxphlx.cchwallstreet.com/nasdaqomxphlx/phlx>, at Phlx’s principal office and at the Commission’s Public Reference room.

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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

The purpose of the proposed rule change is to modify Exchange Rule 3307 to institute a five millisecond delay in the execution time of marketable orders. The proposal will be implemented initially on a one-year pilot basis with respect to the trading of securities listed on the NASDAQ Stock Market ("Tape C Securities"). The Exchange introduced PSX, which features a unique price/size/pro-rata execution algorithm, in order to encourage market participants to display more liquidity in a transparent market environment. As among equally priced orders on the PSX book, PSX allocates execution opportunities in proportion to the size of the posted order, rather than its time of entry. Thus, the Exchange's market model is intended to deemphasize the importance of speed in realizing trading opportunities.

Although PSX has enjoyed a measure of success, the Exchange is concerned that slower liquidity providers that post on PSX are sometimes subject to suboptimal executions due to disparities in the speed with which market participants are able to react to market information. Thus, in a circumstance where a broker posts a large order on PSX and changes in market conditions render the price of the order stale, a market participant with superior capabilities to process information may be able to route an order before the broker can change its price, thereby obtaining a fill at a price that is out of line with the price that will prevail in the market generally once the changes in the market conditions are fully digested. While the potential for a posted order to interact with orders entered by market participants with faster reaction capabilities

responding to short-term information – sometimes referred to as “toxic order flow” – exists on all markets, the larger posted sizes and pro rata allocation model on PSX may make the impact more pronounced, since fills are allocated among all market participants posting orders at a particular price.

It should also be noted that liquidity providers face asymmetric risks as compared with firms that seek to access liquidity opportunistically. To illustrate this point, consider the following example. Firm A is providing liquidity in 1,000 securities while Firm B is seeking opportunistically to access liquidity if it perceives a quote is mispriced. Both firms receive information (e.g., index market data from a futures market) simultaneously that causes both to re-evaluate the fair value of all 1,000 securities quoted by Firm A. Firm A immediately seeks to update its quotes to reflect the change in fair value, while Firm B seeks to access those quotes before they are updated. If Firm B’s orders are able to access a quote before it is updated, Firm A faces the risk of executing at stale prices in up to 1,000 securities. If, on the other hand, Firm A’s updates are processed before Firm B’s orders, Firm B faces the opportunity cost of failing to execute at the opportunistic price, but otherwise has no exposure as a result of its relative latency. As this illustrates, the risk of being technologically inferior is substantially higher for liquidity providers (Firm A is exposed to up to 1,000 mispriced executions) than for liquidity removers (Firm B has no executions).

In an effort to address these issues, the Exchange is proposing to institute a five millisecond delay in the time between when a marketable order is received by the PSX system and when it is presented for execution against the PSX book.³ No information about the receipt of an incoming marketable order will be provided to any market participant before the order is

³ Post-only orders and non-marketable orders with a time-in-force other than “Immediate-or-Cancel” will not be subject to the five millisecond delay.

presented for execution.⁴ However, any updates or cancellations of resting orders that are received during the five millisecond period will be processed before the incoming order is presented for execution. After an order has been presented for execution, any unexecuted shares will be cancelled back to the member, routed, or posted to the book as applicable. As is the case with all orders on PSX, any price improvement will be allocated to the party that entered the incoming order. If the incoming order becomes non-marketable while it is being held, it will nevertheless continue to be held until the end of the five-millisecond period. In addition, the market participant entering the order may not cancel or modify it until the order has been presented at the end of the period.

With the change, the overall processing time for incoming marketable orders will still be extremely rapid – in most cases, about 5.075 milliseconds – and will be faster than the processing time for several existing exchange markets. However, the Exchange believes that the additional time will be sufficient to allow liquidity providers to make adjustments if they believe them to be warranted. Accordingly, the change will “level the playing field” between liquidity providers and opportunistic traders, consistent with the Exchange’s goal of making PSX a market that rewards investors for the size of their trading interest rather than the speed of their trading algorithms.

Although the proposal will allow liquidity providers to adjust their quotes during the delay period after an order is received by PSX, the Exchange does not believe that the proposal presents any issues under the provisions of SEC Rule 602(b),⁵ generally known as the “firm

⁴ Because the incoming order will not be presented for execution against the resting quote until after the end of the five millisecond period, and no market participants will receive notice of the existence of the order during that time, the delay will not cause any compliance issues under SEC Rule 602(b), 17 CFR 242.602(b).

⁵ 17 CFR 242.602(b).

quote rule.” Subject to certain exceptions, paragraph (b)(2) of the rule provides:

[E]ach responsible broker or dealer shall be obligated to execute any order to buy or sell a subject security, other than an odd-lot order, presented to it by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker's or dealer's published bid or published offer (exclusive of any commission, commission equivalent or differential customarily charged by such responsible broker or dealer in connection with execution of any such order) in any amount up to its published quotation size.

However, paragraph (b)(3) provides that “[n]o responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (b)(2) of this section if ... [b]efore the order sought to be executed is presented, such responsible broker or dealer has communicated to its exchange or association pursuant to paragraph (b)(1) of this section, a revised bid or offer.” The application of these provisions to the proposed rule change hinges on the word “presented”: if an order executable against a quote is presented to a broker-dealer, it must be executed unless a revised quote has been communicated to the exchange before the order is presented. The rule does not define the term “presented,” nor do the relevant proposing and adopting releases shed extensive light on its interpretation.⁶ The relevant dictionary definition of “present” – to “show or offer (something) for others to scrutinize or consider”⁷ – suggests the need for awareness of a recipient of the thing that is presented. As a matter of logic, moreover, a broker-dealer should not be held responsible for executing an order of which it is not aware. Indeed, this would appear to be the purpose of the exception provided by paragraph (b)(3): a broker-dealer that has updated its quote before receiving a previously

⁶ Securities Exchange Act Release No. 12670 (July 29, 1976), 41 FR 32856 (August 5, 1976); Securities Exchange Act Release No. 13626 (June 14, 1977), 42 FR 32418 (June 24, 1977); Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978).

⁷ See www.oxforddictionaries.com.

marketable order should not be required to provide an execution against its prior quote. Because, in the case of the proposed rule change, an incoming order will not attempt to execute until after the end of the five millisecond period, and no market participants will receive notice of the existence of the order during that time, the Exchange believes that it would be contrary to the purpose of this exception if a broker-dealer were required to honor its prior quote merely because the Exchange was temporarily holding an order of which the broker-dealer had no awareness.

Under Regulation NMS, a trading center that displays an “automated quotation” must “immediately and automatically” execute an incoming order that is “marked as immediate-or-cancel,” up to the full size of the displayed quotation.⁸ Moreover, the Commission stated that “immediately” means that “a trading center’s systems should provide the fastest response possible without any programmed delay.”⁹ Thus, although PSX’s response time will remain extremely rapid, the Exchange will mark PSX’s quotations for Tape C Securities as “manual quotations” within the meaning of Regulation NMS. The Exchange notes, however, that in adopting Regulation NMS, the Commission “emphasize[d] that adoption of Rule 611¹⁰ in no way lessens a broker-dealer’s duty of best execution.... The duty of best execution requires broker-dealers to execute customers’ trades at the most favorable terms reasonably available under the circumstances, i.e., at the best reasonably available price.” Accordingly, it is the Exchange’s belief that market participants will be required to consider the price, size,

⁸ 17 CFR 242.600(b)(3).

⁹ Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37519 (June 29, 2005) (File No. S7-10-04).

¹⁰ 17 CFR 242.611. Rule 611 provides that trading centers must establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of protected quotations in NMS stocks.

accessibility, and cost of PSX's quotations in determining whether they have satisfied their best execution obligations.

The Exchange proposes adopting the change on a one-year pilot basis with respect to Tape C Securities only. This approach will allow the Exchange to compare trading patterns and market performance with respect to stocks subject to the pilot and those that are not. Based on this information, the Exchange will determine whether to expand the pilot, seek permanent approval for it, or allow it to lapse. The Exchange has selected Tape C Securities for the pilot because it believes that PSX's overall share volumes in Tape C (roughly comparable to its volumes for Tape A Securities and higher than for Tape B Securities¹¹) and its percentage market share (higher than for Tape A Securities) will provide more useful data for assessing the effectiveness of the pilot. The Exchange reserves the right to submit a proposed rule change prior to the end of the pilot period in order to make such changes as it believes warranted.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act¹² in general, and furthers the objectives of Section 6(b)(5) of the Act¹³ 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, and is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. The Exchange believes that the rule change will promote these goals by providing broker-dealers and investors that post liquidity with a better opportunity

¹¹ Tape A Securities are listed on the New York Stock Exchange and Tape B Securities are listed on NYSE MKT and other "regional" exchanges.

¹² 15 U.S.C. 78f(b).

¹³ 15 U.S.C. 78f(b)(5).

to adjust the prices of their orders to reflect changed market circumstances, thereby enhancing their ability to avoid so-called toxic order flow. The Exchange believes that firms willing to provide liquidity in large numbers of stocks provide benefits to investors and listed companies by supporting active markets in those stocks and dampening volatility. Specifically, the Exchange believes that widespread quoting activity benefits retail and institutional investors that have longer investment horizons and do not calibrate their purchases or sales to intraday variations in prices. As discussed above, however, as a firm becomes active in providing liquidity in a larger number of stocks, it faces greater challenges in ensuring that its quoted prices are up-to-date. If firms that wish to actively quote are unable to mitigate the asymmetric risks created by opportunistic traders, they are likely to decrease their quoting activity, rather than incur losses. Accordingly, the Exchange believes that it is appropriate to adopt the proposed rule change as a means to assist liquidity providers in mitigating these risks, and thereby encourage greater levels of liquidity provision in a wider range of stocks.

The Exchange does not believe that the proposal is unfairly discriminatory. Although the change may be seen as diminishing the ability of opportunistic traders to access quotes before they are updated to reflect changed market information, the Exchange believes that the anticipated benefits of the proposal in supporting liquidity provision and the interests of investors with longer trading horizons outweigh the potentially diminished profit opportunities for traders with shorter trading horizons. Moreover, because the Exchange's market share is small, the change will have little effect on the ability of traders to continue trading actively with a short-term focus on numerous other venues.

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. Although the change will delay the execution time for incoming marketable orders, the Exchange believes that the extremely fast overall processing time of 5.075 milliseconds should not be considered a burden on the ability of market participants to compete for order executions. Moreover, the Exchange believes that the change is appropriate in furtherance of the purposes of the Act because it will help liquidity providers to mitigate the asymmetric risks associated with opportunistic traders. The Exchange further believes that any burden on the ability of opportunistic traders to realize short-term trading opportunities on the Exchange will be minimal, because such opportunities will continue to exist on other trading venues. Moreover, the Exchange believes that any such burden will be outweighed by the benefits that it seeks to provide to support liquidity provision and the interests of investors with longer-term trading horizons.

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

Written comments were neither solicited nor received.

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

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission shall: (a) by order approve or disapprove such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be 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. Please include File Number SR-Phlx-2012-106 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-Phlx-2012-106. 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-2012-106 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.¹⁴

Kevin M. O'Neill
Deputy Secretary

¹⁴ 17 CFR 200.30-3(a)(12).