

necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### 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-OCC-2010-15 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-OCC-2010-15. 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 Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule changes 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 inspection and copying in the Commission's Public Reference Section, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filings also will be available for inspection and copying at the principal office of OCC and on OCC's Web site at <http://www.theocc.com>. 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-OCC-

2010-15 and should be submitted on or before October 7, 2010.

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.<sup>16</sup>

Elizabeth M. Murphy,

Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-62877; File No. SR-PHLX-2010-79]

### Self-Regulatory Organizations; NASDAQ OMX PHLX, Inc.; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Establishment of NASDAQ OMX PSX as a Platform for Trading NMS Stocks

September 9, 2010.

#### I. Introduction

On June 8, 2010, NASDAQ OMX PHLX, Inc. ("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 NASDAQ OMX PSX as a new electronic platform for trading NMS stocks. The proposed rule change was published for comment in the **Federal Register** on July 26, 2010.<sup>3</sup> On August 5, 2010, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>4</sup> The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change, as modified by Amendment No. 1.

#### II. Background

The Exchange proposes to establish a new cash equities trading platform, to be called NASDAQ OMX PSX ("PSX" or "System").<sup>5</sup> The System will be an open-

access fully electronic integrated order display and execution system for NMS stocks. PSX will not list securities, but rather will trade NMS stocks listed on other exchanges on an unlisted trading privileges basis.

The System will allow PSX participants to enter orders at multiple price levels. Orders will be integrated and displayed via data feeds to participants and other data subscribers. PSX participants will be able to access the aggregated trading interest of all other PSX participants in accordance with non-discretionary order execution algorithms. The System will not route orders to other market centers.

In contrast with most markets, which employ a price/time execution priority system (where the displayed order on the book that is first in time at the best price is satisfied fully, then the next in time at that price, and so on), PSX will use a price/pro rata execution priority system, with displayed orders receiving priority over non-displayed orders. Specifically, multiple orders displayed on the PSX book at the best price would be allocated shares of an incoming order pro rata based on the proportion of the size of the displayed order to the total size of all displayed orders at that price. Once all displayed size at any price level is exhausted, the same pro rata logic would apply to non-displayed orders at that price level.

The Exchange proposes to adopt new rules governing trading on the System. The proposed new rules are based to a substantial extent on the rules of Nasdaq<sup>6</sup> and NASDAQ OMX BX, Inc. ("BX"). In addition, the Exchange proposes to apply the PHLX rules listed in proposed PHLX Rule 3202, including certain rules that governed XLE when it was operational, to PHLX members with respect to their activities on the System.<sup>7</sup> The Exchange also proposes to amend PHLX Rule 803 (Criteria For Listing—Tier I) to support unlisted trading privileges for NMS stocks on PSX and PHLX Rule 985 (Affiliate and Ownership Restrictions) to address potential competitive advantage and conflict of interest concerns regarding

<sup>16</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See Securities Exchange Act Release No. 62519 (July 16, 2010), 75 FR 43597 ("Notice").

<sup>4</sup> Amendment No. 1 clarifies that the proposal to accept orders routed by Nasdaq Execution Services, LLC to the Exchange on a one-year pilot basis is made by the Exchange, rather than by The NASDAQ Stock Market, LLC ("Nasdaq"). This is a technical amendment and is not subject to notice and comment.

<sup>5</sup> The Exchange previously operated an electronic trading facility, XLE, for the trading of cash equity securities. XLE ceased its operations in October 2008 following the acquisition of the Exchange by The NASDAQ OMX Group, Inc. ("NASDAQ OMX"), the parent corporation of Nasdaq. See Securities Exchange Act Release No. 58613 (September 22,

2008), 73 FR 57181 (October 1, 2008) (SR-PHLX-2008-65). Since ceasing operations of XLE, the Exchange has solely operated an options market.

<sup>6</sup> Unlike Nasdaq, PSX will not route orders to other exchanges and will not have market makers. As a result, the PSX rules do not contain provisions related to outbound routing or market makers that are found in Nasdaq's rules.

<sup>7</sup> The Exchange also proposes to delete two existing PHLX Rules relating to XLE, PHLX Rule 160 (NMS Stock Execution on the Exchange) and PHLX Rule 188 (Trade Execution and Reporting), and to move their content to the proposed rules governing PSX. See proposed PHLX Rules 3301(a), 3305(a)(1) and 3309.

inbound routing from Nasdaq to PSX. Finally, the Exchange proposes to adopt rules governing Recommendations to Customers (Suitability) and Best Execution and Interpositioning,<sup>8</sup> and commentaries relating thereto, which rules shall be applicable to all members of the Exchange, including those trading on PSX.

Pursuant to the terms of a regulatory services agreement (the "FINRA RSA") between PHLX and Financial Industry Regulatory Authority, Inc. ("FINRA"), administration and enforcement of many of the new rules applicable to the System will be supported by FINRA. In addition, certain regulatory responsibilities of PHLX relating to PSX may be administered by personnel employed by Nasdaq or "BX"<sup>9</sup> pursuant to a regulatory services agreement (the "Intercompany RSA").

### 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>10</sup> Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>11</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; 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) of the Act also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

Overall, the Commission believes that approving the Exchange's proposed rule change could benefit the public and market participants. Approval of the proposal would establish rules for the

operation of a new electronic facility for the trading of cash equity securities that is designed to encourage displayed orders of larger size, which could foster best execution, price discovery, competition and innovation. The discussion below does not review every detail of the proposed rule change, but rather focuses on the most significant rules and policy issues considered in review of the proposals.

#### A. Proposed New Rules for PSX

##### 1. Access and Participation

The System will only have one class of membership and, unlike Nasdaq, will not have a separate class of market makers.<sup>12</sup> In addition, PSX will make its facilities available to electronic communications networks ("ECN") and alternative trading systems ("ATS") that meet certain requirements, to allow such ECNs and/or ATSS to display best prices and size of orders on PSX and members to access such orders.<sup>13</sup> PSX will provide authorized access for Sponsored Participants on terms identical to those set forth in Nasdaq Rule 4211(d) (Sponsored Participants).<sup>14</sup>

The System will be accessible to all PHLX members that meet the registration, qualification and other membership requirements set forth in the PHLX rules.<sup>15</sup> In addition, in order to trade on PSX, a member must comply with certain additional requirements set forth in proposed PHLX Rule 3211 (PSX Participant Registration). Such

<sup>12</sup> See Notice, *supra* note 3, 75 FR at 43598.

<sup>13</sup> See proposed Rule 3223. The ATS or ECN must be a PHLX member organization, enter into and comply with applicable agreements, agree that PHLX may disseminate the ECN's or ATS's best priced orders, demonstrate that it is in compliance with applicable regulatory requirements, and accept automated executions against orders that it enters into the System.

<sup>14</sup> See proposed Rule 3211(d). The Exchange has represented that upon implementation by Nasdaq of recently approved changes to its rule governing Sponsored Participants, the Exchange will adopt and implement identical rules to govern sponsored access on PSX. See Securities Exchange Act Release No. 61345 (January 13, 2010), 75 FR 32631 (January 20, 2010) (SR-NASDAQ-2008-104). If NASDAQ's rules are superseded by rules adopted by the Commission, the Exchange has represented that PSX will operate sponsored participant access in accordance with such rules. See Notice, *supra* note 3, 75 FR at 43598.

<sup>15</sup> As discussed above, proposed PHLX Rule 3202 sets forth the current PHLX Rules applicable to market participants trading on PSX, and includes, among others, PHLX Rule 600 (Registration) and PHLX Rule 604 (Registration and Termination of Registered Persons). In a separate order, the Commission approved the amendment of PHLX Rule 604 to require all members trading on PSX to register representatives and principals in accordance with rules similar to those governing registration of associated persons of members of Nasdaq. See Securities Exchange Act Release No. 62776 (August 26, 2010), 75 FR 53727 (September 1, 2010) (SR-Phlx-2010-91).

requirements are substantially similar to the requirements set forth in Nasdaq Rule 4611 (Nasdaq Market Center Participant Registration), and include, among others, the execution of applicable agreements with the Exchange, membership in or access to a registered clearing agency through which PSX-compared trades may be settled, compliance with all applicable rules and operating procedures of PHLX<sup>16</sup> and the Commission in the use of PSX, and maintenance of equipment to prevent the improper use of and access to PHLX systems.<sup>17</sup>

Each PSX participant will be under a continuing obligation to inform PHLX of any noncompliance with any of the registration requirements.<sup>18</sup> Failure by a PSX participant to comply with any registration requirements, including failure to comply with any PHLX rules applicable to PSX, shall subject such participant to censure, fine, suspension or revocation of its registration as a PSX participant, or any other appropriate penalty under the rules of the Exchange.<sup>19</sup> The Exchange may terminate access to the System if a participant fails to meet the participant eligibility qualifications.<sup>20</sup>

The Commission finds that the Exchange's access and participation requirements for the System are consistent with Section 6(b)(5) of the Act, 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; 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.<sup>21</sup> 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. The Commission notes that the access and participation requirements applicable to PSX are substantially similar to rules of

<sup>16</sup> In addition to proposed rules specific to the operation of PSX, members must comply with existing PHLX rules governing member conduct, to the extent that they are relevant to trading on PSX. The PHLX Rules applicable to activities of members on PSX are listed in proposed PHLX Rule 3202.

<sup>17</sup> See proposed PHLX Rule 3211(a).

<sup>18</sup> See proposed PHLX Rule 3211(b).

<sup>19</sup> See proposed PHLX Rule 3228(a).

<sup>20</sup> See proposed PHLX Rule 3222.

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

<sup>8</sup> See proposed PHLX Rules 763 and 764.

<sup>9</sup> Each of Nasdaq and BX is a self-regulatory organization ("SRO") owned by NASDAQ OMX and, therefore, an affiliate of the Exchange.

<sup>10</sup> 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).

<sup>11</sup> 15 U.S.C. 78f(b)(5).

Nasdaq previously approved by the Commission.<sup>22</sup> The Commission also notes that all PSX participants will participate on consistent terms when entering orders into PSX for posting and accessing liquidity. In addition, the Commission notes that the membership and registration requirements applicable to PSX are set forth in the current rules of the Exchange, which have been previously approved by the Commission.

## 2. Trading System and Regulation NMS Compliance

### a. PSX Order Entry, Display and Execution

The System will operate, and orders can be entered into the System, from 9 a.m. to 5 p.m., Eastern Time, on each business day.<sup>23</sup> PSX will not have any specialized opening or closing processes, and will begin to process all eligible orders at 9 a.m.<sup>24</sup>

Participants may submit multiple orders at multiple price levels, which PSX will manage and display, consistent with the parameters of each order.<sup>25</sup> PSX will time-stamp each order upon receipt, although, as discussed below, the time stamp will not determine the order's ranking for execution purposes.<sup>26</sup> The System will not display orders on an attributable basis.<sup>27</sup> Orders may be entered either as Displayed Orders or Non-Displayed Orders.<sup>28</sup>

Displayed Orders will be displayed anonymously to participants through the System book feed and the aggregate size of all best-priced Displayed Orders to buy and sell on the System will be transmitted for display to the appropriate network processor (unless the aggregate size is less than one round lot).<sup>29</sup> Non-Displayed Orders and Reserve Size will not be displayed, but will nevertheless remain available for potential execution against incoming orders.<sup>30</sup>

Incoming marketable orders automatically execute against resting orders on the PSX book, and the posted orders are decremented accordingly.<sup>31</sup> Incoming orders that are not marketable

against posted interest in the System book will be cancelled or posted to the book, depending on the time-in-force for the order.<sup>32</sup> An incoming order with a price that crosses the price of an order posted on the book will execute at the price of the posted order. Thus, any potential price improvement resulting from an execution in the System will accrue to the taker of liquidity.<sup>33</sup>

As provided by PHLX Rule 3309, executions occurring as a result of orders matched on PSX shall be reported by PHLX to an appropriate consolidated transaction reporting system. As transactions executed in the System will be cleared and settled anonymously, the transaction reports produced by the System will indicate the price and size of the transaction, but will not reveal contra party identities.<sup>34</sup>

To determine the allocation of incoming marketable orders against orders on the book, the System uses a price/pro-rata algorithm, with Displayed Orders receiving priority over Non-displayed Orders and round lot orders receiving priority over odd lot orders.<sup>35</sup> The algorithm executes trading interest in the System as follows:

- Better priced trading interest will be executed ahead of inferior-priced trading interest;
- Displayed Orders at a particular price with a size of at least one round lot will be executed ahead of Non-Displayed Orders and the reserve portion of Reserve Orders (collectively, "non-displayed interest") at the same price;
- Displayed Orders at a particular price with a size of at least one round lot will be executed ahead of odd lot at the same price; however, odd-lot Displayed Orders will execute ahead of non-displayed interest of one round lot at the same price, as Displayed Orders will always execute ahead of Non-Displayed Orders at the same price;<sup>36</sup>
- As among equally priced Displayed Orders with a size of at least one round lot, the System will allocate round lot portions of incoming executable orders to displayed trading interest within the System pro rata based on the size of the Displayed Orders. Portions of an order that would be executed in a size other than a round lot if they were allocated on a pro rata basis will be allocated for execution against available displayed trading interest on the basis of a random function that assigns probability of execution based on the size of displayed

interest.<sup>37</sup> As among equally priced Displayed Orders with a size of less than one round lot, the System will allocate incoming orders based on the size of the Displayed Orders, but not in pro rata fashion.<sup>38</sup> If there are two or more odd lot orders of equal size, the System will determine the order of execution on the basis of a random function that assigns each order an equal probability of execution. This same allocation methodology applies to equally-priced non-displayed interest with a size of at least one round lot or with a size of less than one round lot, as the case may be.

The Commission finds that the Exchange's trading rules for the System, including PSX's execution priority rules, are consistent with the Act. The Commission notes that, other than with respect to the price/pro rata execution priority system, the Exchange' market model for the trading of cash equity securities is substantially similar to each of Nasdaq's and BX's equity market models and does not raise novel issues. The Commission believes that PSX's price/pro rata execution priority system may encourage participants, particularly those who wish to execute orders of large size, to display liquidity on the System. This in turn could facilitate the efficient execution of large orders, and foster best execution and price discovery. A novel exchange priority system that is designed to achieve these goals also may foster competition and innovation. Accordingly, the Commission finds that the price/pro rata execution priority system proposed by PHLX is consistent with the Act.

### b. Regulation NMS

The Exchange will implement such systems, procedures, and rules in connection with the operation of PSX as are necessary to render it capable of meeting the requirements for automated quotations.<sup>39</sup>

<sup>37</sup> For example, if Displayed Orders to buy at 10 reside on the PSX book with sizes of 6,000 (Participant A) and 4,000 (Participant B), and an incoming order to sell 1,100 at 10 comes into the System, the System will allocate 600 shares of the incoming order to Participant A and 400 shares of the incoming order to Participant B. The remaining 100 shares of the incoming order will be allocated on the basis of a random function that assigns a 60% probability of executing the 100 shares to Participant A and a 40% probability to Participant B.

<sup>38</sup> Thus, a resting displayed order with a size of 90 shares would get filled in full before a displayed order with size of 50 shares.

<sup>39</sup> See proposed PHLX Rule 3306(c)(4). As defined in PHLX Rule 600(b) of Regulation NMS under the Act, 17 CFR 242.600(b), the term "quotation" includes the "bid price or the offer price communicated by a member of a national securities exchange \* \* \* to any broker or dealer, or to any

<sup>22</sup> See Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (order approving Nasdaq's application to register as a national securities exchange) ("Nasdaq Registration Approval Order").

<sup>23</sup> See proposed PHLX Rules 3217 and 3306(a)(3).

<sup>24</sup> See proposed PHLX Rule 3302.

<sup>25</sup> See proposed PHLX Rule 3306.

<sup>26</sup> *Id.*

<sup>27</sup> See proposed PHLX Rule 3301(a).

<sup>28</sup> See proposed PHLX Rule 3301(e).

<sup>29</sup> See proposed PHLX Rule 3306(c)(1) and (2).

<sup>30</sup> See proposed PHLX Rule 3306(c)(3).

<sup>31</sup> See proposed PHLX Rule 3307(a)(2).

<sup>32</sup> See proposed PHLX Rule 3301(h).

<sup>33</sup> See proposed PHLX Rule 3307(a)(3).

<sup>34</sup> See proposed PHLX Rule 3310.

<sup>35</sup> See proposed PHLX Rule 3307(a)(1).

<sup>36</sup> See *id.*

The Exchange has designed PSX's rules relating to orders, modifiers, and order execution to comply with the requirements of Regulation NMS. The proposed Rules are consistent with Regulation NMS<sup>40</sup> by requiring that all orders be processed in a manner that avoids trading through protected quotations<sup>41</sup> and avoids locked and crossed markets.<sup>42</sup> PSX will not route orders to other market centers. Proposed PHLX Rule 3305(b) provides that in addition to such other designations as may be chosen by a market participant,<sup>43</sup> all orders that are not entered with a time in force of "System Hours Immediate or Cancel"<sup>44</sup> must be designated as an Intermarket Sweep Order, a Pegged Order, a Price to Comply Order, or a Post-Only Order.<sup>45</sup> Any orders that are entered into the System that would lock or cross another order in the System will be executed to avoid a lock or cross.<sup>46</sup>

As described in the Notice, a System Hours Immediate or Cancel Order is compliant with Regulation NMS because by its terms it would not execute or post at a price that would result in a trade-through of a protected quotation or lock or cross another market.<sup>47</sup> A Pegged Order similarly is compliant with Regulation NMS

customer, at which it is willing to buy or sell one or more round lots of an NMS security, either as principal or agent." Thus, the term "quotation" includes orders entered into the System by PSX participants, notwithstanding the fact that PSX will not have market makers with obligations to maintain continuous two-sided quotations. Under Rule 602 of Regulation NMS, brokers and dealers are required to communicate to a national securities exchange or national securities association their best bids, best offers, and quotation sizes. By displaying orders communicated to it by its members and complying with the requirements for automation described in Rule 600(b)(3), PSX will display "automated quotations" within the meaning of that rule, and therefore its best bid and best offer will constitute "protected quotations" entitled to trade-through protection under Regulation NMS.

<sup>40</sup> 17 CFR 242.611.

<sup>41</sup> See discussion of protected quotations *supra* note 39.

<sup>42</sup> See proposed PHLX Rules 3305(b) and 3213(c).

<sup>43</sup> As is the case with Nasdaq, different order designations can be combined. Thus, for example, a Price to Comply Order could be entered with reserve size or as a Non-displayed Order.

<sup>44</sup> A "System Hours Immediate or Cancel" order is an immediate or cancel order that may be entered between 9 a.m. and 5 p.m. Eastern Time, PSX's hours of operation. If a System Hours Immediate or Cancel order (or a portion thereof) is not marketable, the order (or unexecuted portion thereof) is canceled and returned to the entering participant. See proposed PHLX Rule 3301(h)(1).

<sup>45</sup> See proposed PHLX Rule 3305(b).

<sup>46</sup> See proposed PHLX Rule 3213(c). In addition, members may enter orders that are re-priced if they would lock or cross so as to avoid executing.

<sup>47</sup> See Notice, *supra* note 3, 75 FR at 43603; proposed PHLX Rule 3301(h).

because it continually re-prices to avoid locking or crossing.<sup>48</sup>

The proposed rules also permit PSX participants to submit Intermarket Sweep Orders to comply with Regulation NMS. Orders so designated will be automatically matched and executed within the System.<sup>49</sup> As described in the Notice, when a participant enters an Intermarket Sweep Order it is representing that it is also simultaneously routing one or more additional limit orders (also marked as Intermarket Sweep Orders), as necessary, to execute against the full displayed size of any protected bid or offer (as defined in Rule 600(b) of Regulation NMS) in the case of a limit order to sell or buy with a price that is superior to the limit price of the order identified as an Intermarket Sweep Order.<sup>50</sup>

Both a Price to Comply and a Post-Only Order are also designed to comply with the Regulation NMS.<sup>51</sup> Specifically, if at the time of entry, a Price to Comply Order will lock or cross the quotation of an external market, the order will be priced to the current best offer (for bids) or to the current best bid (for offers) but displayed at a price one minimum price increment lower than the offer (for bids) or higher than the bid (for offers).<sup>52</sup> Thus, an incoming order priced to execute against the displayed price will receive the superior undisplayed price.<sup>53</sup> If, at the time of entry, a Post-Only Order will lock an order on the System, the order will be re-priced and displayed on the System to one minimum price increment (*i.e.*, \$0.01 or \$0.0001) below the current best offer (for bids) or above the current best bid (for offers).<sup>54</sup>

The Commission believes that by requiring all orders to be entered with

<sup>48</sup> See Notice, *supra* note 3, 75 FR at 43603; proposed PHLX Rule 3301(f)(4).

<sup>49</sup> See proposed PHLX Rule 3301(f)(6).

<sup>50</sup> See Notice, *supra* note 3, 75 FR at 43603. The Exchange has represented that members will be responsible for ensuring that their use of Intermarket Sweep Orders complies with Regulation NMS, and the Exchange's T+1 surveillance program will monitor members' use of Intermarket Sweep Orders.

<sup>51</sup> See Notice, *supra* note 3, 75 FR at 43603.

<sup>52</sup> See proposed PHLX Rule 3301(f)(8).

<sup>53</sup> For example, if the national best bid and best offer is \$9.97×\$10.00, and a participant enters a price to comply order to buy 10,000 shares at \$10.01, the order will display at \$9.99, but will reside on the System book at \$10.00. If a seller then enters an order at \$9.99, it will execute at \$10.00, up to the full 10,000 shares of the order.

<sup>54</sup> See proposed PHLX Rule 3301(f)(10). For example, if the System best bid and best offer is \$9.97×\$10.00, and a participant enters a Post-Only Order to buy at \$10.01, the order will be repriced and displayed at \$9.99. If a seller enters an order at \$9.96, the order will be repriced and displayed at \$9.98.

one of the designations described above, all PSX orders should either be priced or cancelled in a manner consistent with the avoidance of trade-throughs and locked and crossed markets. The Commission also notes that, because PSX will not route orders to other market centers, the Exchange's Regulation NMS policies and procedures under Rule 611(a) will rely on information provided by Nasdaq for purposes of determining whether another trading center is experiencing a failure, material delay, or malfunction of its systems or equipment within the meaning of Rule 611(b)(1).<sup>55</sup>

The Commission finds that the rules relating to orders, modifiers, and order execution that are designed to comply with Regulation NMS are consistent with the Act.

## 2. Section 11 of the Act

Section 11(a)(1) of the Act<sup>56</sup> prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T) under the Act,<sup>57</sup> known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute transactions on the exchange. To comply with Rule 11a2-2(T)'s conditions, a member: (i) Must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>58</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, may not, nor may its associated person, retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission, the Exchange requests that the Commission concur with PHLX's conclusion that members who enter orders into the System satisfy the requirements of Rule 11a2-2(T).<sup>59</sup> For the reasons set forth

<sup>55</sup> See Notice, *supra* note 3, 75 FR at 43603-42604

<sup>56</sup> 15 U.S.C. 78k(a)(1).

<sup>57</sup> 17 CFR 240.11a2-2(T).

<sup>58</sup> The member may, however, participate in clearing and settling the transaction.

<sup>59</sup> See Letter from Charles Rogers, Chief Regulatory Officer, PHLX, to Elizabeth M. Murphy,

below, the Commission believes that Exchange members entering orders into the System would satisfy the conditions of the Rule.

The Rule's first condition is that orders for covered accounts be transmitted from off the exchange floor. The System receives orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.<sup>60</sup> Because PSX receives orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that the System satisfies the off-floor transmission requirement.

Second, the Rule requires that the member not participate in the execution of its order. PHLX has represented that at no time following the submission of an order is a member organization able to acquire control or influence over the result or timing of an order's execution.<sup>61</sup> According to the Exchange, the execution of a member's order is determined by what other orders are present in the System and the priority of those orders.<sup>62</sup> Accordingly, the Commission believes that a member

does not participate in the execution of an order submitted to the System.

Third, Rule 11a2-2(T) requires that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that this requirement is satisfied when automated exchange facilities, such as PSX, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.<sup>63</sup> PHLX has represented that the design of the System ensures that no member organization has any special or unique trading advantage in the handling of its orders after transmitting its orders to the System.<sup>64</sup> Based on the Exchange's representation, the Commission believes that PSX satisfies this requirement.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T).<sup>65</sup> PHLX represents that member organizations relying on Rule 11a2-2(T) for transactions effected through the System must comply with this condition of the Rule.<sup>66</sup>

<sup>63</sup> In considering the operation of automated execution systems operated by an exchange, the Commission noted that, while there is not an independent executing exchange member, the execution of an order is automatic once it has been transmitted into the system. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, *supra* note 60.

<sup>64</sup> See PHLX 11(a) Letter, *supra* note 59.

<sup>65</sup> See 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated persons thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, *supra* note 62 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests").

<sup>66</sup> See PHLX 11(a) Letter, *supra* note 59.

### B. Exception to Limitation on Affiliation Between PSX and Its Members

Although the Exchange will not route orders to other market centers, it proposes to receive orders routed to it by other market centers, including orders routed from Nasdaq.<sup>67</sup> Nasdaq Execution Services, LLC ("NES") is the approved outbound routing facility of Nasdaq for cash equities. NES is owned by NASDAQ OMX, which also owns the Exchange.<sup>68</sup> Thus, NES is an affiliate of the Exchange.

Nasdaq is permitted to operate NES as a facility providing outbound routing services from Nasdaq to other market centers, subject to the conditions that: (1) NES is operated and regulated as a facility of Nasdaq; (2) NES only provides outbound routing services unless otherwise approved by the Commission; (3) the designated examining authority of NES is a SRO unaffiliated with Nasdaq; and (4) the use of NES for outbound routing is available only to Nasdaq members and the use of NES remains optional.<sup>69</sup> Currently, NES may not route Directed Orders<sup>70</sup> to a facility of an exchange that is an affiliate of Nasdaq, other than BX.<sup>71</sup> In connection with PHLX's resumption of equity trading on PSX pursuant to this filing, Nasdaq has proposed a rule change to permit NES to route all forms of orders, including Directed Orders, to PSX.<sup>72</sup>

Recognizing that the Commission has 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 proposes the following limitations and conditions to NES's affiliation with the Exchange to permit the Exchange to accept inbound orders that NES routes in its capacity as a facility of Nasdaq:

- First, the Exchange states that pursuant to the FINRA RSA, FINRA will review NES's compliance with the Exchange's rules through FINRA's examination program.<sup>73</sup> Pursuant to the

<sup>67</sup> See Notice, *supra* note 3, 75 FR at 43604.

<sup>68</sup> See Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (order approving NASDAQ OMX's acquisition of PHLX).

<sup>69</sup> Nasdaq Rule 4758.

<sup>70</sup> Nasdaq Rule 4751(f)(9) defines Directed Orders as immediate-or-cancel orders that are directed to an exchange other than Nasdaq without checking the Nasdaq book.

<sup>71</sup> Nasdaq Rule 4751(f)(9).

<sup>72</sup> See Securities Exchange Act Release No. 62736 (August 17, 2010) (SR-Nasdaq-2010-100).

<sup>73</sup> The Exchange also states that NES is subject to independent oversight by FINRA, its Designated Examining Authority, for compliance with financial responsibility requirements. See Notice, *supra* note 3, 75 FR at 43605.

Secretary, Commission, dated August 18, 2010 ("PHLX 11(a) Letter").

<sup>60</sup> See, e.g., Securities Exchange Act Release Nos. 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (SR-BATS-2009-031) (approving BATS options trading); 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48) (approving equity securities listing and trading on BSE); 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080) (approving NOM options trading); 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (approving The Nasdaq Stock Market LLC); 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (SR-PCX-00-25) (approving Archipelago Exchange); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (SR-NYSE-90-52 and SR-NYSE-90-53) (approving NYSE's Off-Hours Trading Facility); and 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) ("1979 Release").

<sup>61</sup> See PHLX 11(a) Letter, *supra* note 59.

<sup>62</sup> See *id.* A member may cancel or modify the order, or modify the instruction for executing the order, but only from off the floor. The Commission has stated that the non-participation requirement is satisfied under such circumstances, so long as such modifications or cancellations are also transmitted from off the floor. See Securities Exchange Act Release No. 14713 (April 27, 1978), 43 FR 18557 (May 1, 1978) ("1978 Release") (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor").

FINRA RSA, however, PHLX retains ultimate responsibility for enforcing its rules with respect to NES.

- Second, FINRA and the Exchange<sup>74</sup> will monitor NES for compliance with the Exchange's trading rules, and will collect and maintain certain related information.<sup>75</sup>

- Third, the Exchange states that FINRA will provide a report to the Exchange's CRO, on at least a quarterly basis, that: (i) Quantifies all alerts (of which the Exchange and FINRA are aware) that identify NES as a participant that has potentially violated Commission or Exchange rules, and (ii) quantifies the number of all investigations that identify NES as a participant that has potentially violated Commission or Exchange rules.<sup>76</sup>

- Fourth, the Exchange proposes Rule 985(c)(2), which will require NASDAQ OMX, as the holding company owning both the Exchange and NES, to establish and maintain procedures and internal controls reasonably designed to ensure that NES does not develop or implement changes to its system, based on non-public information regarding planned changes to the Exchange's systems obtained 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 order routing to the Exchange.<sup>77</sup>

- Fifth, the Exchange proposes that routing of orders from NES to the Exchange, in NES's capacity as a facility of Nasdaq, be authorized for a pilot period of one year.<sup>78</sup>

The operation of NES as a facility of Nasdaq providing outbound routing services from that exchange will be subject to Nasdaq oversight, as well as

Commission oversight. Nasdaq will be responsible for ensuring that NES's outbound routing function is operated consistent with Section 6 of the Act and Nasdaq rules. In addition, Nasdaq must file with the Commission rule changes and fees relating to NES's outbound routing function.

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.<sup>79</sup> 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 reasons discussed below, the Commission believes that it is consistent with the Act to permit NES to provide inbound routing to the Exchange on a pilot basis, subject to the conditions described above.

The Exchange has proposed five conditions applicable to NES's routing activities, which are enumerated above. The Commission believes that these conditions mitigate its concerns about potential conflicts of interest and unfair competitive advantage. In particular, the Commission believes that FINRA's oversight of NES,<sup>80</sup> combined with FINRA's monitoring of NES's compliance with the equity trading rules and quarterly reporting to the Exchange's CRO, will help to protect the independence of the Exchange's regulatory responsibilities with respect to NES. The Commission also believes that the proposed addition of Rule 985(c) is designed to ensure that NES 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 NES to route orders inbound to the Exchange from Nasdaq, 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. The Commission notes that it previously approved inbound routing by NES to an affiliate under substantially similar conditions.<sup>81</sup>

### C. Listing Standards/Unlisted Trading Privileges

The Exchange has represented that it will not resume its listings business, and instead will trade all NMS stocks on the System pursuant to unlisted trading privileges ("UTP"), consistent with Section 12(f) of the Act<sup>82</sup> and Rule 12f-5 thereunder.<sup>83</sup> Rule 12f-5 requires an exchange that extends unlisted trading privileges to securities to have in effect a rule or rules providing for transactions in the class or type of security to which the exchange extends unlisted trading privileges.<sup>84</sup>

In connection with its proposal to trade NMS stocks<sup>85</sup> on PSX on an unlisted trading privileges basis, the Exchange proposes several amendments to PHLX Rule 803, including amending PHLX Rule 803(o) (Unlisted Trading Privileges) to, among other things, (1) clearly state that the Exchange will not list any securities, and that any provisions of PHLX Rules 800 through 868 that permit listing of securities will not be effective until the Exchange amends its rules to make any changes needed to comply with Rule 10A-3 under the Act<sup>86</sup> and to incorporate additional qualitative listing standards, and (2) enhance the listing requirements for new derivative securities products (as defined in Rule 19b-4(e) under the Act<sup>87</sup>) trading on the Exchange. In addition, the Exchange proposes to adopt new listing standards for securities linked to the performance of

<sup>74</sup> The Exchange represents that personnel performing real-time oversight of equity trading on Nasdaq will also perform similar functions with respect to PSX pursuant to the Intercompany RSA, under the direction, authority, and oversight of PHLX's Chief Regulatory Officer ("CRO") and the Regulatory Oversight Committee ("ROC") of its Board of Governors.

<sup>75</sup> The Exchange represents that both FINRA and the Exchange will collect and maintain all alerts, complaints, investigations and enforcement actions in which NES (in its capacity as a facility of Nasdaq routing orders to the PSX) 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, 75 FR at 43605.

<sup>76</sup> See *id.*

<sup>77</sup> See proposed PHLX Rule 985(c)(2); Notice, *supra* note 3, 75 FR at 43605.

<sup>78</sup> See Amendment No. 1, *supra* note 4. In Amendment No. 1, the Exchange clarified that its proposal, as opposed to Nasdaq's corresponding proposal, be approved on a one year pilot basis.

<sup>79</sup> 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.); and 58673 (September 29, 2008), 73 FR 57707 (October 8, 2008) (SR-Amex-2008-62) (order approving the combination of NYSE Euronext and the American Stock Exchange LLC).

<sup>80</sup> This oversight will be accomplished through the 17d-2 Agreement between FINRA and the FINRA RSA.

<sup>81</sup> See Securities Exchange Act Release No. 59154 (December 23, 2008), 73 FR 80468, (December 31, 2008) (SR-BSE-2008-48) ("BX Equities Market Approval Order").

<sup>82</sup> 15 U.S.C. 78l(f).

<sup>83</sup> 17 CFR 240.12f-5. See Notice, *supra* note 3, 75 FR at 43599.

<sup>84</sup> 17 CFR 240.12f-5. See also Securities Exchange Act Release No. 35737 (April 21, 1995), 60 FR 20891 (April 28, 1995) (adopting Rule 12f-5).

<sup>85</sup> Proposed PHLX Rule 803(o) defines "NMS Stocks" for purposes of the rule as having the meaning given such term by Rule 600 under Regulation NMS, including, but not limited to, common stock, preferred stock and similar issues, shares or certificates of beneficial interest of trusts, notes, limited partnership interests, warrants, certificates of deposit for common stock, convertible debt securities, American Depositary Receipts, contingent value rights, Trust Shares, Trust Issued Receipts, Index Fund Shares, Equity Index-Linked Securities, Commodity-Linked Securities, Equity-Linked Notes, and Managed Fund Shares.

<sup>86</sup> 17 CFR 240.10A-3.

<sup>87</sup> 17 CFR 240.19b-4(e)

indexes and commodities (including currencies) and managed fund shares, to allow such securities to trade on PSX pursuant to unlisted trading privileges.<sup>88</sup> The Exchange also proposes PHLX Rule 3230 to establish additional rules to govern trading of Commodity-Related Securities on PSX pursuant to unlisted trading privileges, including a requirement that members provide all purchasers of a newly issued Commodity-Related Securities with a prospectus.

The Commission finds that these rules are consistent with the Act. The Commission notes that the Exchange will not list any securities for trading on PSX until it amends its rules to make any changes needed to comply with Rule 10A-3 under the Act<sup>89</sup> and to incorporate additional qualitative listing standards. The Commission also notes that these rules are similar to the rules of other Exchanges.<sup>90</sup>

#### D. Regulation of the Exchange and its Members

As a facility of the Exchange, PSX will be subject to the Exchange's SRO functions and the Exchange will have regulatory responsibility for the activities of the System. Notwithstanding the delegation of such responsibilities via contract, the Exchange retains ultimate legal responsibility for the regulation of its members and its market activities, including activities on PSX.

#### 1. Disciplinary Rules

Trading on PSX is subject to the Exchange's disciplinary rules set forth in PHLX Rules 960.1 through 960.12.<sup>91</sup> Such rules provide the Exchange with disciplinary jurisdiction over its members so that it can enforce

<sup>88</sup> See proposed PHLX Rules 803(m) and (n). As with other standards, PHLX represented that it will not list these securities until the filing and approval of a proposed rule change to authorize such listing. In connection with adopting these new standards, the Exchange also proposed to (1) delete current PHLX Rules 803(m) and (n), which contain listing standards for products that are covered by the new listing standards and (2) amend PHLX Rule 803(f) (Other Securities) to adopt continued listing requirement provisions that are complementary to the new standards for securities linked to commodities.

<sup>89</sup> 17 CFR 240.10A-3.

<sup>90</sup> As proposed to be amended, the requirements of PHLX Rule 803(o) are substantially similar to the requirements set forth in Rule 14.1 (Unlisted Trading Privileges) of EDGX Exchange, Inc. ("Direct Edge"). Proposed PHLX Rule 3230 substantially mirrors the requirements of Nasdaq Rule 4630 (Trading in Commodity-Related Securities). Proposed Rules 803(m) and (n) are substantially similar to those set forth in Nasdaq Rules 5710 (Securities Linked to Performance of Indexes and Commodities (Including Currencies)) and 5735 (Managed Fund Shares).

<sup>91</sup> See proposed PHLX Rule 3202.

members' compliance with its rules and the Act and the rules and regulations thereunder. The Exchange's rules also permit it to sanction members for violations of its rules and violations of the Act by, among other things, expelling or suspending members, limiting or terminating members' activities, functions, or operations, fining or censuring members, or suspending or barring a person from being associated with a member.<sup>92</sup>

#### 2. Order Audit Trail System

PHLX proposes rules requiring FINRA members trading on PSX to comply with FINRA's Order Audit Trail System ("OATS") requirements,<sup>93</sup> which rules are substantially similar to Nasdaq Rules Series 6950 ("Order Audit Trail System").<sup>94</sup> Like Nasdaq, OATS data will be used by PHLX for regulatory purposes only.<sup>95</sup>

#### 3. Trading Halts; Clearly Erroneous Transactions

PSX's proposed rule relating to trading halts is substantially similar to Nasdaq Rule 4120 (Trading Halts), except that the PSX rule includes only those provisions relevant to securities traded on an unlisted trading privileges basis.<sup>96</sup> Proposed PHLX Rule 3100 provides that PSX will participate in the circuit breaker pilot program for stocks included in the S&P 500® Index, which ends on December 10, 2010.<sup>97</sup> Current

<sup>92</sup> See PHLX Rule 960.10 and proposed PHLX Rule 3221.

<sup>93</sup> See proposed PHLX Rule 3400 Series.

<sup>94</sup> As is the case for Nasdaq members under the Nasdaq rules, PHLX members that are not FINRA members must compile and maintain audit trail information for securities listed on Nasdaq, but are required to transmit this information to FINRA only if requested. See proposed PHLX Rule 3405. If PHLX resumes operations as a listing market in the future, all members will be required to maintain audit trail information for securities listed on PHLX, and to transmit the information to FINRA upon request, but daily OATS reporting for such securities would not be required. *Id.*

<sup>95</sup> See Securities Exchange Act Release No. 53128 (January 13, 2006); 71 FR 3350 (January 23, 2006) (File No. 10-131).

<sup>96</sup> See proposed PHLX Rule 3100.

<sup>97</sup> See proposed PHLX Rule 3100(a)(4). See also Securities Exchange Act Release No. 62252 (June 10, 2010), 75 FR 34186 (June 16, 2010) (order approving rules relating to the circuit breaker pilot program adopted by other national securities exchanges). Nasdaq and the other equities exchanges have proposed to expand the circuit breaker pilot program to include securities in the Russell 1000 Index and certain exchange traded products. See, e.g., Securities Exchange Act Release Nos. 62414 (June 30, 2010), 75 FR 39081 (July 7, 2010) and 62415 (June 30, 2010), 75 FR 39086 (July 7, 2010). The Exchange has represented that it will promptly submit a proposed rule change in accordance with Section 19(b) of the Act and Rule 19b-4(f)(6) thereunder to adopt corresponding changes to the rules governing PSX if and when the Commission approves the corresponding Nasdaq rule. See Letter from John Yetter, Vice President

PHLX Rule 133 (Trading Halts Due to Extraordinary Market Volatility) will also apply to trading on PSX.<sup>98</sup>

PHLX has proposed a rule which is substantially similar to Nasdaq Rule 11890 (Clearly Erroneous Transactions) to govern the breaking of clearly erroneous transactions.<sup>99</sup> Appeals from determinations regarding trades made by PHLX staff will be made to a committee of industry and non-industry experts established under the PHLX By-Laws, which committee is subject to identical compositional requirements<sup>100</sup> as NASDAQ's Market Operations Review Committee, which performs a comparable function under NASDAQ rules.<sup>101</sup>

The Commission finds that the Exchange's proposed rules relating to the regulation of PSX and its members are consistent with the requirements of the Act. The Commission notes that the proposed rules relating to the regulation of PSX are substantially similar to rules of Nasdaq previously approved by the Commission.<sup>102</sup> In addition, the disciplinary rules applicable to PSX are set forth in the current rules of the Exchange, which have been previously approved by the Commission.

#### 4. Regulatory Contracts

The Exchange represents that it is a party to two regulatory services agreements (the "Regulatory Contracts").<sup>103</sup> Pursuant to the FINRA

and Deputy General Counsel, The NASDAQ OMX Group, to David Shillman, Associate Director, Division of Trading and Markets, Commission, dated September 8, 2010 ("Yetter Letter").

<sup>98</sup> See proposed PHLX Rule 3202.

<sup>99</sup> See proposed PHLX Rule 3312. As a result of precipitous declines in the prices of certain securities on May 6, 2010, however, the Commission and the national securities exchanges are currently evaluating the advisability of further changes to clearly erroneous rules. As a result of this evaluation, Nasdaq and the other equities exchanges have proposed to amend their clearly erroneous execution rules to set forth clearer standards and curtail their discretion with respect to breaking erroneous trades. See, e.g., Securities Exchange Act Release Nos. 62334 (June 21, 2010), 75 FR 36732 (June 28, 2010) and 62342 (June 21, 2010), 75 FR 36752 (June 28, 2010). The Exchange has represented that it will promptly file a proposed rule change to amend its clearly erroneous rule in a manner consistent with Nasdaq's clearly erroneous rule, in accordance with Section 19(b) of the Act and Rule 19b-4(f)(6) thereunder, if and when the Commission approves the corresponding Nasdaq rule. See Yetter Letter, *supra* note 97.

<sup>100</sup> See Section 10-10 of the PHLX By-Laws, which requires that 20% of the members of the committee represent PHLX members, and prohibits more than 50% of the committee's members from being employed by firms that are market makers or that derive more than 10% of their revenues from market making.

<sup>101</sup> By-Laws of Nasdaq, Article III, Section 6.

<sup>102</sup> See Nasdaq Registration Approval Order, *supra* note 22.

<sup>103</sup> See Notice, *supra* note 3, 75 FR at 43604.

RSA, FINRA will provide a range of regulatory services to the Exchange and its facilities, including PSX, including T+1 surveillance, investigation, and enforcement with respect to the Exchange's rules, arbitration services, and membership services.<sup>104</sup> Under the FINRA RSA, FINRA will conduct T+1 market surveillance and examine members to monitor compliance with applicable PHLX rules and securities laws and regulations.<sup>105</sup> The Intercompany RSA provides that employees and contractors of each party may perform regulatory services for the Exchange.<sup>106</sup> All regulatory services performed for the Exchange under the Intercompany RSA, including those performed with respect to the System, are subject to the direction, authority, and oversight of the Exchange's CRO and the ROC, and all personnel performing services for the Exchange under the Intercompany RSA are subject to the jurisdiction, authority and oversight of the Exchange's CRO and ROC.<sup>107</sup> The Exchange represents that any personnel performing real-time oversight of equity trading on Nasdaq will also perform similar functions with respect to PSX, under the direction, authority, and oversight of the Exchange's CRO and the ROC.<sup>108</sup> The Exchange represents that the Exchange retains ultimate legal responsibility for, and control of, functions performed for PHLX under the Regulatory Contracts.<sup>109</sup>

The Exchange has represented that many aspects of compliance with PSX rules, such as avoidance of locked and crossed markets and trade throughs, will be enforced by the System itself, and the Exchange will periodically test operations of PSX to determine that the System is operating in accordance with applicable rules.<sup>110</sup>

The Commission notes that the Exchange will continue to bear ultimate regulatory responsibility for functions performed on its behalf under the Regulatory Contracts. Further, the Exchange retains ultimate legal responsibility for the regulation of its members and its markets (including PSX).

The Commission believes that it is consistent with the Act and the public interest to allow the Exchange to contract with FINRA to perform surveillance, disciplinary, and

enforcement functions.<sup>111</sup> Surveillance, discipline, and enforcement are fundamental elements to a regulatory program, and constitute core self-regulatory functions. It is essential to the public interest and the protection of investors that these functions are carried out in an exemplary manner. With respect to certain regulatory functions contracted to FINRA by the Exchange, including surveillance, disciplinary and enforcement functions, the Commission previously noted its belief that FINRA has the expertise and experience to perform such functions on behalf of an exchange, and that the contracting of such functions to FINRA is consistent with the Act and the public interest.<sup>112</sup> The Commission continues to believe that this is true with respect to FINRA's regulation of the Exchange and the conduct of its members pursuant to the FINRA RSA.

The Commission believes that it is consistent with the Act and the public interest to allow the Exchange to enter into the Intercompany RSA. Nasdaq and BX have self-regulatory obligations similar to those of the Exchange, and it is beneficial to the public interest and the protection of investors that these functions are carried out in an exemplary manner. The Commission notes that the Exchange has represented that all regulatory services performed for the Exchange under the Intercompany RSA are subject to the direction, authority, and oversight of the Exchange's CRO and ROC, and any personnel performing such services for the Exchange are subject to the jurisdiction, authority and oversight of the Exchange's CRO and ROC. In this way, the Exchange will maintain control over the performance of regulatory services with respect to the Exchange.

The Exchange, unless relieved by the Commission of its responsibility,<sup>113</sup> shall bear the responsibility for self-regulatory conduct and primary liability

<sup>111</sup> See, e.g., Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998). See also Securities Exchange Act Release Nos. 57478 (March 12, 2008) 73 FR 14521, (March 18, 2008) (order approving rules governing the trading of options on the NASDAQ Options Market) ("NOM Approval Order"); 50122 (July 29, 2004), 69 FR 47962 (August 6, 2004) (order approving File No. SR-Amex-2004-32) ("Amex Approval Order"); 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (File No. 10-127) (order approving ISE's registration as a national securities exchange) ("ISE Registration Approval Order"); Nasdaq Registration Approval Order, *supra* note 22.

<sup>112</sup> See Nasdaq Registration Approval Order, *supra* note 22; BX Equities Market Approval Order, *supra* note 81.

<sup>113</sup> See Section 17(d)(1) of the Act and Rule 17d-2 thereunder, 15 U.S.C. 78q(d)(1); and 17 CFR 240.17d-2. The Commission notes that it is not approving or declaring effective the FINRA RSA or the Intercompany RSA.

for self-regulatory failures, not the SRO retained to perform regulatory functions on the Exchange's behalf.<sup>114</sup> In performing these functions, however, an SRO may nonetheless bear liability for causing or aiding and abetting the failure of the Exchange to perform its regulatory functions.<sup>115</sup> Accordingly, although FINRA, Nasdaq and BX will not act on their own behalf under their respective SRO responsibilities in carrying out regulatory services for the Exchange pursuant to the FINRA RSA or Intercompany RSA, as applicable, such SROs may have secondary liability if, for example, the Commission finds that the contracted functions are being performed so inadequately as to cause a violation of the federal securities laws by the Exchange.<sup>116</sup>

#### *E. Additional Proposed Rules for the Exchange*

PHLX proposes to adopt rules addressing recommendations to customers (or suitability) and best execution and interpositioning,<sup>117</sup> which mirror the requirements of NASD Rules 2310 and 2320. Although members would become subject to these rules by virtue of being members of FINRA, PHLX believes that the requirements set forth in these rules are sufficiently important that they should be explicitly set forth in the PHLX rulebook.<sup>118</sup>

The Commission finds that the proposed rules regarding suitability and best execution and interpositioning are consistent with the Act. The Commission notes that rules are substantially similar to the requirements of NASD Rules 2310 and 2320.

#### **V. Conclusion**

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>119</sup> that the proposed rule change (SR-PHLX-2010-79), as modified by Amendment No. 1, be, and it hereby is, approved, except for (1) the circuit breaker pilot program, which is approved on a pilot basis through December 10, 2010, and (2) the inbound routing of orders from NES to PSX, which is approved on a pilot basis through September 9, 2011.

Although the Commission's approval of the rule proposal, as amended, is final and the proposed rules are therefore effective, it is further ordered

<sup>114</sup> See NOM Approval Order, *supra* note 111; Nasdaq Registration Approval Order, *supra* note 22; Amex Approval Order, *supra* note 111; and ISE Registration Approval Order, *supra* note 111.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> See proposed PHLX Rules 763 and 764.

<sup>118</sup> See Notice, *supra* note 3, 75 FR at 43604.

<sup>119</sup> 15 U.S.C. 78s(b)(2).

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*



that the operation of PSX is conditioned on the satisfaction of the following requirements:

A. *Examination by the Commission.* The Exchange must have, and must represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations that it has adequate surveillance procedures and programs in place to effectively regulate PSX.

B. *Trade Processing and Exchange Systems.* The Exchange must have, and must represent in a letter to the staff in the Commission's Division of Trading and Markets that it has adequate procedures and programs in place, as noted in Commission Automation Review Policy guidelines,<sup>120</sup> to effectively process trades and maintain the confidentiality, integrity, and availability of the Exchange's systems.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>121</sup>

**Elizabeth M. Murphy,**  
Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-62885; File No. SR-FINRA-2010-032]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of Proposed Rule Change Relating to Clearly Erroneous Transactions

#### I. Introduction

September 10, 2010.

On June 17, 2010, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), and Rule 19b-4 thereunder, a proposed rule change to amend its rules to set forth clearer standards and curtail its discretion with respect to breaking

<sup>120</sup> On November 16, 1989, the Commission published its first Automation Review Policy ("ARP I"), in which it created a voluntary framework for self-regulatory organizations to establish comprehensive planning and assessment programs to determine systems capacity and vulnerability. On May 9, 1991, the Commission published its second Automation Review Policy ("ARP II") to clarify the types of review and reports that were expected from self-regulatory organizations. See Securities Exchange Act Release Nos. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989); and 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

<sup>121</sup> 17 CFR 200.30-3(a)(12).

erroneous trades.<sup>1</sup> The proposed rule change was published for comment in the **Federal Register** on June 28, 2010.<sup>2</sup> The Commission received nine comment letters on the proposal.<sup>3</sup> BATS responded to the comments in a letter dated August 16, 2010.<sup>4</sup> This order approves the proposed rule change.

#### II. Background and Description of the Proposal

On May 6, 2010, the U.S. equity markets experienced a severe disruption.<sup>5</sup> Among other things, the

<sup>1</sup> Also, on June 17, 2010, each of BATS Exchange, Inc. ("BATS"), NASDAQ OMX BX, Inc. ("BX"), Chicago Board Options Exchange, Incorporated ("CBOE"), Chicago Stock Exchange, Inc. ("CHX"), EDGA Exchange, Inc. ("EDGA"), EDGX Exchange, Inc. ("EDGX"), International Securities Exchange LLC ("ISE"), The NASDAQ Stock Market LLC ("Nasdaq"), National Stock Exchange, Inc. ("NSX"), New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex"), NYSE Arca, Inc. ("NYSE Arca") (collectively, the "Exchanges") filed similar proposed rule changes with respect to breaking erroneous trades. See Securities Exchange Act Release Nos. 62330 (June 21, 2010), 75 FR 36725; 62331 (June 21, 2010), 75 FR 36746; 62332 (June 21, 2010), 75 FR 36749; 62333 (June 21, 2010), 75 FR 36759; 62334 (June 21, 2010), 75 FR 36732; 62335 (June 21, 2010), 75 FR 37494; 62336 (June 21, 2010), 75 FR 36743; 62337 (June 21, 2010), 75 FR 36739; 62338 (June 21, 2010), 75 FR 36762; 62339 (June 21, 2010), 75 FR 36765; 62340 (June 21, 2010), 75 FR 36768; and 62342 (June 21, 2010), 75 FR 36752. These proposals also were approved today. See Securities Exchange Act Release No. 62886 (Sept. 10, 2010).

<sup>2</sup> See Securities Exchange Act Release No. 62341 (June 21, 2010), 75 FR 36756.

<sup>3</sup> See letter from Peter Ianello, Partner, CSS, LLC, to Elizabeth Murphy, Secretary, Commission, dated July 15, 2010 ("CSS Letter"); letter from Gary DeWaal, Senior Managing Director and Group General Counsel, Newedge USA, LLC, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Newedge Letter"); letter from Carrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("ICI Letter"); David C. Cushing, Director of Global Equity Trading, Wellington Management Company, LLP, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Wellington Letter"); letter from John A. McCarthy, General Counsel, GETCO, to Elizabeth M. Murphy, Secretary, Commission, dated July 20, 2010 ("GETCO Letter"); letter from Ira P. Shapiro, Managing Director, BlackRock, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 20, 2010 ("BlackRock Letter"); and letter from Manisha Kimmel, Executive Director, Financial Information Forum, on behalf of the FIF Front Office Committee, to Elizabeth M. Murphy, Secretary, Commission, dated July 21, 2010 ("FIF Letter"); letter from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, Commission, dated July 26, 2010 ("SIFMA Letter"); and letter from Leonard J. Amoroso, General Counsel, Knight Capital Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 27, 2010 ("Knight Letter").

<sup>4</sup> See letter from Eric J. Swanson, SVP and General Counsel, BATS, to Elizabeth M. Murphy, Secretary, Commission, dated August 16, 2010 ("BATS Letter").

<sup>5</sup> The events of May 6 are described more fully in the report of the staffs of the Commodity Futures Trading Commission ("CFTC") and the Commission,

prices of a large number of individual securities suddenly declined by significant amounts in a very short time period, before suddenly reversing to prices consistent with their pre-decline levels. This severe price volatility led to a large number of trades being executed at temporarily depressed prices, including many that occurred at prices dramatically away from pre-decline levels. In response, the Exchanges and FINRA exercised their authority under their clearly erroneous execution rules to break trades that were effected at prices 60% or more away from pre-decline prices, using a process that was not sufficiently clear or transparent to market participants. There are reports that the lack of clear guidelines for dealing with clearly erroneous transactions under circumstances such as occurred on May 6, and the lack of transparency surrounding the Exchanges' and FINRA's decision to break only trades at least 60% away from the market, added to the confusion and uncertainty faced by investors on May 6.<sup>6</sup>

The Commission is concerned that events such as those that occurred on May 6 can undermine the integrity of the U.S. securities markets. Accordingly, it is working on a variety of fronts to assess the causes and contributing factors of the May 6 market disruption and to fashion policy responses that will help prevent a recurrence. The Commission also recognizes the importance of moving quickly to implement steps that could help limit potential harm from extreme price volatility. On June 10, 2010, the Commission approved rules, on a pilot basis, that require the Exchanges to pause trading in securities included in the S&P 500 Index if the price moves 10% or more in a five-minute period.<sup>7</sup> By establishing circuit breakers that uniformly pause trading in these securities across all markets, the new rules are designed to facilitate coordinated price discovery and provide time for investors to trade at rational prices. In addition to the individual stock trading pause rules, FINRA

titled *Report of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues*, "Preliminary Findings Regarding the Market Events of May 6, 2010," dated May 18, 2010.

<sup>6</sup> See, e.g., Written Statement of Leonard J. Amoroso, Senior Managing Director and General Counsel, Knight Capital Group, Inc., Submitted before the CFTC-SEC Advisory Committee on Emerging Regulatory Issues, Panel Discussion, "The events of May 6—views and observations regarding liquidity, trading and the apparent breakdown of an orderly market," dated June 22, 2010.

<sup>7</sup> See Securities Exchange Act Release Nos. 62251; 75 FR 34183 (June 10, 2010); and 62252, 75 FR 34186 (June 16, 2010).