

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>11</sup>

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Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-69452; File No. SR-Phlx-2013-24]

### Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto To Adopt a Price/Display/Time Priority Algorithm, Permit the Registration of Market Makers, and Amend the Order Types Available on PSX

April 25, 2013.

#### I. Introduction

On March 8, 2013, NASDAQ OMX PHLX LLC ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> proposed rule changes to adopt a price/display/time algorithm, permit the registration of market makers, and amend the order types available on NASDAQ OMX PSX ("PSX"). Phlx filed Amendment No. 1 to the proposed rule change on March 18, 2013.<sup>3</sup> The proposed rule change, as amended by Amendment No. 1, was published for comment in the **Federal Register** on March 26, 2013.<sup>4</sup> The Commission received no comment letters on the proposal. The Commission is approving the Exchange's proposal, as modified by Amendment No. 1.

#### II. Background

In 2010, the Exchange launched PSX as a new platform for trading cash equity securities, establishing a price/size pro rata priority model for allocating the execution of incoming orders against orders resting on the PSX book.<sup>5</sup> The Exchange had anticipated that this market model would gain traction as an alternative to the price/time priority model currently used by

other national securities exchanges. According to the Exchange, however, the price/size priority model has been only marginally successful in garnering market share, primarily due to the risk of a large execution at a stale price that a market participant would face if unable to adjust the prices of its posted orders quickly.<sup>6</sup> Therefore, the Exchange proposes to adopt a price/time priority model (but with displayed orders receiving priority over non-displayed orders) for PSX. The Exchange also proposes to allow member organizations that satisfy certain criteria to register as market makers on PSX ("PSX Market Makers"). Finally, the Exchange proposes to introduce Midpoint Peg Post-Only Orders and Price to Comply Post Orders, to adjust the operation of Minimum Quantity Orders and Post-Only Orders, and to eliminate Minimum Life Orders.

#### III. Discussion and Commission Findings

The Commission finds that the proposed rule changes filed by the Exchange are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>7</sup> Specifically, the Commission finds that the proposed rule changes are consistent with Section 6(b)(5) of the Act,<sup>8</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 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. Overall, the Commission believes that approving the Exchange's proposed rule change could benefit the public and market participants to the extent that it provides a more competitive venue for the trading of cash equity securities, resulting in better prices and executions for investors. The Commission finds that, for the reasons discussed below, the Exchange's proposal is consistent with the Act.

##### A. Order Processing Algorithm

PSX currently employs a price/size pro rata execution order processing algorithm, with displayed orders receiving priority over non-displayed orders. Specifically, multiple orders

displayed on the PSX book at the best price are 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 applies to non-displayed orders at that price level.<sup>9</sup>

Phlx proposes to amend its rules to replace its price/size pro rata order processing algorithm with a price/time priority algorithm that is substantially similar to the order processing algorithms used at the NASDAQ Stock Market ("NASDAQ") and/or NASDAQ OMX BX, Inc. ("BX"). Specifically, PSX's new order processing algorithm would allocate orders as follows:

(1) Price. Better priced orders would be executed first.

(2) Displayed orders. As among equally priced displayed orders, the first to arrive on the book would be executed first.

(3) Non-displayed orders and the reserve portion of quotes and reserve orders. As among equally priced non-displayed orders and the reserve portion of quotes and reserve orders, the first to arrive on the book would be executed first.<sup>10</sup>

The Commission believes that the proposed PSX execution priority rules are consistent with Section 6(b)(5) of the Act. The Commission notes that the price/time priority model is the prevailing execution algorithm for the exchange trading of cash equity securities. The Commission has previously determined price/time execution algorithms to be consistent with the Act.<sup>11</sup> Moreover, the particular price/time priority model proposed by Phlx is substantially similar to the model currently used by NASDAQ and BX and does not raise any novel issues.

##### B. Market Making

Phlx proposes to adopt rules to allow member organizations that are PSX participants to register and act as PSX Market Makers. Under the proposed rules, quotations and quotation sizes may be entered into PSX only by a PSX Market Maker or other entity approved by the Exchange to function in a market-making capacity.<sup>12</sup> A PSX participant may register as a PSX Market Maker in an issue by entering an electronic

<sup>11</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> Amendment No. 1 replaced the original filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 69194 (March 20, 2013), 78 FR 18386 (March 26, 2013) ("Notice").

<sup>5</sup> See Securities Exchange Act Release No. 62877 (September 9, 2010), 75 FR 56633 (September 16, 2010) (SR-Phlx-2010-79) ("PSX Approval Order").

<sup>6</sup> See Notice, *supra* note 4, at 18386.

<sup>7</sup> In approving these proposed rule changes, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

<sup>9</sup> See Rule 3307. See also PSX Approval Order, *supra* note 5.

<sup>10</sup> See proposed Rule 3307.

<sup>11</sup> See, e.g., Securities Exchange Act Release No. 54155 (July 14, 2006), 71 FR 41291 (July 20, 2006) (SR-NASDAQ-2006-001); Securities Exchange Act Release No. 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48).

<sup>12</sup> Proposed Rule 3212(a).

request or by contacting PSX Market Operations.<sup>13</sup> Registration would become effective on the day the registration request is entered.<sup>14</sup> A PSX Market Maker's registration in an issue will be terminated by the Exchange if the PSX Market Maker fails to enter quotations in the issue within five (5) business days after the PSX Market Maker's registration in the issue becomes effective.<sup>15</sup>

The proposed rules provide that a PSX Market Maker for a particular security must be willing to buy and sell that security for its own account on a continuous basis during regular market hours,<sup>16</sup> and that a PSX Market Maker must also display a two-sided trading interest in that security of at least one normal unit of trading in PSX's quotation montage at all times. Proposed Rule 3213(a)(2) would require a PSX Market Maker for NMS stocks to adhere to certain pricing obligations that are premised on entering quotation prices that are not more than a designated percentage<sup>17</sup> away from the national best bid or best offer (as applicable) and that must be refreshed if a change in the national best bid or best offer causes the quotation price to be more than a defined limit<sup>18</sup> away from the national best bid or best offer.

In general, a PSX Market Maker that wishes to withdraw quotations in a security would be required to contact the Exchange's MarketWatch Department to obtain excused withdrawal status prior to withdrawing its quotations. An exception to the requirement for prior approval would exist for withdrawals based on a PSX Market Maker's systemic equipment problems. For other circumstances beyond the PSX Market Maker's control, a PSX Market Maker that wishes to withdraw its quotations would be required to contact the Exchange's MarketWatch Department to obtain excused withdrawal status prior to withdrawing its quotations. If a PSX Market Maker's ability to enter or update quotations is impaired, the PSX Market Maker would be required to immediately contact PSX Market Operations to request a withdrawal of its quotations. A PSX Market Maker that elects to remain in PSX when its ability to update quotations is impaired would be obligated to execute orders presented

for execution against its disseminated quotations.<sup>19</sup>

Under the proposed rules, a PSX Market Maker may voluntarily terminate its registration in a security by withdrawing its two-sided quotation from PSX, but a PSX Market Maker that voluntarily terminated its registration in a security could not re-register as a PSX Market Maker in that security for one (1) business day.<sup>20</sup> A PSX Market Maker would not be deemed to have terminated its registration in a security by voluntarily withdrawing its two-sided quotation from PSX if the PSX Market Maker's two-sided quotation in the subject security is withdrawn by the Exchange's systems due to certain issuer corporate actions and the PSX Market Maker satisfies specified conditions following the withdrawal of the quotation.<sup>21</sup>

A PSX Market Maker that accidentally withdraws as a PSX Market Maker may be reinstated at the Exchange's discretion, if the PSX Market Maker notifies the Exchange's MarketWatch department promptly, the PSX Market Maker was not attempting to avoid its market making obligations, and the PSX Market Maker's firm has not exceeded the Exchange's reinstatement limitations.<sup>22</sup>

The Exchange also proposes several rules to govern conduct of PSX Market Makers in connection with securities that are subject of offerings governed by SEC Regulation M.<sup>23</sup> The proposed rules address the entry of stabilizing bids,<sup>24</sup> excused withdrawals based on status as a distribution participant or affiliated purchaser within the meaning of Regulation M,<sup>25</sup> the imposition of penalty bids or engaging in syndicate covering transactions,<sup>26</sup> and the meaning of certain new defined terms.<sup>27</sup>

Phlx also proposes to require a member organization that is acting as a PSX Market Maker in a Commodity-Related Security<sup>28</sup> to establish adequate information barriers when engaging in inter-departmental communications.<sup>29</sup> A member organization acting as a PSX Market Maker in a Commodity-Related Security would be required to file with the Exchange's Regulation Department

and keep current a list identifying all accounts—in which the PSX Market Maker holds an interest, over which it may exercise investment discretion, or in which it shares in the profits and losses—for trading in commodities or derivatives underlying that Commodity-Related Security.<sup>30</sup> A member organization acting as a PSX Market Maker in a Commodity-Related Security would not be permitted to act or register as a market maker in any commodities or derivatives underlying that Commodity-Related Security.<sup>31</sup>

A member organization acting as a registered PSX Market Maker in a Commodity-Related Security would be required to make available to the Exchange's Regulation Department certain information pertaining to transactions by the PSX Market Maker or by registered or non-registered employees affiliated with it for its or their own accounts for trading commodities or derivatives underlying that Commodity-Related Security.<sup>32</sup> Finally, in connection with trading a Commodity-Related Security or commodities or derivatives underlying a Commodity-Related Security, the member organization acting as a PSX Market Maker in a Commodity-Related Security would be prohibited from using any material nonpublic information received from any person associated with the member organization or employee of that person regarding trading by that person or employee in the commodities or derivatives underlying such Commodity-Related Security.<sup>33</sup>

The Commission finds the proposed rules governing the registration and regulation of PSX Market Makers to be consistent with Section 6(b)(5) of the Act. In particular, the proposed rules should help to ensure that quotations submitted by PSX Market Makers, and displayed to market participants, bear some relationship to the prevailing market price and should thus promote fair and orderly markets and the protection of investors.<sup>34</sup> The proposed

<sup>30</sup> Proposed Rule 3230(e).

<sup>31</sup> *Id.*

<sup>32</sup> Proposed Rule 3230(f).

<sup>33</sup> Proposed Rule 3230(g).

<sup>34</sup> See, e.g., Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (approving NASDAQ market maker rules as part of its registration as a national securities exchange); Securities Exchange Act Release No. 59154 (December 23, 2008), 73 FR 80468 (December 31, 2008) (SR-BSE-2008-48); Securities Exchange Act Release No. 63255 (November 5, 2010), 75 FR 69484, 69485 (November 12, 2010) (SR-BATS-2010-025, SR-BX-2010-66, SR-CBOE-2010-087, SR-CHX-2010-22, SR-FINRA-2010-049, SR-NASDAQ-2010-115, SR-NSX-2010-12, SR-NYSE-2010-69, SR-

<sup>13</sup> Proposed Rule 3212(b).

<sup>14</sup> *Id.*

<sup>15</sup> Proposed Rule 3212(c).

<sup>16</sup> Proposed Rule 3213(a)(1).

<sup>17</sup> The applicable percentages are defined in proposed Rule 3213(a)(2)(D).

<sup>18</sup> The applicable limits are defined in proposed Rule 3213(a)(2)(E).

<sup>19</sup> Proposed Rule 3213(c).

<sup>20</sup> Proposed Rule 3220(a).

<sup>21</sup> Proposed Rule 3220(d).

<sup>22</sup> Proposed Rule 3220(b).

<sup>23</sup> Rules 100-105 under Regulation M, 17 CFR 242.100-242.105.

<sup>24</sup> Proposed Rule 3214.

<sup>25</sup> Proposed Rule 3219(e).

<sup>26</sup> Proposed Rule 3224.

<sup>27</sup> Proposed Rule 3203.

<sup>28</sup> The term "Commodity-Related Security" is defined in Rule 3230(c).

<sup>29</sup> Proposed Rule 3230(d).

rules are substantially similar to requirements currently in place at NASDAQ and BX and raise no novel issues.<sup>35</sup>

### C. Modifications to Order Types

Phlx proposes to make certain changes to PSX's order functionality. Specifically, Phlx proposes to adjust the operation of Minimum Quantity Orders and Post-Only Orders, adopt rules to institute Midpoint Peg Post-Only Orders and Price to Comply Orders, and eliminate Minimum Life Orders.

Under current PSX rules, if the size of a Minimum Quantity Order is reduced to less than one round lot due to a partial execution, the minimum quantity condition on the order will be removed.<sup>36</sup> Phlx proposes to modify the operation of PSX's Minimum Quantity Order by permitting such orders to retain their minimum quantity condition even after their size is reduced to less than one round lot.<sup>37</sup> The Commission believes that Phlx's proposed changes to the Minimum Quantity Order type are consistent with the Act. The Commission notes that the proposed change will allow the operation of the order to better reflect the intention of the market participants entering the order, since it will allow a minimum quantity condition to continue to be attached to an order at a size below one round lot. This change also will make the operation of the PSX Minimum Quantity Order consistent with functionality currently in place at NASDAQ.<sup>38</sup>

Phlx also proposes to modify the functionality associated with its existing Post-Only Order on PSX. Currently, if a Post-Only Order would lock or cross an order on PSX at the time of entry, the order is re-priced and displayed by PSX one minimum price increment below the current low offer (for bids) or above the current best bid (for offers).<sup>39</sup> Under

the proposed change, if a Post-Only Order would cross an existing order, the order would be repriced unless the value of price improvement associated with executing against a resting order equals or exceeds the sum of fees charged for the execution and the value of any rebate that would be provided if the order posted to the book and subsequently provided liquidity, in which case the order would execute.<sup>40</sup> The Commission believes that Phlx's proposed changes to the Post-Only Order type are consistent with the Act. According to the Exchange, the proposed changes to the Post-Only Order are designed to provide market participants with better control over their execution costs by ensuring that a Post-Only Order will post to the PSX book only when an immediate execution of the order would not be more economically advantageous to the market participant that entered it.<sup>41</sup> The Commission notes that the proposed changes to the Post-Only Order functionality would make this order type consistent with functionality currently existing on NASDAQ and BX.<sup>42</sup>

In addition, Phlx also proposes to adopt two new order types: the Midpoint Peg Post-Only Order and the Price to Comply Post Order. A Midpoint Peg Post-Only Order would be a non-displayed order that is priced at the mid-point between the national best bid and best offer.<sup>43</sup> Like a Post-Only Order, the Midpoint Peg Post-Only Order would not remove liquidity from PSX upon entry if it would lock a non-displayed order on PSX. Rather, the Midpoint Peg Post-Only Order would post and lock the pre-existing order but will remain undisplayed.<sup>44</sup> The Price to Comply Post Order would permit participants to post liquidity at or near the inside market in compliance with the restrictions on locked and crossed markets and trade-throughs under Rules 610(d) and 611 under Regulation NMS.<sup>45</sup> If, at the time of its entry, a Price to Comply Post Order would lock or cross the protected quotation of another trading center or would execute at a price inferior to the protected quotation of another trading center, the

order would be re-priced and displayed one minimum price increment below the current low offer (for bids) or one penny above the current best bid (for offers). Price to Comply Post Orders would not be routable.<sup>46</sup>

The Commission believes that Phlx's proposed new order types are consistent with the Act. The Commission notes that the proposed introduction of Midpoint Peg Post-Only Orders is intended to provide market participants with better control over their execution costs and to provide a means to offer price improvement opportunities.<sup>47</sup> The proposed Midpoint Peg Post-Only Order functionality is identical to an order currently operative on NASDAQ.<sup>48</sup> The Exchange represents that the proposed Price to Comply Post Order is intended to provide PSX Market Makers and other participants with a straightforward mechanism to enter an order that re-prices to ensure that it does not lock or cross or trade through the protection quotation of another market center.<sup>49</sup> The Commission notes that the Proposed Price to Comply Post Order is substantially similar to an order type that is currently in use at NASDAQ.<sup>50</sup>

Finally, Phlx also proposes to eliminate PSX's Minimum Life Order. The Minimum Life Order is a displayed order that may not be cancelled for a period of 100 milliseconds following its receipt.<sup>51</sup> The Commission finds that Phlx's proposed elimination of the Minimum Life Order type is consistent with the Act. The Commission notes that no other national securities exchange has adopted this order type.

### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>52</sup> that the proposed rule change (SR-Phlx-2013-24), as amended, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>53</sup>

**Kevin M. O'Neill,**

*Deputy Secretary.*

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NYSEAmex-2010-96, SR-NYSEArca-2010-83) (approving corresponding marketwide rules with respect to market maker quoting and pricing obligations) ("2010 Order").

<sup>35</sup> See, e.g., proposed Rule 3212 (addressing the registration of PSX Market Makers), which is substantially similar to NASDAQ Rule 4612 and BX Rule 4612.

<sup>36</sup> Rule 3301(f)(5).

<sup>37</sup> Proposed Rule 3301(f)(5).

<sup>38</sup> NASDAQ Rule 4751(f)(5).

<sup>39</sup> Rule 3301(f)(10). In addition, if the order would lock or cross a protected quotation of another market center, the order will be accepted at the locking price (i.e., the current low offer (for bids) or the current best bid (for offers)) and displayed by PSX to one minimum price increment (i.e., \$0.01 or \$0.0001) below the current low offer (for bids) or above the current best bid (for offers). Thus, if the national best bid and offer, as displayed on another market center, was \$10 x \$10.05, an order to buy at \$10.05 or higher would be accepted at the locking price of \$10.05, but would be displayed at

\$10.04. Subsequently, an incoming order to sell at \$10.05 or lower would be matched against the Post-Only buy order.

<sup>40</sup> Proposed Rule 3301(f)(11).

<sup>41</sup> Proposed Rule 3301(f)(11).

<sup>42</sup> NASDAQ Rule 4751(f)(10) and BX Rule 4751(9).

<sup>43</sup> Proposed Rule 3301(f)(7).

<sup>44</sup> SEC Rule 610(d) under Regulation NMS, 17 CFR 242.610(d), restricts displayed quotations that lock protected quotations in NMS Stocks, but does not apply to non-displayed trading interest.

<sup>45</sup> 17 CFR 242.610(d), 611.

<sup>46</sup> Proposed Rule 3301(f)(9).

<sup>47</sup> Proposed Rule 3301(f)(7).

<sup>48</sup> NASDAQ Rule 4751(f)(11).

<sup>49</sup> Proposed Rule 3301(f)(9).

<sup>50</sup> NASDAQ Rule 4715(f)(8).

<sup>51</sup> Rule 3301(e)(11).

<sup>52</sup> 15 U.S.C. 78s(b)(2).

<sup>53</sup> 17 CFR 200.30-3(a)(12).