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SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-73719; File No. SR-Phlx-2014-76]

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Adopt Anti-Internalization Functionality for Registered Market Makers on the PHLX Options Market

December 2, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on November 28, 2014, NASDAQ OMX PHLX LLC ("Phlx," "PHLX," or "Exchange") filed with the Securities and Exchange Commission ("Commission") a proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to adopt anti-internalization functionality for registered market makers on the PHLX Options Market.

While these amendments are effective upon filing, the Exchange has designated the proposed amendments to be operative on or before January 15, 2015.

The text of the proposed rule change is below; proposed new language is italicized; proposed deletions are in brackets.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

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Rule 1080. Phlx XL and Phlx XL II

(a) – (o) No Change.

(p) Execution Protections

(1) **Acceptable Trade Range**.

(A) After the opening, the System will calculate an Acceptable Trade Range to limit the range of prices at which an order or quote (except an All-or-none order) will be allowed to execute. The Acceptable Trade Range is calculated by taking the Reference Price, plus or minus a value to be determined by the Exchange. (i.e., the Reference Price - (x) for sell orders/quotes and the Reference Price + (x) for buy orders/quotes). Upon receipt of a new order/quote, the Reference Price is the National Best Bid ("NBB") for sell orders and the National Best Offer ("NBO") for buy orders/quotes or the last price at which the order/quote is posted whichever is higher for a buy order/quote or lower for a sell order/quote.

(B) If an order/quote reaches the outer limit of the Acceptable Trade Range (the "Threshold Price") without being fully executed, it will be posted at the Threshold Price for a brief period, not to exceed one second ("Posting Period"), to allow more liquidity to be collected, unless a Quote Exhaust has occurred, in which case the Quote Exhaust process in Rule 1082(a)(ii)(B)(3) will ensue, triggering a new Reference Price. Upon posting, either the current Threshold Price of the order or an updated NBB for buy orders or the NBO for sell orders (whichever is higher for a buy order/lower for a sell order) then becomes the Reference Price for calculating a new Acceptable Trade Range. If the order/quote remains unexecuted, a New Acceptable Trade Range will be calculated and the order/quote will execute, route, or post up to the new Acceptable Trade Range Threshold Price, unless a member organization has requested that their orders be returned if posted at the outer limit of the Acceptable Trade Range (in which case, the order will be returned). This process will repeat until either i) the order/quote is executed, cancelled, or posted at its limit price or ii) the order has been subject to a configurable number of instances of the Acceptable Trade Range as determined by the Exchange (in which case it will be returned).

(C) During the Posting Period, the Exchange will disseminate as a quotation: (i) the Threshold Price for the remaining size of the order triggering the Acceptable Trade Range and (ii) on the opposite side of the market, the best price will be displayed using the "non-firm" indicator message in accordance with the specifications of the network processor. Following the Posting Period, the Exchange will return to a normal trading state and disseminate its best bid and offer.

(2) **Anti-Internalization –** Quotes and orders entered by Specialists and Registered Options Traders (as defined in Rule 1014) using the same Phlx badge will not be executed against quotes and orders entered on the opposite side of the market using the same badge. In such a case, the System will cancel the resting quote or order back to the entering party prior to execution. This functionality shall not apply in any auction or with respect to complex transactions.

(3) Order Price Protection ("OPP"). OPP is a feature of Phlx XL that prevents certain day limit, good til cancelled, immediate or cancel, and all-or-none orders at prices outside of pre-set standard limits from being accepted by the system. OPP applies to all options but does not apply to market orders, stop limit orders, Intermarket Sweep Orders or complex orders.

(A) OPP is operational each trading day after the opening until the close of trading, except during trading halts. The Exchange may also temporarily deactivate OPP from time to time on an intraday basis at its discretion if it determines that volatility warrants deactivation. Members will be notified of intraday OPP deactivation due to volatility and any subsequent intraday reactivation by the Exchange through the issuance of system status messages.

(B) OPP will reject incoming orders that exceed certain parameters according to the following algorithm.

(i) If the NBBO on the contra-side of an incoming order is greater than $1.00, orders with a limit more than 50% through such contra-side NBBO will be rejected by Phlx XL upon receipt. For example, if the NBBO on the offer side is $1.10, an order to buy options for more than $1.65 would be rejected. Similarly, if the NBBO on the bid side is $1.10, an order to sell options for less than $0.55 will be rejected.

(ii) If the NBBO on the contra-side of an incoming order is less than or equal to $1.00, orders with a limit more than 100% through such contra-side NBBO will be rejected by Phlx XL upon receipt. For example, if the NBBO on the offer side is $1.00, an order to buy options for more than $2.00 would be rejected. However, if the NBBO of the bid side of an incoming order to sell is less than or equal to $1.00, the OPP limits set forth above will result in all incoming sell orders being accepted regardless of their limit. To illustrate, if the NBBO on the bid side is equal to $1.00, the OPP limits provide protection such that all orders to sell with a limit less than $0.00 would be rejected.

(iii) For purposes of this rule, the NBBO is defined as the PBBO for singly-listed issues.

Commentary .01 -- .06 No Change.

[**Commentary .07 – Order Price Protection** ("OPP"). OPP is a feature of Phlx XL that prevents certain day limit, good til cancelled, immediate or cancel, and all-or-none orders at prices outside of pre-set standard limits from being accepted by the system. OPP applies to all options but does not apply to market orders, stop limit orders, Intermarket Sweep Orders or complex orders.

(a) OPP is operational each trading day after the opening until the close of trading, except during trading halts. The Exchange may also temporarily deactivate OPP from time to time on an intraday basis at its discretion if it determines that volatility warrants deactivation. Members will be notified of intraday OPP deactivation due to volatility and any subsequent intraday reactivation by the Exchange through the issuance of system status messages.

(b) OPP will reject incoming orders that exceed certain parameters according to the following algorithm.

(i) If the NBBO on the contra-side of an incoming order is greater than $1.00, orders with a limit more than 50% through such contra-side NBBO will be rejected by Phlx XL upon receipt. For example, if the NBBO on the offer side is $1.10, an order to buy options for more than $1.65 would be rejected. Similarly, if the NBBO on the bid side is $1.10, an order to sell options for less than $0.55 will be rejected.

(ii) If the NBBO on the contra-side of an incoming order is less than or equal to $1.00, orders with a limit more than 100% through such contra-side NBBO will be rejected by Phlx XL upon receipt. For example, if the NBBO on the offer side is $1.00, an order to buy options for more than $2.00 would be rejected. However, if the NBBO of the bid side of an incoming order to sell is less than or equal to $1.00, the OPP limits set forth above will result in all incoming sell orders being accepted regardless of their limit. To illustrate, if the NBBO on the bid side is equal to $1.00, the OPP limits provide protection such that all orders to sell with a limit less than $0.00 would be rejected.

(iii) For purposes of this rule, the NBBO is defined as the PBBO for singly-listed issues.]

Commentary .08 -- Renumbered as Commentary .07.

Commentary .09 -- Renumbered as Commentary .08.

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II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in

Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

PHLX is proposing to provide anti-internalization ("AIQ") functionality to Specialists and Registered Options Traders on the PHLX Options Market.[3] Anti-internalization functionality is widely available and has been for many years.[4] It is designed to assist market participants in complying with certain rules and regulations of the Employee Retirement Income Security Act ("ERISA") that preclude and/or limit managing broker-dealers of such accounts from trading as principal with orders generated for those accounts. It can also assist market makers in reducing trading costs from unwanted executions potentially resulting from the interaction of executable buy and sell trading interest from the same firm when performing the same market making function.

Under the proposal, quotes and orders entered by Specialists and Registered Options Traders using the same PHLX badge will automatically be prevented from interacting with each other in the System. Rather than executing quotes or orders from the same badge, the System will instead cancel the resting quotes and orders back to the entering party. PHLX uses "badges" to identify the party or parties entering trades into the System, similar to Market Participant

3 See PHLX Rule 1014. The category of Specialist and Registered Options Traders ("ROTs") as defined in Rule 1014 are all considered market makers on the Exchange. This category includes the subcategories of Streaming Quote Traders ("SQTs"), Remote Streaming Quote Traders ("RSQTs"), and Non-SQT ROTs, all of which have market making obligations also defined in Rule 1014.

4 See, e.g., NASDAQ Rule 4757(a)(4), NASDAQ Options Market Rule Chapter VI, Section 10(6), NYSE Arca Equities Rule 7.31(qq)(2), and BATS Rule 11.9(f)(2). PSX Rule 3307(c) governing trading on the PHLX equity facility provides similar self-match prevention for equities trading.

Identifiers (MPIDs) and other pneumonic devices used at other exchanges. Because firms have multiple badges associated with multiple functions, linking AIQ to specific badges ensures that the functionality will be limited to the appropriate function, as explained in more detail below. Tying AIQ to specific PHLX badges will also enable market participants to carefully and systematically target the orders that should be prevented from interacting.

AIQ will apply in the PHLX XL system with respect to simple orders only; it will not apply in any auction or with respect to complex transactions. AIQ is difficult to apply during auctions, and there is limited benefit in doing so. The difficulty stems from the need to freeze the order book and quickly arrange and match large quantities of orders based upon simple instructions. Even if that could be accomplished, there is limited benefit because, generally speaking, auctions do not raise the same policy concerns for wash sales and ERISA due to the semi-random manner in which trades are matched.[5] AIQ is unnecessary with respect to complex orders due to the highly specialized nature of such orders and the high level of control that market participants exercise over complex orders. In addition, owing to the number of different legs involved in complex orders, applying AIQ to complex orders would also require freezing the book, which market participants and PHLX view as detrimental to the market.

Anti-internalization functionality was requested by Specialists and Registered Options Traders on PHLX. Anti-internalization processing is available only to market makers and only on an individual badge basis. Specialists and Registered Options Traders that conduct order entry business via alternative badges will not be afforded the protection of AIQ functionality with respect to such alternative badges. PHLX considered making AIQ functionality available to

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5 See NYSE Arca Equities Rule 7.31(qq).

other participants, but rejected that approach. Limiting AIQ to Specialists and Registered Options Traders also helps to maintain simplicity of System processing.[6]

PHLX notes that use of the functionality does not relieve or otherwise modify the duty of best execution owed to orders received from public customers. Options market makers generally do not display customer orders in market making quotations, opting instead to enter customer orders using separate identifiers. In the event that an options market maker opts to include a customer order within a market making quotation, the market maker must take appropriate steps to ensure that public customer orders that do not execute due to anti-internalization functionality ultimately receive the same execution price (or better) they would have originally obtained if execution of the order was not inhibited by the functionality.

Finally, the Exchange is proposing to combine several existing price protection mechanisms in Rule 1080(p) and to rename that subsection as "Execution Protections, [sic] PHLX believes the rules will become clearer by adding AIQ and moving current Commentary .07 governing Order Price Protection to existing Rule 1080(p) governing the Acceptable Trade Range. As a result, PHLX will renumber existing Commentaries .08 and .09 as Commentaries .07 and .08. The proposed changes will not impact the substance and operation of the existing functionality of the Acceptable Trade Range, Order Price Protection or Commentaries .08 and .09.

2. <u>Statutory Basis</u>

PHLX believes that the proposed rule change is consistent with the provisions of Section

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6 If demand should arise from other participants, PHLX will reconsider providing this functionality to all participants at that time.

6 of the Act,[7] in general, and with Section 6(b)(5) of the Act[8] in particular, in that the proposal is 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, 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. Specifically, PHLX believes that the change, which is responsive to member input, will facilitate transactions in securities and perfect the mechanism of a free and open market by providing Specialists and Registered Options Traders with additional functionality that will assist them with managing the book of orders that they submit to PHLX and the associated execution costs.

PHLX believes the proposal is consistent with the Act because it provides tools for Specialists and Registered Options Traders to comply with existing rules against internalization in certain circumstances. Limiting AIQ to Specialists and Registered Options Traders is consistent with Act because inadvertent internalization is much more likely to impact market makers than other participants and offering AIQ more broadly would burden the System and provide little or no offsetting regulatory benefit. Finally, PHLX believes that it is reasonable to limit AIQ to simple options orders, as opposed to complex options and auctions, because the execution risk is much lower with respect to complex options and auctions and because those functions operate quite differently than individual orders in simple options.

B. Self-Regulatory Organization's Statement on Burden on Competition

PHLX does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as

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[7] 15 U.S.C. 78f.

[8] 15 U.S.C. 78f(b)(5).

amended. Specifically, by providing market participants additional tools to prevent inadvertent internalization of orders submitted to PHLX, the change has the potential to improve the trading environment on the Exchange, which will enhance PHLX's competitiveness with respect to other trading venues, thereby promoting greater competition. Moreover, the change does not burden competition in that it will be provided at no additional cost to members.

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

No written comments were either solicited or received.

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

Because the foregoing proposed rule change does not: (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A)(ii) [sic] of the Act[9] and subparagraph (f)(6) of Rule 19b-4 thereunder.[10]

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is: (i) necessary or appropriate in the public interest; (ii) for the protection of investors; or (iii) otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

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9 15 U.S.C. 78s(b)(3)(a)(ii) [sic].

10 17 CFR 240.19b-4(f)(6). In addition, Rule 19b-4(f)(6) requires a self-regulatory organization to give the Commission written notice of its intent to file the proposed rule change at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-Phlx-2014-76 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-Phlx-2014-76. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal offices of the Exchange. All comments received will be posted without change; the

Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Phlx-2014-76, and should be submitted on or before [INSERT DATE 21 DAYS FROM PUBLICATION IN THE FEDERAL REGISTER].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[11]

Kevin M. O'Neill,
Deputy Secretary.

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[11] 17 CFR 200.30-3(a)(12).