JEFFREY S. DAVIS
VICE PRESIDENT & DEPUTY GENERAL COUNSEL
805 KING FARM BLVD
ROCKVILLE, MD 20850
P: +1 301 978 8484
F: +1 301 978 8472
E: [redacted]

May 9, 2014

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-Phlx-2013-113—Request for Comment

Dear Ms. Murphy:

NASDAQ OMX PHLX LLC ("Phlx") respectfully submits the following response to the Commission's Request for Comment and Designation of Longer Period for Commission Action, dated April 7, 2014, which posed questions relating to Phlx's proposal to amend its pricing schedule to increase the rebates available to certain market participants who transact Customer orders on Phlx (the "Proposal"). The Commission requested comments addressing the questions it posed by April 25, 2014, with rebuttal comments due by today, May 9. Phlx previously informed the Commission that it intended to submit a single response to the Commission's questions and any other comments by the rebuttal comment deadline.[1] To Phlx's knowledge, no other comments have been filed to date. Phlx therefore focuses this response on the specific questions posed in the Commission's Request for Comment.

Phlx is attempting to reduce its fees and thereby lower investors' cost of trading. The Proposal offers an enhanced rebate to market participants who transact a certain percentage of national customer volume in multiply-listed options on any of three NASDAQ-affiliated exchanges. As Phlx has explained in prior submissions, the Proposal furthers the purposes of the Exchange Act in multiple respects. By increasing the rebates available to certain market participants who transact customer orders on Phlx, the proposed rule would reduce the transaction costs of doing business on the exchange, which would ultimately reduce the costs passed on to investors. As a result, market participants would be more likely to direct customer

[1] In the meantime, Phlx has separately responded to additional questions posed by Commission staff relating to the Proposal in a letter that is now part of the record in this matter. *See* Letter from Jeffrey Davis to Elizabeth Murphy, File No. SR-Phlx-2013-113 (Apr. 18, 2014).

liquidity to Phlx, which would result in tighter spreads, increased trading opportunities, and an overall better functioning trading platform. Thus, the proposed rebate would benefit both the market participants who receive it and the investing public as a whole.

The rebate would also provide an incentive for other exchanges to match the discounted prices by developing their own pricing strategies or increasing the quality of their execution services. In so doing, the Proposal would enhance competition among markets and create a more efficient, less costly national market system—furthering two key purposes underlying the Exchange Act.

The Commission's Request for Comment focuses principally on the possibility that the Proposal could create an incentive for other SROs to establish new exchanges and offer similar "cross-SRO" rebates—purportedly increasing the possibility for market fragmentation. As an initial matter, there is no evidence or basis for the Commission to conclude that other SROs will respond to the Proposal by creating new exchanges. Rather, a single-exchange operator could offer a variety of rebates or other incentives that would allow it to compete with a "cross-SRO" proposal without creating a new exchange—such as an enhanced volume-based discount or rebates for trades in proprietary options products.

Even if a single-exchange operator chose to respond to the Proposal by creating a second exchange, that should not be cause for concern or for disapproval of the Proposal. A rule does not violate the Exchange Act merely because it creates an incentive for another market operator to open a new exchange. To the contrary, the Commission historically has praised the increase in securities exchanges in the United States as critical to enhancing competition for order flow and promoting consumer choice.[2]

To be sure, the Commission has expressed concern in the past that a multiplicity of trading venues could lead to fragmentation if market participants are unable to interact with order flow on each exchange to ensure that they are obtaining the best available price.[3] But to Phlx's knowledge, the Commission has never suggested that the possibility of future order fragmentation is a sufficient reason to discourage or prohibit the creation of new exchanges under the Exchange Act. Nor would this conclusion be consistent with the Commission's recognition that new exchanges have contributed positively to the national market system by encouraging product innovation and price competition.[4]

Rather, the Commission has responded to concerns about market fragmentation by adopting or proposing measures to increase price transparency, promote interaction among

---

[2] Regulation NMS, 70 Fed. Reg. 37,496, 37,499 (June 29, 2005); *see also* Concept Release, 75 Fed. Reg. 3,594, 3,597 (Jan. 21, 2010) (benefits of competition among markets include "incentives for trading centers to create new products, provide high quality trading services that meet the needs of investors, and keep trading fees low").

[3] *See* Regulation NMS, 70 Fed. Reg. at 37,499; Concept Release, 75 Fed. Reg. at 3,597.

[4] *See* Concept Release, 75 Fed. Reg. at 3,597.

exchanges, and ensure that broker-dealers fulfill their duties of best execution.[5] In addition, the Commission has discretion, at the time that a proposed exchange seeks registration under the Exchange Act, to deny such registration if necessary to "protect investors and the public interest" or ensure that "the rules of the exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act.[6] In other words, the Commission has multiple tools at its disposal to protect investors from any fragmentation that might be caused by the creation of new exchanges. The Commission should not reject the current Proposal based on the mere *possibility* that it could encourage another SRO to create a new exchange—a contingency that may never come to pass.

Moreover, the Commission's concern that the Proposal could lead to the creation of new exchanges presupposes that the Proposal will be successful and encourage other exchanges to respond in kind to offer similarly attractive options to investors. The Commission should not disallow the Proposal based on the presumption that investors will respond favorably to it and encourage other exchanges to offer additional rebates or other market-based incentives. The Commission should not stifle such innovation out of the gate before it has an opportunity to evaluate the actual effects of that innovation on investors, other exchanges, and the market system as a whole.

Finally, mere conjecture about the possible effect that the Proposal might have on the creation of future exchanges or on market fragmentation cannot supply a "reasoned explanation" for rejecting it, under the arbitrary and capricious standard of review that applies to all Commission decisions. *FCC v. Fox TV Stations, Inc.*, 556 U.S. 502, 515 (2009). Because the Proposal enhances competition and offers a pro-competitive price cut to Phlx members, it is presumptively valid under the Exchange Act: There would need to be significant countervailing evidence supporting any conclusion that the Proposal conflicts with the purposes underlying the Act. No such evidence exists here. The Commission therefore should permit market forces to determine both the optimal number of exchanges and the manner in which exchanges offer and respond to pro-competitive price discounts. The Commission should approve the Proposal without further delay.

Phlx also responds to the Commission's specific information requests as follows.

<u>Question 1:</u>

What are commenters' views on the impact that Phlx's proposal would have on the current options market structure? Please explain. What would the impact be, if any, on the current equity market structure? Please explain.

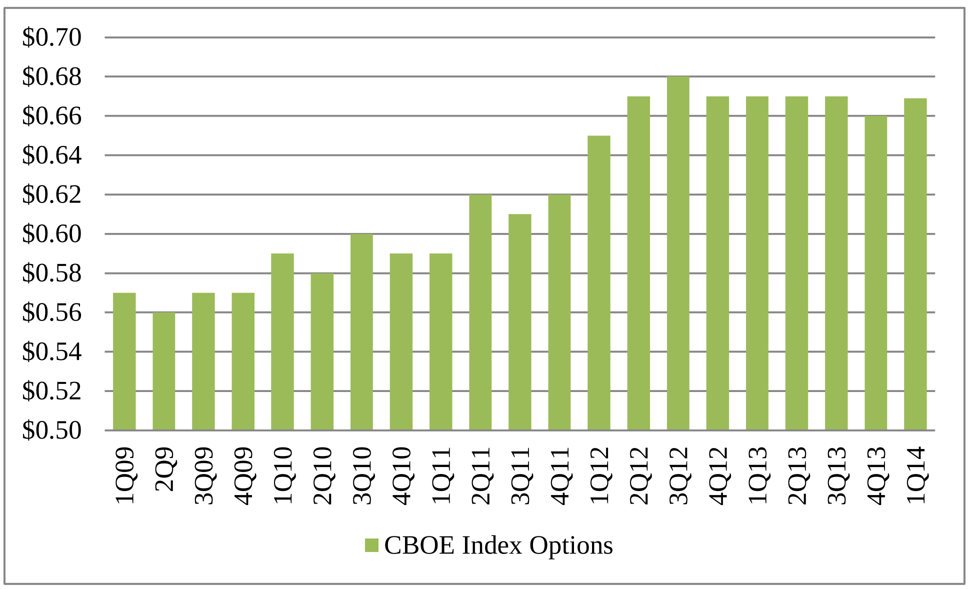
---

[5] *See* Regulation NMS, 70 Fed. Reg. at 37,501-37,503; Concept Release, 75 Fed. Reg. at 3,600-3,602.

[6] 15 U.S.C. §§ 78f(b), 78s(a).

Phlx Response:

Phlx does not believe that the Proposal will have a material effect on the structure of the options or equities markets. Phlx's competitors can respond to the Proposal in a number of different ways, most of which do not involve opening a new exchange (or closing an existing one). Exchange operators can match the discount offered in the Proposal by increasing the rebates available on a single exchange.[7] Alternatively, they can develop other strategies for offering differentiated pricing, products, or services that could appeal to market participants.[8] For example, as discussed in Phlx's previous submissions, CBOE offers larger discounted fees for trades for proprietary options contracts to certain members who also meet certain volume thresholds for multiply-listed options contracts.[9] Similarly, CBOE recently reported to investors that it will "maximize market share in multiply-listed options," presumably by offering high rebates and discounted fees as evidenced by declining revenue capture in multiply-listed options, and by lengthening the trading day for proprietary products and creating new options products.[10] The latter potentially increases revenues from proprietary products to fund discounts and rebates in multiply-listed options. The chart below demonstrates how CBOE has increased prices in index options, where over 90% of the volume executed is in CBOE's proprietary index options.



Of course, it is possible that Phlx's rivals might respond to the Proposal by opening new exchanges and adopting similar cross-exchange pricing structures. But Phlx believes the

---

[7] *See* Phlx Response Letter, at 9 (April 18, 2014).

[8] *Id.* at 9-10.

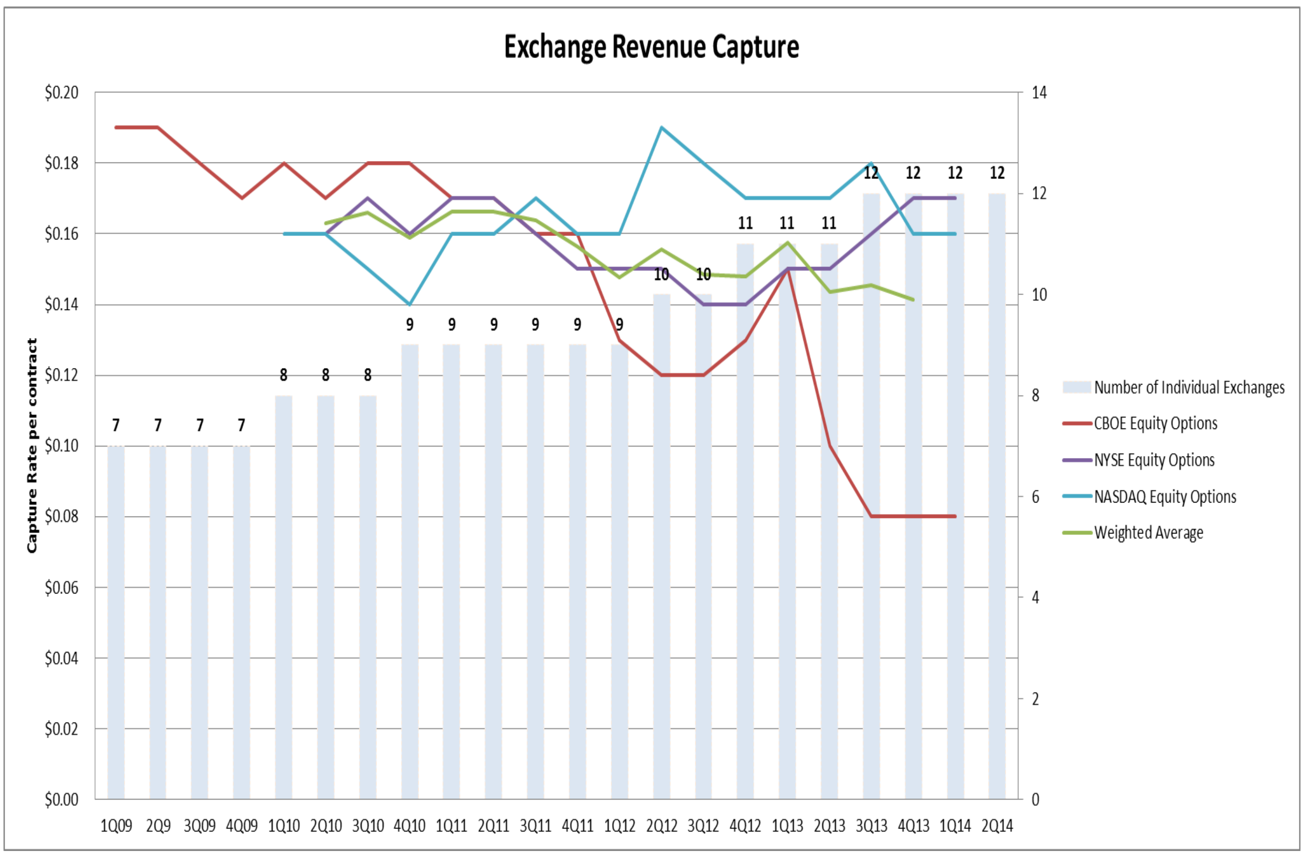
[9] *Id.* at 10.

[10] CBOE Holdings, First Quarter 2014 Earnings Presentation, at 15-19, 24 (May 6, 204), *available at*: http://files.shareholder.com/downloads/ABEA-2BARL5/3148898273x0x751542/ad9d9f80-3e8f-4c76-9c56-7931900bb5d3/1Q14%20Earnings%20Slides%20Final.pdf.

decision to open a new exchange is influenced primarily by other factors. Most importantly, exchange operators consider whether opening a new exchange will allow them to offer a new market model that will provide a different value proposition to market participants than is available through their existing exchanges. By contrast, the need to compete with the two-cent fee reduction offered in the Proposal is probably less likely to spur the opening of new exchanges.

In any event, to the extent that rivals open new exchanges, that should be expected to benefit market participants. Presumably, an exchange operator would only open an exchange if it believed doing so would better serve the needs of market participants. And the exchange would only be successful if it, in fact, provided benefits to participants. For that reason, market forces should ensure that the needs of consumers dictate whether new exchanges will operate successfully.

The Commission appears to be concerned that the addition of new exchanges could lead to fragmentation, which might arguably have certain undesirable effects on the market. Phlx notes, however, that in the past five years, as the number of exchanges has increased from seven to twelve, the revenue per contract of CBOE, NASDAQ, and NYSE has decreased or remained relatively flat (see table below). Since revenue per contract is one important component of trading costs, this suggests that trading costs do not necessarily increase when additional markets open.



Question 2:

What are commenters' views on the impact the proposal would have, if any, on the trading of options orders across multiple options exchanges? Please explain. Specifically, what are commenters' views as to the impact, if any, on order interaction, quote competition, liquidity (both top of book and depth of book) on each options exchange or across all options exchanges, and/or short-term and long-term volatility? Please explain. What are commenters' views on the impact the proposal would have, if any, on the best execution of investor orders, including the implicit costs of executing their orders (such as spreads and price impact)? Please explain.

Phlx Response:

As Phlx has discussed in its previous submissions, the Proposal should enable Phlx to increase its volume, which would result in enhanced liquidity and tighter spreads and thereby benefit Phlx market participants through improved execution quality and lower costs.[11] In addition, rivals could respond with price cuts of their own, which would provide market participants with additional savings.[12] Price competition is generally viewed as beneficial to consumers.

Phlx believes that the Proposal will not otherwise materially affect order interaction, liquidity, volatility, or execution. As discussed in Phlx's response to Question 1, Phlx expects that the Proposal will not change the structure of the options or equities markets, and will not result in fragmentation or any of the problems that might arguably result from fragmentation.

Question 3:

What are commenters' views on the impact the proposal would have, if any, on the current total number of options exchanges? Please explain. Do commenters believe that the total number of exchanges that list and trade standardized options would likely increase, decrease, or remain unchanged? Please explain.

Phlx Response:

Phlx believes that the Proposal will not lead to an increase or decrease in the total number of options exchanges. As discussed in Phlx's response to Question 1, options exchange operators can respond to the Proposal in a number of ways, most of which do not require them to open new exchanges. In addition, the decision to open a new exchange is likely to be influenced more by other factors (such as the need to offer a new market model) than by the Proposal.

Question 4:

What are commenters' views on how the proposal would impact the incentives for existing exchanges or new entities to create multiple exchanges under one group? What are

---

[11] *See, e.g., id.* at 1.

[12] *See, e.g., id.*

commenters' views on how, if any, the proposal would impact the incentives for: (1) entities that currently operate multiple options exchanges under common ownership ("exchange group") to create additional options exchanges under their existing exchange group; (2) stand-alone options exchanges to create new options exchanges under an exchange group; or (3) stand-alone exchanges and/or exchange groups to consolidate and form new options exchange groups. Please elaborate.

Phlx Response:

As discussed in Phlx's answers to Questions 1 and 3, Phlx believes that the Proposal will not materially affect the incentives for exchanges or new entities to create additional options exchanges. Exchange operators can respond to the Proposal in many different ways, including by offering better pricing on a single exchange. And the decision to open an additional exchange is likely to be influenced primarily by factors other than the Proposal.

Similarly, Phlx does not expect that the Proposal will materially affect the incentives for existing exchanges or exchange groups to consolidate. Consolidation is primarily driven by other considerations, including whether it would help exchanges better serve the interests of market participants. Consolidation also involves significant transaction costs. Phlx believes that a two-cent price cut would not create a sufficient incentive to prompt exchange groups to consolidate—when they otherwise would not do so—given the significance of those transaction costs.

Question 5:

What are commenters' views on the potential explicit costs (e.g., connectivity costs, routing costs) or benefits of increasing or decreasing the total number of options exchanges? Please identify such potential costs or benefits and explain why they would change.

Phlx Response:

As discussed in Phlx's answers to Questions 1, 3, and 4, Phlx believes that the Proposal will not lead to an increase or decrease in the total number of options exchanges. The Proposal thus should not generate any costs or benefits associated with a change in the number of options exchanges.

Respectfully submitted,

Jeffrey S. Davis
V.P. and Deputy General Counsel