

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-84624; File No. SR-Phlx-2018-72)

November 19, 2018

Self-Regulatory Organizations; Nasdaq PHLX LLC; Notice of Filing of Proposed Rule Change to Establish Rules Governing the Give Up of a Clearing Member by a Member Organization on Exchange Transactions

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> notice is hereby given that on November 6, 2018, Nasdaq PHLX LLC (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III, below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to establish rules governing the give up of a Clearing Member<sup>3</sup> by a member organization on Exchange transactions.

The text of the proposed rule change is available on the Exchange’s website at <http://nasdaqphlx.cchwallstreet.com/>, at the principal office of the Exchange, and at the Commission’s Public Reference Room.

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

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

<sup>3</sup> Clearing Member means a member organization which has been admitted to membership in the Options Clearing Corporation pursuant to the provisions of the rules of the Options Clearing Corporation. See Rule 1000(b)(3).

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

The Exchange proposes to amend Phlx Rule 1037, which is currently reserved, to establish requirements related to the give up of a Clearing Member by a member organization on Exchange transactions.

By way of background, to enter transactions on the Exchange, a member organization must either be a Clearing Member or have a clearing arrangement with a Clearing Member.<sup>4</sup> Rule 1052 currently provides that every Clearing Member shall be responsible for the clearance of the Exchange options transactions of such Clearing Member and of each member organization who gives up the name of such Clearing Member in an Exchange options transaction, provided the Clearing Member has authorized such member organization to give up its name with respect to Exchange options transactions.

Recently, certain Clearing Members, in conjunction with the Securities Industry and Financial Markets Association (“SIFMA”), expressed concerns related to the process by which executing brokers on U.S. options exchanges (“Exchanges”) are allowed to designate or ‘give

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<sup>4</sup> See Rule 1046.

up' a clearing firm for purposes of clearing particular transactions. The SIFMA-affiliated Clearing Members have recently identified the current give up process as a significant source of risk for clearing firms, and subsequently requested that the Exchanges alleviate this risk by amending Exchange rules governing the give up process.<sup>5</sup>

#### Proposed Rule Change

Based on the above, the Exchange now seeks to amend its rules regarding the current give up process in order to allow a Clearing Member to opt in, at The Options Clearing Corporation ("OCC") clearing number level, to a feature that, if enabled by the Clearing Member, will allow the Clearing Member to specify which member organizations are authorized to give up that OCC clearing number. As proposed, Rule 1037, which is currently reserved, will be titled as "Authorization to Give Up" and will provide that for each transaction in which a member organization participates, the member organization may indicate, at the time of the trade, with respect to floor trading only, or through post trade allocation, any OCC number of a Clearing Member through which a transaction will be cleared ("Give Up"), provided the Clearing Member has not elected to "Opt In," as defined in paragraph (b) of the proposed Rule, and restrict one or more of its OCC number(s) ("Restricted OCC Number").<sup>6</sup> A member

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<sup>5</sup> NYSE Arca Inc. ("Arca") recently filed to amend its give up procedures. Arca's proposal would allow a Designated Give Up to opt out of acting as the give up for certain OTP Holders and OTP Firms. See Securities Exchange Act Release No. 84284 (September 25, 2018), 83 FR 49434 (October 1, 2018) (SR-NYSEArca-2018-68). The Exchange's proposal leads to the same result of providing its Clearing Members the ability to control risk, but it differs in process from Arca's proposal.

<sup>6</sup> Today, electronic trades need a valid mnemonic, which is only set up if there is a clearing arrangement already in place through a Letter of Guarantee. As such, electronic trades automatically clear through the guarantor associated with the mnemonic at the time of the trade, so a member organization may only amend its Give Up post-trade. As proposed, the Exchange will also restrict the post-trade allocation portion of an electronic trade systematically. See note 13 below.

organization may Give Up a Restricted OCC Number provided the member organization has written authorization as described in paragraph (b)(ii) (“Authorized Member Organization”).

Proposed Rule 1037(b) provides that Clearing Members may request the Exchange restrict one or more of their OCC clearing numbers (“Opt In”) as described in subparagraph (b)(i) of Rule 1037. If a Clearing Member Opt In, the Exchange will require written authorization from the Clearing Member permitting a member organization to Give Up a Clearing Member’s Restricted OCC Number. An Opt In would remain in effect until the Clearing Member terminates the Opt In as described in subparagraph (iii). If a Clearing Member does not Opt In, that Clearing Member’s OCC number may be subject to Give Up by any member organization.

Proposed Rule 1037(b)(i) will set forth the process by which a Clearing Member may Opt In. Specifically, a Clearing Member may Opt In by sending a completed “Clearing Member Restriction Form” listing all Restricted OCC Numbers and Authorized Member Organizations.<sup>7</sup> A copy of the proposed form is attached in Exhibit 3 to the filing. A Clearing Member may elect to restrict one or more OCC clearing numbers that are registered in its name at OCC. The Clearing Member would be required to submit the Clearing Member Restriction Form to the Exchange’s Membership Department as described on the form. Once submitted, the Exchange requires ninety days before a Restricted OCC Number is effective within the System. This time period is to provide adequate time for the member users of that Restricted OCC Number who are not initially specified by the Clearing Member as Authorized Member Organizations to obtain

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<sup>7</sup> This form will be available on the Exchange’s web site. The Exchange will also maintain, on its web site, a list of the Restricted OCC Numbers, which will be updated on a regular basis, and the Clearing Member’s contact information to assist member organizations (to the extent they are not already Authorized Member Organizations) with requesting authorization for a Restricted OCC Number. The Exchange may utilize additional means to inform its members of such updates on a periodic basis.

the required written authorization from the Clearing Member for that Restricted OCC Number. Such member users would still be able to Give Up that Restricted OCC Number during this ninety day period (i.e., until the number becomes restricted within the System).

Proposed Rule 1037(b)(ii) will set forth the process for member organizations to Give Up a Clearing Member's Restricted OCC Number. Specifically, a member organization desiring to Give Up a Restricted OCC Number must become an Authorized Member Organization.<sup>8</sup> The Clearing Member will be required to authorize a member organization as described in subparagraph (i) or (iii) of Rule 1037(b) (i.e., through a Clearing Member Restriction Form), unless the Restricted OCC Number is already subject to a Letter of Guarantee that the member organization is a party to, as set forth in Rule 1037(d).

Pursuant to proposed Rule 1037(b)(iii), a Clearing Member may amend the list of its Authorized Member Organizations or Restricted OCC Numbers by submitting a new Clearing Member Restriction Form to the Exchange's Membership Department indicating the amendment as described on the form. Once a Restricted OCC Number is effective within the System pursuant to Rule 1037(b)(i), the Exchange may permit the Clearing Member to authorize, or remove authorization for, a member organization to Give Up the Restricted OCC Number intra-day only in unusual circumstances, and on the next business day in all regular circumstances. The Exchange will promptly notify the member organizations if they are no longer authorized to Give Up a Clearing Member's Restricted OCC Number. If a Clearing Member removes a Restricted OCC Number, any member organization may Give Up that OCC clearing number once the removal has become effective on or before the next business day.

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<sup>8</sup> The Exchange will develop procedures for notifying member organizations that they are authorized or unauthorized by Clearing Members.

Proposed Rule 1037(c) will provide that the System will not allow an unauthorized member organization to Give Up a Restricted OCC Number.<sup>9</sup> Specifically:

- For orders that are executed on the trading floor in open outcry using the Options Floor Based Management System (“FBMS”),<sup>10</sup> the System will reject the clearing portion of the trade if an unauthorized Give Up with a Restricted OCC Number was entered. The member organization will receive notification of the rejected clearing information, and will be required to modify the clearing information by contacting the Exchange.<sup>11</sup>
- For all other orders (i.e., orders that are submitted directly to the System through the Exchange’s various protocols),<sup>12</sup> the System will not allow an unauthorized Give Up with a Restricted OCC Number to be submitted at the firm mnemonic level at the point of order entry.<sup>13</sup>

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<sup>9</sup> As described below, the Exchange’s proposed process closely follows the current process.

<sup>10</sup> See Phlx Rules 1063(e) and 1080(a)(i)(C).

<sup>11</sup> In this case, the FBMS order will be executed, provided the terms of the trade comply with the relevant Exchange rules, and the execution reported to the consolidated tape. The System will, however, reject the clearing portion, and the member organization will have to amend the clearing information by contacting the Nasdaq Correction Post once it receives the reject notification. The Exchange will then promptly process the requested change. This is how such orders are processed today if, for instance, a member organization enters an erroneous OCC clearing number (i.e., ‘keypunch errors’).

<sup>12</sup> See Phlx Rule 1080(a)(i).

<sup>13</sup> Specifically, the System will block the entry of the order from the outset. This is because a valid mnemonic will be required for any order to be submitted directly to the System, and a mnemonic will only be set up for a member organization if there is already a clearing arrangement in place for that firm either through a Letter of Guarantee (as is the case today) or in the case of a Restricted OCC Number, the member organization becoming an Authorized Member Organization. The System will also restrict any post-

Furthermore, the Exchange proposes to adopt paragraph (d) to Rule 1037 to provide, as is the case today, that a clearing arrangement subject to a Letter of Guarantee would immediately permit the Give Up of a Restricted OCC Number by the member organization that is party to the arrangement. Since there is an OCC clearing arrangement already established in this case, no further action is needed on the part of the Clearing Member or the member organization.

The Exchange also proposes to adopt paragraph (e) to Rule 1037 to provide that an intentional misuse of this Rule is impermissible, and may be treated as a violation of Rule 707, titled “Conduct Inconsistent with Just and Equitable Principles of Trade,” or Rule 708, titled “Acts Detrimental to the Interest or Welfare of the Exchange.” This language will make clear that the Exchange will regulate an intentional misuse of this Rule (e.g., sending orders to a Clearing Member’s OCC account without the Clearing Member’s consent), and that such behavior would be a violation of Exchange rules.

Finally, the Exchange proposes to amend Rule 1052, which addresses the financial responsibility of Exchange options transactions clearing through Clearing Members, to clarify that this Rule will apply to all Clearing Members, regardless of whether or not they elect to Opt In pursuant to proposed Rule 1037. Specifically, the Exchange proposes to add that Rule 1052 will apply to all Clearing Members who either (i) have Restricted OCC Numbers with Authorized Member Organizations pursuant to Rule 1037, or (ii) have non-Restricted OCC Numbers.

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trade allocation changes if the member organization is not authorized to use a Restricted OCC Number.

## Implementation

The Exchange proposes to implement the proposed rule change no later than by the end of Q1 2019. The Exchange will announce the implementation date to its member organizations in an Options Trader Alert.

### 2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act,<sup>14</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>15</sup> in particular, in that it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in 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.

Particularly, as discussed above, several clearing firms affiliated with SIFMA have recently expressed concerns relating to the current give up process, which permits member organizations to identify any Clearing Member as a designated give up for purposes of clearing particular transactions, and have identified the current give up process (i.e., a process that lacks authorization) as a significant source of risk for clearing firms.

The Exchange believes that the proposed changes to Rule 1037 help alleviate this risk by enabling Clearing Members to ‘Opt In’ to restrict one or more of its OCC clearing numbers (i.e., Restricted OCC Numbers), and to specify which Authorized Member Organizations may Give Up those Restricted OCC Numbers. As described above, all other member organizations would be required to receive written authorization from the Clearing Member before they can Give Up

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<sup>14</sup> 15 U.S.C. 78f(b).

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



that Clearing Member's Restricted OCC Number. The Exchange believes that this authorization provides proper safeguards and protections for Clearing Members as it provides controls for Clearing Members to restrict access to their OCC clearing numbers, allowing access only to those Authorized Member Organizations upon their request. The Exchange also believes that its proposed Clearing Member Restriction Form allows the Exchange to receive in a uniform fashion, written and transparent authorization from Clearing Members, which ensures seamless administration of the Rule.

The Exchange believes that the proposed Opt In process strikes the right balance between the various views and interests across the industry. For example, although the proposed rule would require member organizations (other than Authorized Member Organizations) to seek authorization from Clearing Members in order to have the ability to give them up, each member organization will still have the ability to Give Up a Restricted OCC Number that is subject to a Letter of Guarantee without obtaining any further authorization if that member organization is party to that arrangement. The Exchange also notes that to the extent the executing member organization has a clearing arrangement with a Clearing Member (i.e., through a Letter of Guarantee), a trade can be assigned to the executing member organization's guarantor.<sup>16</sup> Accordingly, the Exchange believes that the proposed rule change is reasonable and continues to provide certainty that a Clearing Member would be responsible for a trade, which protects investors and the public interest. Finally, the Exchange believes that adopting paragraph (e) of Rule 1037 will make clear that an intentional misuse of this Rule (e.g., sending orders to a Clearing Member's OCC account without the Clearing Member's consent) will be a violation of

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<sup>16</sup> See Rule 1046 (providing that a member organization conducting an options business must be a Clearing Member or have a clearing arrangement with a Clearing Member).

the Exchange's rules, and that such behavior would subject a member organization to disciplinary action.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The Exchange does not believe that the proposed rule change will impose an unnecessary burden on intramarket competition because it would apply equally to all similarly situated Members. The Exchange also notes that, should the proposed changes make Phlx more attractive for trading, market participants trading on other exchanges can always elect to become Members on Phlx to take advantage of the trading opportunities.

Furthermore, the proposed rule change does not address any competitive issues and ultimately, the target of the Exchange's proposal is to reduce risk for Clearing Members under the current give up model. Clearing firms make financial decisions based on risk and reward, and while it is generally in their beneficial interest to clear transactions for market participants in order to generate profit, it is the Exchange's understanding from SIFMA and clearing firms that the current process can create significant risk when the clearing firm can be given up on any market participant's transaction, even where there is no prior customer relationship or authorization for that designated transaction.

In the absence of a mechanism that governs a market participant's use of a Clearing Member's services, the Exchange's proposal may indirectly facilitate the ability of a Clearing Member to manage their existing customer relationships while continuing to allow market participant choice in broker execution services. While Clearing Members may compete with executing brokers for order flow, the Exchange does not believe this proposal imposes an undue burden on competition. Rather, the Exchange believes that the proposed rule change balances

the need for Clearing Members to manage risks and allows them to address outlier behavior from executing brokers while still allowing freedom of choice to select an executing broker.

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

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

IV. Solicitation of Comments

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-Phlx-2018-72 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-2018-72. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Phlx-2018-72 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.<sup>17</sup>

Eduardo A. Aleman  
Assistant Secretary

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