

fine levels specified with respect to both individual members and member organizations, and providing for a rolling 24-month surveillance period, will serve as an effective deterrent to such violative conduct.<sup>4</sup>

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>5</sup> In particular, the Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,<sup>6</sup> which requires that the rules of an exchange be designed to promote just and equitable principles of trade, to facilitate 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. The Commission further believes that ISE's proposal to impose sanctions on individuals and member organizations who fail to submit Advice Cancel or exercise instructions in a timely manner is consistent with Sections 6(b)(1) and 6(b)(6) of the Act,<sup>7</sup> which require that the rules of an exchange enforce compliance with, and provide appropriate discipline for, violations of Commission and Exchange rules. In addition, the Commission finds that the proposal is consistent with the public interest, the protection of investors, or otherwise in furtherance of the purposes of the Act, as required by Rule 19d-1(c)(2) under the Act,<sup>8</sup> which governs minor rule violation plans. The Commission believes that the proposed rule change should strengthen the Exchange's ability to carry out its oversight and enforcement responsibilities as an SRO in cases where full disciplinary proceedings are unsuitable in view of the minor nature of the particular violation.

In approving this proposed rule change, the Commission in no way

minimizes the importance of compliance with ISE rules and all other rules subject to the imposition of fines under the MRVP. The Commission believes that the violation of any SRO rules, as well as Commission rules, is a serious matter. However, the MRVP provides a reasonable means of addressing rule violations that do not rise to the level of requiring formal disciplinary proceedings, while providing greater flexibility in handling certain violations. The Commission expects that ISE would continue to conduct surveillance with due diligence and make a determination based on its findings, on a case-by-case basis, whether a fine of more or less than the recommended amount is appropriate for a violation under the ISE MRVP or whether a violation requires formal disciplinary action.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act<sup>9</sup> and Rule 19d-1(c)(2) under the Act,<sup>10</sup> that the proposed rule change (SR-ISE-2008-09) be, and hereby is, approved and declared effective.

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

**Florence E. Harmon,**

*Deputy Secretary.*

[FR Doc. E8-5351 Filed 3-17-08; 8:45 am]

**BILLING CODE 8011-01-P**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-57478; File Nos. SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080]

**Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 2 to a Proposed Rule Change and Order Granting Accelerated Approval to a Proposed Rule Change, as Amended, To Establish Rules Governing the Trading of Options on the NASDAQ Options Market; Order Approving a Proposed Rule Change Relating to the LLC Agreement Establishing the NASDAQ Options Market LLC and Delegation Agreement Delegating to NOM LLC the Authority To Operate the NASDAQ Options Market; Order Granting an Application of The NASDAQ Stock Market LLC for an Exemption Pursuant to Section 36(a) of the Exchange Act from the Requirements of Section 19(b) of the Exchange Act; and Order Granting an Exemption for the NASDAQ Options Market LLC from Section 11A(b) of the Exchange Act**

March 12, 2008.

### I. Introduction

On January 30, 2007, The NASDAQ Stock Market LLC ("Nasdaq" 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 ("Trading Rules Proposal") to adopt rules governing participation in and trading on The NASDAQ Options Market ("NOM"), which will be an options exchange facility of Nasdaq operated by The Nasdaq Options Market LLC ("NOM LLC"). The proposed rule change, as modified by Amendment No. 1, was published for comment in the **Federal Register** on May 1, 2007.<sup>3</sup> The Commission received five comment letters regarding the proposed rule change.<sup>4</sup> Nasdaq responded to the

<sup>4</sup> In addition, as a member of the Intermarket Surveillance Group, the Exchange, as well as certain other self-regulatory organizations ("SROs") executed and filed on October 29, 2007 with the Commission, a final version of an Agreement pursuant to Section 17(d) of the Act (the "17d-2 Agreement"). As set forth in the 17d-2 Agreement, the SROs have agreed that their respective rules concerning the filing of Expiring Exercise Declarations, also referred to as Contrary Exercise Advices, of options contracts, are common rules. As a result, the proposal to amend ISE's MRVP will result in further consistency in sanctions among the SROs that are signatories to the 17d-2 Agreement concerning Contrary Exercise Advice violations.

<sup>5</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>6</sup> 15 U.S.C. 78f(b)(5).

<sup>7</sup> 15 U.S.C. 78f(b)(1) and 78f(b)(6).

<sup>8</sup> 17 CFR 240.19d-1(c)(2).

<sup>9</sup> 15 U.S.C. 78s(b)(2).

<sup>10</sup> 17 CFR 240.19d-1(c)(2).

<sup>11</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(44).

<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. 55667 (April 25, 2007), 72 FR 23869 ("Trading Rules Proposal Notice").

<sup>4</sup> See letters to Nancy M. Morris, Secretary, Commission, from Stephen Schuler, Managing Member, Global Electronic Trading Company ("GETCO"), and Daniel Tierney, Managing Member, GETCO, dated July 20, 2007 ("GETCO Letter"); Michael J. Simon, Secretary, The International Securities Exchange, LLC ("ISE"), dated June 15, 2007 ("ISE Letter"); John C. Nagel, Director and Associate General Counsel, Citadel Investment

commenters in a letter dated December 13, 2007,<sup>5</sup> and filed Amendment No. 2 to the proposal on December 13, 2007. This notice and order provides notice and solicits comments from interested persons regarding Amendment No. 2 and approves the Trading Rules Proposal, as amended, on an accelerated basis.

Also, on September 17, 2007, the Exchange filed with the Commission a proposed rule change, pursuant to Section 19(b)(1) of the Act<sup>6</sup> and Rule 19b-4 thereunder,<sup>7</sup> to establish, through a limited liability company agreement, NOM LLC, and to delegate to NOM LLC the authority to operate NOM as a facility of Nasdaq ("Corporate Structure Proposal," and, with the Trading Rules Proposal, the "Proposals"). The proposed rule change was published for comment in the **Federal Register** on October 12, 2007.<sup>8</sup> The Commission received no comments on the proposal. This order approves the Corporate Structure Proposal.

On December 13, 2007, Nasdaq requested that the Commission grant NOM LLC a permanent exemption from the requirement under Section 11A(b) of the Act and Rule 609 thereunder that a securities information processor ("SIP") acting as an exclusive processor register with the Commission.<sup>9</sup> Further, on December 13, 2007, Nasdaq asked the Commission to exempt Nasdaq from the rule filing requirements of Section 19(b) of the Act for changes to NOM rules that are effected solely by virtue of a change to a Chicago Board Options Exchange ("CBOE"), New York Stock Exchange ("NYSE"), or Financial Industry Regulatory Authority ("FINRA") rule that NOM has incorporated by reference. This order grants these exemptions.

## II. Discussion and Commission Findings

After careful review of the Trading Rule Proposal, as amended, and

Group L.L.C. ("Citadel"), dated June 11, 2007 ("Citadel Letter"); Michael T. Bickford, Senior Vice President, Options, American Stock Exchange LLC ("Amex"), dated May 24, 2007 ("Amex Letter"); and Christopher Nagy, Chair, Securities Industry and Financial Markets Association ("SIFMA") Options Committee, dated May 22, 2007 ("SIFMA Letter").

<sup>5</sup> See letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, to Nancy M. Morris, Secretary, Commission, dated December 13, 2007 ("Nasdaq Response").

<sup>6</sup> 15 U.S.C. 78s(b)(1).

<sup>7</sup> 17 CFR 240.19b-4.

<sup>8</sup> See Securities Exchange Act Release No. 56604 (October 3, 2007), 72 FR 58137 ("Corporate Structure Proposal Notice").

<sup>9</sup> 15 U.S.C. 78k-1(b). Rule 609 under the Act, 17 CFR 242.609, requires that the registration of a securities information processor be on Form SIP, 17 CFR 249.1001.

consideration of the comment letters and Nasdaq's response to the commenters, and the Corporate Structure Proposal, the Commission finds that the Trading Rules Proposal, as amended, and the Corporate Structure Proposal are 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 Proposals are 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) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers. Further, the Commission finds that the Proposals are consistent with Sections 6(b)(1) of the Act,<sup>12</sup> which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulation thereunder, and the rules of the exchange, and Section 6(b)(2) of the Act,<sup>13</sup> which requires, in part, that the rules of an exchange assure a fair representation of its members in the selection of its directors and administration of its affairs.

Overall, the Commission believes that approving Nasdaq's Proposals could confer important benefits on the public and market participants. In particular, NOM's entry into the marketplace could provide market participants with an additional venue for executing orders in standardized options, enhance innovation, and increase competition between and among the options exchanges, resulting in better prices and executions for investors.

<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).

<sup>12</sup> 15 U.S.C. 78f(b)(1).

<sup>13</sup> 15 U.S.C. 78f(b)(2).

This discussion does not review every detail of the proposed rule changes, but focuses on the comments received and the most significant rules and policy issues considered in review of the proposals.

### A. Corporate Structure

In connection with the establishment of NOM, Nasdaq has entered into a limited liability company agreement ("NOM LLC Agreement") to establish NOM LLC as a Delaware limited liability company that will operate NOM as a facility of Nasdaq, as that term is defined in Section 3(a)(2) of the Act.<sup>14</sup> Nasdaq and NOM LLC also will enter into a delegation agreement ("NOM Delegation Agreement"), pursuant to which Nasdaq will delegate to NOM LLC certain limited responsibilities and obligations with respect to the operation of NOM as an options facility of Nasdaq.<sup>15</sup>

Nasdaq, a registered national securities exchange, is the wholly-owned subsidiary of The NASDAQ Stock Market, Inc. ("Nasdaq Holding Company"). NOM LLC will be a direct, wholly-owned subsidiary of Nasdaq, and, pursuant to the NOM LLC Agreement, Nasdaq may not transfer or assign, in whole or in part, its interest in NOM LLC.<sup>16</sup> Further, NOM will be operated as a facility of the Exchange and Nasdaq will retain self-regulatory responsibility for NOM.

#### 1. Changes in Control of NOM; Ownership and Voting Limitations

The Commission notes that the Nasdaq Holding Company's Restated Certificate of Incorporation imposes limits on direct and indirect changes in control, which are designed to prevent any shareholder from exercising undue control over the operation of the Exchange and to ensure that the

<sup>14</sup> 15 U.S.C. 78c(a)(2). Pursuant to Section 3(a)(2), a "facility" "with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service."

<sup>15</sup> The form of each of the NOM LLC Agreement and NOM Delegation Agreement are available at the Commission's Web site <http://www.sec.gov>.

<sup>16</sup> See NOM LLC Agreement, Section 19. Also, Nasdaq Holding Company may not transfer or assign its interest in Nasdaq, other than to an affiliate of Nasdaq Holding Company. See Limited Liability Company Agreement of The NASDAQ Stock Market LLC, Section 20. Any change to Nasdaq's status as the sole member of NOM LLC, or to Nasdaq Holding Company's status as the sole member of Nasdaq, would have to be filed pursuant to Section 19(b) of the Act. 15 U.S.C. 78s.

Exchange and the Commission are able to carry out their regulatory obligations under the Act. Specifically, no person who beneficially owns shares of common stock, preferred stock, or notes in excess of five percent of the securities generally entitled to vote may vote shares in excess of five percent.<sup>17</sup>

The Exchange's rules also prohibit Exchange members and persons associated with Exchange members from beneficially owning more than 20 percent of the then-outstanding voting securities of Nasdaq Holding Company.<sup>18</sup> Members that trade on an exchange or through the facility of an exchange traditionally have ownership interests in such exchange or facility. The Commission has noted in the past, however, that a member's interest in an exchange could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member.<sup>19</sup> A member that is a controlling shareholder of an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and surveil the member's conduct or diligently enforce its rules and the federal securities laws with respect to conduct by the member that violates such provisions.

The Commission believes that the proposed corporate structure for NOM is consistent with the Act. The voting restrictions imposed on shareholders of Nasdaq Holding Company will flow through to NOM LLC by virtue of the fact that NOM LLC will be a wholly-owned subsidiary of Nasdaq, which is a wholly-owned subsidiary of Nasdaq Holding Company. The ownership limitation on members of Nasdaq will apply to NOM participants by virtue of the fact that all NOM participants must be members of the Exchange. These ownership and voting restrictions are designed to minimize the potential that a person could improperly interfere

with or attempt to restrict the ability of the Commission or the Exchange to effectively carry out their regulatory oversight responsibilities under the Act.

## 2. Fair Representation

NOM LLC will not have its own board of directors or committees separate from the board and committees of the Exchange. The Commission believes that because NOM LLC does not have a separate board, and because all NOM participants will be Exchange members, the composition of and selection process for the Exchange board continues to satisfy the requirement in Section 6(b)(3) of the Act that the rules of the Exchange provide for the fair representation of members in the selection of directors and the administration of the Exchange.<sup>20</sup>

## 3. Regulatory Independence

As noted above, NOM LLC will not have its own board or committees separate from those of the Exchange. Additionally, pursuant to the NOM LLC Agreement, management of the company is vested in the Exchange, and the officers of NOM LLC will be the officers of the Exchange.<sup>21</sup> As a result, NOM LLC may only act through the Exchange and its officers and directors.

The Commission notes that certain provisions of the Exchange's and Nasdaq Holding Company's corporate documents are designed to maintain the independence of Nasdaq's self-regulatory function, enable the Exchange to operate in a manner that complies with federal securities laws, including the objectives of Sections 6(b) and 19(g) of the Act, and facilitate the ability of Nasdaq and the Commission to fulfill their regulatory and oversight obligations under the Act.<sup>22</sup> As a facility of Nasdaq, the protections afforded by these provisions in the corporate documents of the Exchange and Nasdaq Holding Company extend to the operation of NOM.

Similar provisions also are included in the NOM Delegation Agreement. For example, NOM agrees: (1) To keep confidential non-public information

relating to Nasdaq and not to use such information for any commercial purposes; (2) to provide the Commission and Nasdaq access to NOM's books and records at all times and to maintain such books and records within the United States; (3) that the books, records, premises, officers, and employees of NOM shall be deemed to be those of Nasdaq for purposes of the Act; and (4) to cooperate with, and take reasonable steps to cause its agents to cooperate with, the Commission and Nasdaq pursuant to their regulatory authority. In addition, NOM and its officers and employees submit to the jurisdiction of the Commission and agree to give due regard to the preservation of the self-regulatory function of Nasdaq.<sup>23</sup> Further, the NOM Delegation Agreement may not be amended unless such amendment is filed with, or filed with and approved by, the Commission pursuant to Section 19 of the Act.<sup>24</sup> The Commission believes that these provisions, which are designed to assist Nasdaq in fulfilling its self-regulatory obligations and in administering and complying with the requirements of the Act, are consistent with the Act, in particular Sections 6(b)(1) and 19(g).

### *B. Status of NOM as a Facility of Nasdaq and Delegation of Authority to NOM LLC*

As a facility of Nasdaq, NOM will be subject to the Commission's oversight and examination. Consequently, the Commission will have the same authority to oversee the premises, personnel, and records of NOM LLC as it currently has with respect to Nasdaq. In addition, Nasdaq will be fully responsible for all activity that takes place through NOM, and NOM participants will be subject to Nasdaq's rules and oversight.

As described in detail in the Notice, the NOM Delegation Agreement provides that Nasdaq will delegate to NOM LLC performance of certain limited responsibilities and obligations of Nasdaq with respect to the operation of NOM as an options trading facility. Nasdaq, however, expressly retains ultimate responsibility for the fulfillment of its statutory and self-regulatory obligations under the Act. Accordingly, as described more fully below, Nasdaq will retain ultimate responsibility for such delegated responsibilities and functions, and any actions taken pursuant to delegated authority will remain subject to review, approval or rejections by Nasdaq's board

<sup>17</sup> See Nasdaq Holding Company Restated Certificate of Incorporation, Article Fourth, C. The Nasdaq Holding Company board of directors may approve an exemption from the five percent voting limitation for any person that is not a broker-dealer, an affiliate of a broker-dealer, or a person subject to a statutory disqualification under Section 3(a)(39) of the Act. See *id.* Any such exemption from the five percent voting limitation would not be effective until approved by the Commission pursuant to Section 19 of the Act. See Nasdaq Holding Company By-Laws, Article XII, Section 12.5.

<sup>18</sup> See Exchange Rule 2130.

<sup>19</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) ("Registration Approval Order") at note 42 and accompanying text.

<sup>20</sup> See Registration Approval Order, *supra* note 19, at 3553.

<sup>21</sup> See NOM LLC Agreement, Sections 9 and 10, respectively. See also Section 9(b) of the NOM LLC Agreement which requires NOM LLC and the Exchange to comply with federal securities laws and the rules and regulations thereunder, and to cooperate with the Commission and NOM pursuant to their regulatory authority.

<sup>22</sup> A discussion of Nasdaq's corporate structure and the protections afforded by the corporate documents of Nasdaq and Nasdaq Holding Company, is set forth in the Registration Approval Order, *supra* note 19. The corporate documents of Nasdaq and Nasdaq Holding Company are not being amended by this proposed rule change.

<sup>23</sup> See NOM Delegation Agreement, II.B.

<sup>24</sup> See NOM Delegation Agreement, III.

of directors in accordance with procedures established by Nasdaq's board of directors. Nasdaq has filed the NOM Delegation Agreement as part of its rules.

Pursuant to the Delegation Agreement, Nasdaq expressly retains the authority to (1) delegate authority to NOM LLC to take actions on behalf of the Exchange, and (2) direct NOM LLC to take action necessary to effectuate the purposes and functions of Nasdaq, consistent with the independence of Nasdaq's regulatory functions, exchange rules, policies and procedures, and the federal securities laws.<sup>25</sup> NOM LLC will have delegated authority to, among other things, operate NOM, develop and adopt governing listing standards applicable to options listed on NOM in consultation with Nasdaq, and establish and assess listing fees, transaction fees, market data fees and other fees for the products and services offered by NOM.<sup>26</sup> In addition, NOM LLC will have the authority to act as a SIP for quotations and transaction information related to securities traded on NOM and any trading facilities operated by NOM LLC.<sup>27</sup>

NOM LLC also will have authority to develop, adopt, and administer rules governing participation in NOM,<sup>28</sup> but the Exchange represents that it will have ultimate responsibility for the operations, rules and regulations developed by NOM LLC, as well as their enforcement. Further, the Exchange represents that actions taken by NOM LLC pursuant to its delegated authority will remain subject to review, approval or rejection by the Exchange's board of directors.<sup>29</sup> In addition, NOM LLC will be responsible for referring to Nasdaq any complaints of a regulatory nature involving potential rule violations by member organizations or employees,<sup>30</sup> and Nasdaq will retain overall responsibility for ensuring that the statutory and self-regulatory functions of the Exchange are fulfilled.<sup>31</sup>

The Commission finds that it is consistent with the Act for Nasdaq to delegate the operation of NOM to NOM LLC, while retaining ultimate responsibility for statutory and self-regulatory obligations and ensuring that

NOM's business is conducted in a manner consistent with the requirements of the Act.

### C. Access to NOM

Only Options Participants ("Options Participants" or "Participants") may transact business on NOM via the System.<sup>32</sup> There are two categories of Participants: (1) Options Order Entry Firms ("OEFs"), which represent customer orders as agent or conduct proprietary trading; and (2) Options Market Makers ("Options Market Makers" or "Market Makers"). A Participant must be a member of Nasdaq and of another registered options exchange that is not registered solely under Section 6(g) of the Act.<sup>33</sup> As Nasdaq members, Participants must satisfy the requirements of the Nasdaq Rule 1000 Series (Membership, Registration, and Qualification Requirements), as well as additional requirements set forth in the NOM rules.<sup>34</sup> Further, an OEF may transact business with Public Customers only if it is a member of another registered national securities exchange or association with which Nasdaq has entered into an agreement under Rule 17d-2 under the Act<sup>35</sup> pursuant to which the other exchange or association is the designated options examining authority for the OEF.<sup>36</sup> In addition, Options Participants that transact

<sup>32</sup> See NOM Rules, Chapter II, Section 1(a). An Options Participant is a firm or organization registered with Nasdaq pursuant to Chapter II of the NOM Rules for purposes of participating in options trading on NOM as an Order Entry Firm or Options Market Maker. See NOM Rules, Chapter I, Section 1(a)(40).

<sup>33</sup> 15 U.S.C. 78f(g). See NOM Rules, Chapter II, Sections 1(a)(iii) and 2(f). In Amendment No. 2, Nasdaq proposes to eliminate from Chapter II, Section 1(b)(iii) a provision stating that a Nasdaq member would automatically become a NOM Participant upon completing a NOM Application and paying the applicable fees. Nasdaq believes that this provision did not accurately reflect the intended scope of review of NOM applicants, and that eliminating the provision will improve the quality of regulation of NOM. The Commission finds that this change is consistent with the Act.

<sup>34</sup> See NOM Rules, Chapter II. Nasdaq's rules apply to Participants unless a specific NOM rule governs or unless the context otherwise requires. See NOM Rules, Chapter I, Section 2. Among others, Participants will be able to provide sponsored access to NOM to a non-member ("Sponsored Participant") pursuant to Nasdaq Rule 4611(d), which Nasdaq adopted in 2007. See Securities Exchange Act Release Nos. 55061 (January 8, 2007), 72 FR 2052 (January 17, 2007) (notice of filing and immediate effectiveness of File No. SR-Nasdaq-2006-061) (adopting Nasdaq Rule 4611(d)); and 55550 (March 28, 2007), 72 FR 16389 (April 4, 2007) (notice of filing and immediate effectiveness of File No. SR-Nasdaq-2007-010) (revising Nasdaq Rule 4211(d)).

<sup>35</sup> 17 CFR 240.17d-2.

<sup>36</sup> See NOM Rules, Chapter XI, Section 1. See also notes 240 to 241, *infra*, and accompanying text for a discussion of Rule 17d-2.

business with customers must be members of FINRA.<sup>37</sup>

Among other things, each Participant must be registered as a broker-dealer and have as the principal purpose of being a Participant the conduct of a securities business, which shall be deemed to exist if and so long as: (1) The Participant has qualified and acts in respect of its business on NOM as either an OEF or an Options Market Maker or both; and (2) all transactions effected by the Participant are in compliance with Section 11(a) of the Act<sup>38</sup> and the rules and regulations thereunder.<sup>39</sup> Participants may trade options for their own proprietary accounts or, if authorized to do so under applicable law, may conduct business on behalf of customers.<sup>40</sup>

### 1. OEFs

OEFs are Participants representing customer orders as agent on NOM or trading as principal on NOM.<sup>41</sup> OEFs also may register as Market Makers. A Market Maker that engages in specified Other Business Activities, or that is affiliated with a broker-dealer that engages in Other Business Activities, including functioning as an OEF, must have an Information Barrier between the market making activities and the Other Business Activities.<sup>42</sup>

One commenter believes that the ability of OEFs, like Market Makers, to enter orders on both sides of the market for the same customer raises questions concerning the rights and responsibilities of the OEF and the customer. In particular, the commenter asks whether Market Makers will have exclusive access to certain NOM systems or other tools, or otherwise have rights that differ from the rights of these customers. The commenter also asserts that NOM's proposal lacks clarity regarding its Participants' responsibility for surveillance of the activities of these market participants.<sup>43</sup>

In response, Nasdaq stated its belief that the NOM market model is similar to Nasdaq's equity market structure and does not raise any unique or challenging issues for order entry firms and investors. Nasdaq further believes that most Participants will be familiar with the regulatory and surveillance requirements associated with access to NOM from their businesses in equity securities.<sup>44</sup> Nasdaq represents that,

<sup>37</sup> See NOM Rules, Chapter II, Section 2(f).

<sup>38</sup> 15 U.S.C. 78k(a).

<sup>39</sup> See NOM Rules, Chapter II, Section 2(e).

<sup>40</sup> See NOM Rules, Chapter II, Section 1(a).

<sup>41</sup> See NOM Rules, Chapter VII, Section 1.

<sup>42</sup> See NOM Rules, Chapter VII, Section 10.

<sup>43</sup> See SIFMA Letter, *supra* note 4, at 2.

<sup>44</sup> See Nasdaq Response, *supra* note 5, at 2.

<sup>25</sup> See Corporate Structure Proposal Notice, *supra* note 8, at 58140 and NOM Delegation Agreement, I.

<sup>26</sup> See Corporate Structure Proposal Notice, *supra* note 8, at 58140 and NOM Delegation Agreement, II.A.

<sup>27</sup> See NOM Delegation Agreement, II.A.3.

<sup>28</sup> *Id.*

<sup>29</sup> See Corporate Structure Proposal Notice, *supra* note 8, at 58140.

<sup>30</sup> See NOM Delegation Agreement, II.A.9.

<sup>31</sup> See NOM Delegation Agreement, I.1.

within the System, Market Makers will not have any special priorities or other privileges.<sup>45</sup>

The Commission believes that it is consistent with the Act for an options exchange not to prohibit a user of its market from effectively operating as a market maker by holding itself out as willing to buy and sell options contracts on a regular or continuous basis without registering as a market maker.<sup>46</sup> The Commission notes that although an entity that effectively acts as a market maker but is not registered as such will not be required to comply with any rules applicable to a Market Maker, it also will not be eligible to receive certain benefits of being a Market Maker.<sup>47</sup> The Commission also agrees with Nasdaq's assertion that NOM does not raise any unique issues related to surveillance or the responsibilities of OEFs, and notes that all Options Participants must also be members of Nasdaq. Further, the Commission notes that an entity that acts as a "dealer," as defined in Section 3(a)(5) of the Act,<sup>48</sup> would be required to register with the Commission under Section 15 of the Act,<sup>49</sup> and the rules and regulations thereunder, or qualify for any exception or exemption from registration.<sup>50</sup>

## 2. Market Makers

### a. Registration of Market Makers

An Options Market Maker is a Participant registered with Nasdaq as a Market Maker.<sup>51</sup> To register as a Market Maker, a Participant must file a written

<sup>45</sup> *Id.* at 5. Registered market makers do, however, receive certain benefits for carrying out their responsibilities. For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange (see 12 CFR 221.5(c)(6)). In addition, market makers are excepted from the prohibition in Section 11(a) of the Act.

<sup>46</sup> See Securities Exchange Act Release No. 38054 (December 16, 1996), 61 FR 67365 (December 20, 1996) (order approving File No. SR-CBOE-95-48).

<sup>47</sup> See *infra* notes 76 and 84 and accompanying text.

<sup>48</sup> 15 U.S.C. 78c(a)(5).

<sup>49</sup> 15 U.S.C. 78o.

<sup>50</sup> Activity that may cause a person to be deemed a dealer includes "quoting a market in or publishing quotes for securities (other than quotes on one side of the market on a quotations system generally available to non-broker-dealers, such as a retail screen broker for government securities)." See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Securities Exchange Act Release No. 47364, 68 FR 8685, 8689, note 26 (February 24, 2003) (quoting OTC Derivatives Dealers, Securities Exchange Act Release No. 40594, 63 FR 59362, 59370, note 61 (November 3, 1998)).

<sup>51</sup> See NOM Rules, Chapter VII, Section 2.

application with Nasdaq Regulation, which will consider an applicant's market making ability and other factors it deems appropriate in determining whether to approve an applicant's registration.<sup>52</sup> All Market Makers are designated as specialists on NOM for all purposes under the Act or rules thereunder.<sup>53</sup> The NOM Rules place no limit on the number of qualifying entities that may become Market Makers.<sup>54</sup> The good standing of a Market Maker may be suspended, terminated, or withdrawn if the conditions for approval cease to be maintained or the Market Maker violates any of its agreements with Nasdaq or any provisions of the NOM Rules.<sup>55</sup> A Participant that has qualified as a Market Maker may register to make markets in individual series of options.<sup>56</sup>

The Commission finds that NOM Market Maker qualifications requirements are consistent with the Act, and notes that they are similar to those of other options exchanges.<sup>57</sup> Further, the Commission believes that allowing NOM Market Makers to register by series, rather than by class, will permit Market Makers to select the options series they are most interested in trading. This is designed to help to reduce the number of quotes submitted by such Market Makers, and therefore could help to mitigate NOM's quote message traffic and capacity.<sup>58</sup>

### b. Market Maker Obligations

Pursuant to NOM rules, the transactions of a Market Maker in its market making capacity must constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly

<sup>52</sup> See NOM Rules, Chapter VII, Section 2(a).

<sup>53</sup> See NOM Rules, Chapter VII, Section 2.

<sup>54</sup> See NOM Rules, Chapter VII, Rule 2(c).

However, Nasdaq may limit access to the System based on system constraints, capacity restrictions, or other factors relevant to protecting the integrity of the System, pending action required to address the issue of concern. To the extent that Nasdaq places limitations on access to the System on any Participant(s), such limits shall be objectively determined and submitted to the Commission for approval pursuant to a rule change filed under Section 19(b) of the Act. See NOM Rules, Chapter VII, Section 2(c).

<sup>55</sup> See NOM Rules, Chapter VII, Section 4(b).

<sup>56</sup> See NOM Rules, Chapter VII, Section 3(a).

<sup>57</sup> See, e.g., BOX Rules, Chapter VI, Section 2 and ISE Rule 804.

<sup>58</sup> See Securities Exchange Act Release No. See Securities Exchange Act Release No. 55027 (December 29, 2006), 72 FR 1358 (January 11, 2007) (order approving File No. SR-Phlx-2006-53). Further, one commenter believes that series-by-series registration will allow market makers to target the series for which they are most apt to provide liquidity, which in turn will create greater liquidity across the entire market. See GETCO Letter, *supra* note 4, at 2.

market.<sup>59</sup> Further, among other things, a Market Maker must: (1) On a daily basis participate in the pre-opening phase and maintain a two-sided market on a continuous basis in at least 75% of the options series in which it is registered;<sup>60</sup> (2) enter a size of at least ten contracts for its best bid and its best offer;<sup>61</sup> and (3) maintain minimum net capital in accordance with Commission and Nasdaq rules.<sup>62</sup> In addition, Nasdaq may call upon a Market Maker to submit a single bid or offer or to maintain continuous bids and offers in one or more of the series in which the Market Maker is registered if, in Nasdaq's judgment, it is necessary to do so in the interest of fair and orderly markets.<sup>63</sup> If Nasdaq finds any substantial or continued failure by a Market Maker to engage in a course of dealings as specified in Chapter VII, Section 5(a) of the NOM Rules, such Market Maker will be subject to disciplinary action or suspension or revocation of registration in one or more of the securities in which the Market Maker is registered.<sup>64</sup>

One commenter notes that NOM's rules do not appear to assure that there will be continuous quotes in a particular series because a Market Maker could cease disseminating quotes for a series at any time during the trading day, and requests that Nasdaq clarify a market maker's continuous quoting obligations.<sup>65</sup> In response, Nasdaq notes that other options markets face the possibility that a registered market maker will withdraw its quotes during the trading day, and that NOM's rules permit Nasdaq to require a market maker to quote continuously in a series in which it is registered.<sup>66</sup> Nasdaq further notes that it intends to provide functionality that will allow its Market Makers to instruct the NOM System to automatically input a quotation on the side of the market that has been depleted. In addition, Nasdaq represents that it will bring an appropriate disciplinary action against a Market

<sup>59</sup> See NOM Rules, Chapter VII, Section 5(a). Amendment No. 2 replaces the provisions in the NOM proposal related to the Exchange's ability to automatically cancel all bids and offers posted by a Market Maker under certain circumstances with provisions allowing any Options Participant to ask NOM staff to simultaneously cancel all of the Options Participant's bids, offers, and orders in all series. See NOM Rules, Chapter VII, Section 11. The Commission believes that the proposed change is reasonably designed to enable Participants to limit their risk and is consistent with the Act.

<sup>60</sup> See NOM Rules, Chapter VII, Section 6(d)(i).

<sup>61</sup> See NOM Rules, Chapter VII, Section 6(a).

<sup>62</sup> See NOM Rules, Chapter VII, Section 4(a)(i).

<sup>63</sup> See NOM Rules, Chapter VII, Section 6(d)(ii).

<sup>64</sup> See NOM Rules, Chapter VII, Section 5(c).

<sup>65</sup> See SIFMA Letter, *supra* note 4, at 1.

<sup>66</sup> See Nasdaq Response, *supra* note 5, at 3, and NOM Rules, Chapter VII, Section 6(d)(ii).

Maker that fails to meet its quoting obligations.<sup>67</sup>

This commenter also requests clarification of NOM's treatment of options series without a Market Maker. In particular, the commenter questions the actions NOM will take if a Market Maker withdraws from making markets in a series, including whether NOM will continue to match orders in the series.<sup>68</sup> To the extent that the commenter is questioning what will happen if a Market Maker registered in a series does not have a quote in that series (as opposed to the Market Maker withdrawing from registration in the series),<sup>69</sup> Nasdaq states that NOM will continue to route and execute orders in that series. In addition, Nasdaq states that, if an order is received by NOM when its quote is not at the NBBO, NOM will route the order automatically to a market at the NBBO. An order displayed on NOM that becomes marketable will be accessible through the Linkage.<sup>70</sup>

The definition of a "market maker" includes a dealer who holds itself out as being willing to buy and sell a security for his account on a regular or continuous basis.<sup>71</sup> Therefore, although under NOM's proposal certain series may not have continuous quotes disseminated by NOM, the Commission believes that the obligations imposed by the NOM Rules on Market Makers fall within the definition of market maker because they will require a NOM Market Maker to hold itself out as being willing to buy and sell a security for its account on a regular basis. The Commission therefore believes that the obligations imposed by the NOM Rules on Market Makers are consistent with the Act.<sup>72</sup>

The commenter also asserts that other options exchanges generally require market makers to provide two-sided quotations for 80% of the classes in which a market maker is registered, and that uniform quotation requirements

among the options markets would be desirable.<sup>73</sup> In its response letter, Nasdaq states that NOM's Market Maker participation standard, which will allow Market Makers to register in particular options series rather than an entire class, should result in active participation in all series for which a Market Maker registers voluntarily.<sup>74</sup> In addition, Nasdaq maintains that its approach is numerically superior to other options exchanges, noting that the BOX Rules effectively require market makers to maintain continuous two-sided quotes in only 72% of the series in which they are registered, or at times in only 60% of the series in which they are registered.<sup>75</sup>

Market makers receive certain benefits for carrying out their responsibilities. For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange.<sup>76</sup> In addition, market makers are exempted from the prohibition in Section 11(a) of the Act. The Commission believes that a market maker must have sufficient affirmative obligations, including the obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis, to justify this favorable treatment. The Commission further believes that the rules of all U.S. options markets need not provide the same standards for market maker participation, so long as they impose affirmative obligations that are consistent with the Act. The Commission believes that NOM's market maker participation requirements impose sufficient affirmative obligations on NOM Market Makers and, accordingly, that NOM's requirements are consistent with the Act.

Nasdaq will open trading in an options series only if there is at least one Market Maker registered for trading in that series.<sup>77</sup> One commenter requests clarification of NOM's treatment of options series without a Market Maker. In particular, the commenter questions the actions NOM will take if a Market Maker withdraws from making markets in a series, including whether NOM will continue to match orders in the series.<sup>78</sup>

In response, Nasdaq states that it is amending proposed Chapter IV, Section 5 to provide that, in the event a sole Market Maker for a series withdraws its registration and ceases making markets, NOM will place the series in a non-regulatory suspension and halt trading until such time as a member registers to make markets in that series.<sup>79</sup>

In addition, the commenter notes that the proposal does not address a Market Maker's use of the matching system for new customer orders after it has withdrawn as a Market Maker.<sup>80</sup> To the extent that the commenter is asking whether a Market Maker can enter a customer order when it is not quoting in a series in which it is registered, Nasdaq notes that the NOM Rules require that, if a Market Maker enters a bid in a series in which he is registered, he must also enter an offer,<sup>81</sup> and that therefore a Market Maker will not be able to enter customer orders without submitting a quote on the other side of the market from the customer order.<sup>82</sup> Further, Nasdaq notes that the NOM Rules prohibit a Market Maker from acting as an OEF without instituting appropriate information barriers.<sup>83</sup> To the extent that the commenter is asking whether an entity that withdraws as a Market Maker in a series can then act as an OEF in that series, Nasdaq notes that a Participant that has withdrawn as a Market Maker and is participating in NOM as an OEF would not receive favorable margin treatment under Regulation T.<sup>84</sup>

The Commission believes that Nasdaq has adequately clarified NOM's treatment of options series when either: (1) A registered Market Maker is not quoting in that series or (2) a registered Market Maker withdraws from registration in the series.

#### c. Single Market Maker Requirement

One commenter believes that Nasdaq should require at least two market makers for an options series to be listed and traded on NOM so that adequate depth and liquidity will be available to market participants.<sup>85</sup> The commenter

<sup>67</sup> See Nasdaq Response, *supra* note 5, at 3.

<sup>68</sup> See SIFMA Letter, *supra* note 4, at 2.

<sup>69</sup> See discussion *infra* notes 77 to 79 and accompanying text.

<sup>70</sup> See Nasdaq Response, *supra* note 5, at 3.

<sup>71</sup> See 15 U.S.C. 78c(a)(38) (definition of "market maker").

<sup>72</sup> The Commission notes that in approving the rules of the Boston Options Exchange ("BOX"), the Commission acknowledged that certain options series might not have continuous quotes disseminated by BOX, but concluded that the obligations imposed on market makers under the BOX Rules were consistent with the Act. The Commission also noted that the CBOE's Hybrid trading system had market maker obligations comparable to those proposed for BOX and also did not require market makers to quote all series. See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (order approving File No. SR-BSE-2002-15) ("BOX Approval Order").

<sup>73</sup> See SIFMA Letter, *supra* note 4, at 2.

<sup>74</sup> See Nasdaq Response, *supra* note 5, at 5.

<sup>75</sup> See *id.* and BOX Rules, Chapter VI, Section 6(d)(i).

<sup>76</sup> 12 CFR 221.5(c)(6).

<sup>77</sup> See NOM Rules, Chapter IV, Section 5.

<sup>78</sup> See SIFMA Letter, *supra* note 4, at 2.

<sup>79</sup> See Nasdaq Response, *supra* note 5, at 3.

Nasdaq further notes that, in Amendment No. 2, it proposes to clarify that in such circumstances, NOM will not execute orders on its book and will have no rights and privileges under the Linkage Plan to accept inbound orders from away markets. Nasdaq will continue to accept and route Participant orders that are designated for routing and execution at the best price in away markets. *Id.*

<sup>80</sup> See SIFMA Letter, *supra* note 4, at 2.

<sup>81</sup> See NOM Rules, Chapter VII, Section 6(b), which states that a Market Maker that enters a bid (offer) in a series in which he is registered on NOM must enter an offer (bid).

<sup>82</sup> See Nasdaq Response, *supra* note 5, at 4.

<sup>83</sup> See NOM Rules, Chapter VII, Section 10.

<sup>84</sup> See Nasdaq Response, *supra* note 5, at 4.

<sup>85</sup> See Amex Letter, *supra* note 4, at 2.

also believes that, in the context of the order exposure requirements established in Chapter VII, Section 14 of the NOM Rules,<sup>86</sup> there will not be meaningful order exposure with a “trading crowd” of fewer than two market makers.<sup>87</sup> In addition, the commenter believes that the term “trading crowd” may be a misnomer if the trading crowd consists of only one market maker.<sup>88</sup>

In response, Nasdaq asserts that neither the Act nor Commission rules require a market to provide for more than one market maker, and, in fact, the specialist system is an example of a one market maker market model.<sup>89</sup> Nasdaq believes that the NOM structure fulfills the objectives of Section 11A of the Act by providing a trading platform that will allow customer orders to meet without the intervention of a dealer.<sup>90</sup> Nasdaq further maintains that lower barriers to participation will attract liquidity and market depth from order entry firms and other market participants. Nasdaq also notes that it intends to provide an environment whereby robust competition between multiple market makers will provide depth and liquidity, but that it does not believe market participants should be prevented from trading directly with one another due to the absence of multiple dealers.<sup>91</sup>

The Commission agrees that the Act does not mandate a particular market model for national securities exchanges, and believes that many different types of market models could satisfy the requirements of the Act. The Commission does not believe that the Act requires an exchange to have market makers.<sup>92</sup> Although Market Makers could be an important source of liquidity on NOM, they likely will not be the only source. In particular, the NOM System is designed to match

buying and selling interest of all Participants on NOM. The Commission therefore believes that the NOM structure is consistent with the Act.

#### D. NOM Trading System

##### 1. Overview

NOM will be a fully automated electronic system (“System”) for trading standardized options, and will be a facility of Nasdaq, as defined in Section 3(a)(2) of the Act.<sup>93</sup> Participants will be able to enter Displayed Orders on NOM at single and multiple price levels for the following order types:<sup>94</sup> Market Orders; Limit Orders; Reserve Orders;<sup>95</sup> Minimum Quantity Orders;<sup>96</sup> Discretionary Orders;<sup>97</sup> and Price

<sup>93</sup> 15 U.S.C. 78c(a)(2). The System includes: (1) An order execution service that allows Participants to automatically execute transactions in securities listed and traded on NOM; (2) a trade reporting service that submits locked-in trades to a registered clearing agency for clearance and settlement, transmits last sale reports to the Options Price Reporting Authority, if required, for dissemination to the public and industry, and provides Participants with monitoring and risk management capabilities; and (3) a data feed(s) that can be used to display without attribution to Participants’ MPIDs Displayed Orders on both the bid and offer side of the market for price levels within NOM using the minimum price variation applicable to the security. See NOM Rules, Chapter VI, Section 1(a). See Trading Rules Proposal Notice, *supra* note 3, for a more complete description of NOM operation and rules. The Commission notes that the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information (“OPRA Plan”) requires each party to the plan to collect and promptly transmit to OPRA all last sale reports relating to its market. See OPRA Plan, Section V(a).

<sup>94</sup> NOM does not propose to trade complex orders at this time. Participants may enter orders with the following time-in-force designations: Expire Time; Immediate or Cancel (“IOC”); DAY; and Good Til Cancelled. See NOM Rules, Chapter VI, Section 1(g).

<sup>95</sup> A Reserve Order is a limit order with displayed size and an additional non-displayed amount, both of which are available for execution against incoming orders. If the displayed portion of a Reserve Order is executed fully, the System will replenish the display portion from reserve up to the size of the original display amount. The System creates a new time stamp for the replenished portion of an order each time it is replenished from reserve, while the reserve portion retains the time stamp of its original entry. See NOM Rules, Chapter VI, Section 1(e)(1).

<sup>96</sup> A Minimum Quantity Order must be designated as IOC and requires that a specified minimum number of contracts be traded. A Minimum Quantity Order received prior to the Opening Cross or after the market close will be cancelled. See NOM Rules, Chapter VI, Section 1(e)(3).

<sup>97</sup> A Discretionary Order has both a displayed price and size and a non-displayed discretionary price range at which the entering party is willing to buy or sell. The non-displayed interest is not entered into the System book but is converted, along with the displayed size, into an IOC buy (sell) order at the highest (lowest) price in the discretionary price range when displayed contracts become available on the opposite side of the market or an execution takes place at any price within the discretionary price range. If more than one Discretionary Order is available for conversion into

Improving Orders.<sup>98</sup> Participants may designate orders to be routed to other market centers when trading interest is not present on NOM or to be executed only on NOM.<sup>99</sup> Nasdaq also had originally proposed to allow Participants to enter Non-Displayed Orders.<sup>100</sup> Commenters expressed concerns about the use of Non-Displayed Orders in the options markets.<sup>101</sup> Nasdaq in Amendment No. 2 has proposed to eliminate Non-Displayed Orders.<sup>102</sup> Because Nasdaq has proposed to eliminate this order type, this order does not make any findings with respect to Non-Displayed Orders.

All trading interest on NOM will be automatically executable. The NOM System and rules provide for the ranking, display, and execution of all orders in price/time priority without regard to the status of the entity entering an order.<sup>103</sup> Displayed Orders will have priority over non-displayed interest at the same price.<sup>104</sup> Any price improvement resulting from an execution in the System will accrue to the party taking liquidity.<sup>105</sup>

an IOC order, the System will convert and process all such orders in the same order as they were entered. If an IOC order is not executed in full, the unexecuted portion of the order is reposted automatically and displayed in the System book with a new time stamp at its original displayed price and with its non-displayed discretionary price range. See NOM Rules, Chapter VI, Section 1(e)(4).

<sup>98</sup> A Price Improving Order is an order to buy or sell an option at a specified price smaller than the minimum price variation (“MPV”) in the security. Price Improving Orders may be entered in increments as small as one cent. A Price Improving Order will be displayed at the MPV in that security and rounded up for sell orders and down for buy orders. See NOM Rules, Chapter VI, Section 1(e)(6).

<sup>99</sup> See NOM Rules, Chapter VI, Section 11(a). See also Amendment No. 2 and the Trading Rules Proposal Notice, *supra* note 3, at 23871.

<sup>100</sup> A Non-Displayed Order was defined as a limit order that is not displayed in the System but is available for execution against all incoming orders until executed in full or cancelled.

<sup>101</sup> See Citadel Letter, *supra* note 4, at 3, and Amex Letter, *supra* note 4, at 2.

<sup>102</sup> Nasdaq has made corresponding changes throughout the NOM Rules to reflect the deletion of this order type.

<sup>103</sup> See NOM Rules, Chapter VI, Section 10. In Amendment No. 2, Nasdaq made a technical change to Chapter VI, Section 10 to clarify that the System will execute trading interest at the best price in the System before executing trading interest at the next best price. This change does not alter the execution algorithm as it was proposed. See Amendment No. 2.

<sup>104</sup> See NOM Rules, Chapter VI, Section 10(1). At each price, trading interest will be executed in the following order: (A) Displayed Orders; (B) the Non-Displayed portion of Reserve Orders, in time priority among such interest; and (C) the discretionary portion of Discretionary Orders, in time priority among such interest.

<sup>105</sup> See NOM Rules, Chapter VI, Section 10. One commenter maintains that the original proposal did not define “taker of liquidity” and failed to specify

Continued

<sup>86</sup> Amendment No. 2 rennumbers this provision as Chapter VII, Section 12 of the NOM Rules.

<sup>87</sup> See Amex Letter, *supra* note 4, at 1.

<sup>88</sup> *Id.* at 2. Amex also questions the meaning of the term “trading crowd” in Chapter III, Section 4(f) of the NOM Rules. Nasdaq notes that it has deleted the term “trading crowd” from this rule to make clear that the electronic crowd will be composed of all NOM Participants, as is the case for other electronic markets. See Nasdaq Response, *supra* note 5, at note 9.

<sup>89</sup> See Nasdaq Response, *supra* note 5, at 8 to 9.

<sup>90</sup> *Id.* at 8.

<sup>91</sup> *Id.* at 9.

<sup>92</sup> In its release adopting Regulation ATS, the Commission rejected the suggestion that a guaranteed source of liquidity was a necessary component of an exchange. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) (“Regulation ATS Release”). See also Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (File No. SR-PCX-00-25) (order approving Archipelago Exchange as the equities trading facility of the Pacific Exchange), at Section IV.B.

The Commission believes that NOM's proposed execution priority rules are consistent with the Act. The Commission notes that one commenter specifically supported NOM's price/time priority algorithm, noting its belief that "flat and open" systems encourage better executions and provide increased liquidity to the market.<sup>106</sup> The Commission also believes that NOM's proposed order types are consistent with the Act, and discusses several particular order types below.

## 2. Attributable Orders

A Displayed Order may be entered with attribution to a Participant's MPID (an Attributable Order) or on an anonymous basis (a Non-Attributable Order).<sup>107</sup> One commenter expresses concern that Attributable Orders could result in discrimination against particular members.<sup>108</sup> The commenter believes, for example, that it is beneficial for a firm to identify itself when facilitating customer order flow since an exchange and its members may want to allow particular members to trade against more than the minimum guaranteed amount of the order to encourage the member to send more order flow to that exchange.<sup>109</sup>

The commenter also expressed concern that identifying the entering firm could encourage internalization. The commenter also asserts that Attributable Orders would defeat the anti-internalization function of the information barriers between a firm's market making and customer order entry activities.<sup>110</sup> The commenter believes that the internalization concern is particularly significant in the context of Nasdaq's "first-in-first-out" market model, where orders at a given price will be executed in sequence, with no priority for customer orders at the best price or pro rata distribution among participants quoting at that price. With no customer priority or pro rata allocation among Participants quoting at the best price, the commenter believes that a Participant that sees its firm's order at the top of the book would be able to execute against, and internalize, all of the displayed order.<sup>111</sup>

how price improvement would accrue to the taker of liquidity. See Amex Letter, *supra* note 4, at 3. In response, Amendment No. 2 modifies NOM's rules to indicate that any price improvement will accrue to the party removing liquidity previously posted to the Book. See NOM Rules, Chapter VI, Section 10(3). The Commission believes that this change clarifies NOM's rules and is consistent with the Act.

<sup>106</sup> See GETCO Letter, *supra* note 4, at 1.

<sup>107</sup> See NOM Rules, Chapter VI, Section 1(d).

<sup>108</sup> See ISE Letter, *supra* note 4, at 2.

<sup>109</sup> *Id.* at note 3.

<sup>110</sup> *Id.* at 2-3.

<sup>111</sup> *Id.* at 3.

In its response letter, Nasdaq notes that Attributable Orders are a voluntary feature of the System, and that no firm will be required to reveal its identity.<sup>112</sup> Nasdaq also argues that there is no selective disclosure; Nasdaq will publish the identity of the NOM Participant only when the order is posted on the NOM book, and that disclosure will be made simultaneously to all market participants in a proprietary data feed.<sup>113</sup> Further, Nasdaq notes that information barriers are designed to prevent a Market Maker from obtaining and using information about customer orders prior to execution, and that OEFs must route customer orders to the best available market, even if that is the market displaying the firm's Attributable Order.<sup>114</sup> Nasdaq also believes that its price/time algorithm allows less internalization than ISE's pro rata allocation, which guarantees 40% of the order to a market maker under certain conditions. Nasdaq further notes that there is always the possibility that an incoming order trades with a Price Improving Order, rather than a displayed Attributable Order.

To the extent that a market participant is concerned that its order would be discriminated against, as Nasdaq notes, the market participant can choose to enter a Non-Attributable Order. In addition, the Commission does not believe that it is likely that participants in a fully electronic market, such as NOM, will refrain from trading with a particular Participant's Attributable Orders in order to allow that Participant to do so, particularly in light of their best execution obligations.

Moreover, the Commission does not believe that a member's use of Attributable Orders, by itself, will cause a Market Maker to violate NOM's information barrier rule. The purpose of requiring information barriers is to prohibit the flow of material non-public information between the market making activities and other business activities of a firm. With respect to Attributable Orders, a Market Maker will learn the identity of an Attributable Order at the same time as all other Participants—that is, once it is displayed on NOM and disseminated over NOM's proprietary data feed. The Market Maker will not have any knowledge of the order prior to that time. The Commission does not believe that allowing Market Makers to see this information once it is posted on the book undermines the policy of having information barriers. The

<sup>112</sup> See Nasdaq Response, *supra* note 5, at 7.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

Commission might reach a different conclusion, however, if order attribution information were disclosed preferentially to certain Participants or if Market Makers had a systemic or other advantage that allowed them to receive this information in a more timely manner.

## 3. Reserve Orders and Price Improving Orders<sup>115</sup>

Nasdaq proposes to allow participants to enter Reserve Orders, which are limit orders with displayed size and an additional non-displayed amount, both of which are available for execution against incoming orders. If the displayed portion of a Reserve Order is executed fully, the System will replenish the display portion from reserve up to the size of the original display amount. The non-displayed portion of a Reserve Order has lower priority than any displayed order.

In addition, Nasdaq proposes a new order type called a Price Improving Order. A Price Improving Order has a specified price smaller than the minimum price variation ("MPV") in the option. Price Improving Orders may be entered in increments as small as one cent. Price Improving Orders will be displayed at the MPV in that security and rounded up for sell orders and down for buy orders. For the reasons discussed below, the Commission finds Reserve Orders and Price Improving Orders consistent with the Act.

### a. Quote Rule

One commenter argues that Price Improving Orders would violate Rule 602 of Regulation NMS (the "Quote Rule") because Nasdaq will not disseminate its best bid or offer.<sup>116</sup>

The Quote Rule requires a national securities exchange to collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security that is communicated on any national securities exchange by a responsible broker or dealer. A "bid" or "offer" is defined as "the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer.

<sup>115</sup> Nasdaq has proposed in Amendment No. 2 to eliminate the Non-Displayed Order type. Therefore, this approval order does not discuss Non-Displayed Orders. See *supra* notes 100 to 102 and accompanying text.

<sup>116</sup> See ISE Letter, *supra* note 4, at 2 (incorporating by reference the commenter's June 1, 2007, letter from Michael J. Simon, Secretary, ISE, to Nancy M. Morris, Secretary, Commission, regarding File No. SR-CBOE-2007-39 ("ISE June 2007 Letter")).



\* \* \*<sup>117</sup> Because the non-displayed size of a Reserve Order or the non-displayed price of a Price Improving Order is sent to NOM but not communicated to anyone, it is not a bid, offer, or quotation. Thus, the Quote Rule does not require this information to be disseminated.<sup>118</sup>

The Quote Rule also requires responsible brokers and dealers to be firm for their quotes.<sup>119</sup> In Amendment No. 2 Nasdaq has proposed to modify Chapter VII, Section 6(c)(1) of the NOM Rules to explicitly state that all quotes and orders entered into NOM by Options Participants, including the non-displayed portions of Reserve Orders and Price Improving Orders, must be firm under NOM rules and Rule 602 of Regulation NMS.

#### b. Transparency, Quote Competition, and Internalization

Several commenters expressed concern about the impact of Price Improving Orders and Reserve Orders on market quality. In particular, one commenter believes such orders will undermine transparency in the options markets and that, because the prices and sizes of such orders are not disseminated, it will be impossible for market participants to know the true best trading interest on NOM.<sup>120</sup> This commenter argues that Price Improving Orders will discourage market participants from quoting their best prices and submitting displayable limit orders because contra-side orders could be “pennied” by Price Improving Orders at opportune moments. The commenter believes that these disincentives ultimately will reduce price competition in the U.S. options markets.<sup>121</sup> Another commenter expresses a concern that no one will know the actual prices communicated to the exchange, which are prices at which transactions can take place.<sup>122</sup> This commenter is concerned that if other options markets adopted similar order types, there would be a trading environment in which there would be no way for customers to make intelligent pricing decisions or for

broker-dealers to fulfill their best execution obligations.<sup>123</sup>

One commenter expresses the concern that Price Improving Orders will enable Participants to internalize their order flow without the possibility of real order interaction. This commenter argues that the purpose of the requirement that a member display a customer order and wait three seconds before trading against the order is to provide other market participants with a chance to trade with the order before the member internalizes it. The commenter argues that, because only the Participant that enters the Price Improving Order will know the true price of the order, only that member can accurately run its pricing model to determine whether it is economically viable to trade against the order. The commenter does not believe this is a level playing field.<sup>124</sup> Similarly, another commenter asserts that permitting Price Improving Orders to satisfy NOM’s order exposure requirement<sup>125</sup> will “invite rampant internalization” by Participants, who will be able to trade with their agency orders without the market having a meaningful opportunity to compete for the orders.<sup>126</sup>

On the other hand, another commenter asserts that the use of non-displayed and reserve orders, which have been available for years in the equity markets, has not diminished competition or liquidity in these markets.<sup>127</sup> This commenter believes that Reserve Orders will encourage liquidity providers to bring their interest to the market in a manner best suited to their trading requirements. The commenter further believes that the increased use of reserve orders in the options markets would help to mitigate concerns regarding the effect of penny increments on institutional investors.<sup>128</sup>

<sup>123</sup> *Id.* at 2.

<sup>124</sup> See ISE June 2007 Letter, *supra* note 116, at 3.

<sup>125</sup> See NOM Rules, Chapter VII, Section 12. Chapter VII, Section 12 of the NOM Rules prohibits a Participant from executing as principal an order it represents as agent unless (1) the order is exposed on NOM for at least three seconds, or (2) the Participant has been bidding or offering on NOM for at least three seconds prior to receiving the agency order that is executable against such bid or offer.

<sup>126</sup> See Citadel Letter, *supra* note 4, at 3. This commenter further argues that Nasdaq should amend Chapter VII, Section 12, Commentary .04 to provide that a Participant cannot inform another Options Participant or any other third party of the terms of an order submitted to NOM after, as well as prior to, submitting the order to NOM. Nasdaq has made this change in Amendment No. 2.

<sup>127</sup> See GETCO Letter, *supra* note 4, at 2–3.

<sup>128</sup> *Id.* at 3. The commenter also notes that the Commission previously approved a reserve order type for NYSE Arca Options, citing to NYSE Arca Options Rule 6.62(c)(3). *Id.* at note 6 and accompanying text.

Price Improving Orders will allow market participants to submit an order priced between the MPV that will be rounded to the nearest MPV for display.<sup>129</sup> Without this order type, market participants would not be able to submit orders priced between the MPV. Instead, orders, if submitted, would be priced (and displayed) at the MPV. Thus, the Price Improving Order type will not “take away” transparency that would already exist. The Commission recognizes that Price Improving Orders will not be displayed at their actual penny price. Price Improving Orders, however, will provide for investors the opportunity to trade at a better price than would otherwise be available—inside the disseminated best bid and offer for a security. The Commission believes that this opportunity for investors to receive executions inside the disseminated best bid or offer could result in better executions for investors, and that Price Improving Orders are consistent with the Act.

In response to a commenter’s concern about broker-dealers’ ability to fulfill their best execution obligations,<sup>130</sup> as just discussed, the Commission believes that Price Improving Orders likely will provide another opportunity for investors to receive executions inside the disseminated best bid or offer for a security, which could result in better executions for investors. The availability of this price improvement feature will be a factor to be considered in a broker-dealer’s best execution routing determination, similar to other factors a broker-dealer must consider in connection with its best execution obligation.

The duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer’s transaction.<sup>131</sup> The Commission has not viewed the duty of best execution as requiring automated routing on an order-by-order basis to the market with the best quoted price at that time. Rather, the duty of best execution requires broker-dealers to periodically assess the quality of competing markets

<sup>129</sup> Price Improving Orders are defined as orders to buy or sell at a specified increment smaller than the MPV in a security, and they may be entered in increments as small as one cent. See NOM Rules, Chapter VI, Section 1(e)(6). Because a Price Improving Order can only be entered in an increment smaller than the MPV in an options series, and cannot be entered in an increment smaller than one cent, Participants will not be able to enter Price Improving Orders in options series for which the MPV is a penny.

<sup>130</sup> See ISE Letter, *supra* note 4, at note 1–2.

<sup>131</sup> See, e.g., Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (“Order Handling Rules Release”).

<sup>117</sup> 17 CFR 242.600(a)(8).

<sup>118</sup> See also Citadel Letter, *supra* note 4, at 4 supporting this analysis.

<sup>119</sup> 17 CFR 242.602(b)(2) and (c)(3).

<sup>120</sup> See Citadel Letter, *supra* note 4, at 1–3.

<sup>121</sup> See Citadel Letter, *supra* note 4, at 3. The commenter further believes that the concerns raised by Hidden Orders exceed those raised by the auction facilities on other options exchanges (including BOX’s PIP and the International Securities Exchange’s PIM) because Hidden Orders would be a fundamental component of NOM rather than a separate auction facility operating parallel to the regular options market. *Id.*

<sup>122</sup> See ISE Letter, *supra* note 4, at note 1–2.

to assure that order flow is directed to markets providing the most beneficial terms for their customer orders.<sup>132</sup> Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available terms.<sup>133</sup> In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.<sup>134</sup>

The Commission also believes that Price Improving Orders will provide market participants with an additional tool to submit trading interest to the Exchange. This order type may serve to increase liquidity to the extent that market participants find the order type to be useful and result in better executions. Further, market participants may be incented to compete by putting forth their best price—priced in a penny increment—to potentially match or better any other Price Improving Orders resident in the System. This may result in more aggressive, rather than less aggressive, trading interest.

The Commission also believes that Reserve Orders will provide market participants with an additional tool to submit trading interest to the exchange. Specifically, the ability to enter an order with a certain size displayed and additional size not displayed may provide market participants greater choice to submit trading interest in a manner best suited to their trading needs. This in turn may encourage market participants to bring liquidity to the exchange that they might not otherwise have submitted.

<sup>132</sup> Order Handling Rules Release, 61 FR at 48322–48333 (“In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security.”). See also *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, at 271, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Payment for Order Flow, Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, at 55009 (November 2, 1994).

<sup>133</sup> Order Handling Rules, 61 FR at 48323.

<sup>134</sup> Order Handling Rules, 61 FR at 48323. For example, in connection with orders that are to be executed at a market opening price, “[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders.” Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000) (adopting new Exchange Act Rules 11Ac1–5 and 11Ac1–6 and noting that alternative methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

Moreover, the Commission believes that the ability to “fish” inside the displayed quote, coupled with the restriction on the Participant that initially submitted the Price Improving Order from trading with that order until after three seconds has elapsed, will provide a meaningful opportunity for interaction prior to the time at which the submitting Participant can interact with the order. The Commission also notes that a Participant that would like to trade against its customer order runs the risk that the customer order, if entered as a Price Improving Order, will execute against another Price Improving Order (or Discretionary Order) resident in the system. The Commission does not believe that the availability and use of Price Improving Orders will reduce the quality or competitiveness of the options markets by increasing the level of internalization in the options markets.

#### c. Linkage Plan

One commenter believes that the Trading Rules Proposal fails to address how Reserve Orders and Price Improving Orders will interact with the requirements of the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage (“Linkage Plan”).<sup>135</sup> Specifically, this commenter notes that, because such orders are not disseminated, they presumably will not trigger other options markets’ obligations to avoid trading through or obligate other markets to send orders to NOM through the Linkage.<sup>136</sup> Accordingly, the commenter believes that away markets will fail to benefit from superior prices available on NOM, and Non-Displayed Orders and Price Improving Orders will undermine market-wide trade-through protection.<sup>137</sup>

In its response, Nasdaq states that incoming orders from the intermarket linkage will interact with Price Improving Orders. Such incoming orders will automatically execute against any such order with a better price than the displayed bid or offer.<sup>138</sup>

The Commission believes that NOM’s Rules adequately address how its market will interact with the Linkage Plan. The Linkage Plan, and SRO rules adopted pursuant to the Plan, provide trade through protection to the national

<sup>135</sup> See Citadel Letter, *supra* note 4, at 3. Another commenter generally states its belief that the concept of a Non-Displayed Order is inconsistent with the obligations required by the Linkage Plan. See Amex Letter, *supra* note 4, at 2.

<sup>136</sup> See Citadel Letter, *supra* note 4, at 3.

<sup>137</sup> *Id.*

<sup>138</sup> See Nasdaq Response, *supra* note 5, at 13.

best bid and offer (“NBBO”).<sup>139</sup> The NBBO will not include the non-displayed price of a Price Improving Order or the reserve size of a Reserve Order. Therefore, the non-displayed price of a Price Improving Order and the non-displayed size of a Reserve Order are not subject to trade through protection under the Linkage Plan.

#### d. Penny Pilot

One commenter believes that the Trading Rules Proposal will circumvent the industry efforts with respect to the Penny Pilot Program by moving to hidden penny quoting without the benefit of careful study of the data yielded in the Pilot.<sup>140</sup> Another commenter believes that the appropriate way to address penny pricing in options is through the current Penny Pilot. This commenter recommends that the Commission consider any expansion of penny quoting only through review of the experience under the Pilot.<sup>141</sup>

As discussed above and below, the Commission finds that the Trading Rules Proposal, as amended, is consistent with the Act. The Commission previously has approved proposals by other options exchanges to trade in penny increments.<sup>142</sup> The Commission does not believe it is appropriate to prohibit Nasdaq from implementing another initiative designed to allow limited trading, not quoting, in penny increments.

#### 4. Opening and Halt Cross

Nasdaq had originally proposed a single price opening and reopening via an electronic cross, modeled on the Opening and Halt Crosses Nasdaq developed for the trading of equities.<sup>143</sup> Nasdaq in Amendment No. 2 proposes to revise the procedures it will use to resume trading in an option following the conclusion of a trading halt in the underlying security. Specifically, rather than using a single price reopening following a trading halt, as originally

<sup>139</sup> The national best bid or offer is defined in the Linkage Plan as the national best bid and offer in an options series calculated by a Participant. See Section 2(19) of the Linkage Plan.

<sup>140</sup> See Citadel Letter, *supra* note 4, at 4.

<sup>141</sup> See ISE June 2007 Letter, *supra* note 116, at 3.

<sup>142</sup> See, e.g., Securities Exchange Act Release Nos. 54229 (July 27, 2006), 71 FR 44508 (August 3, 2006) (File No. SRSR–CBOE–2005–90) (order approving CBOE’s Simple Auction Liaison system); 50819 (December 8, 2004), 69 FR 75093 (December 15, 2004) (File No. SR–ISE–2003–06) (order approving ISE’s Price Improvement Mechanism); and BOX Approval Order, *supra* note 72 (approving BOX’s Price Improvement Period).

<sup>143</sup> See NOM Rules, Chapter VI, Section 8. See Trading Rules Proposal Notice, *supra* note 3, for a detailed description of the proposed Opening and Halt Crosses.

proposed, Nasdaq proposes to process orders in time priority according to the execution algorithm provided in the NOM Rules.<sup>144</sup> According to Nasdaq, the proposal to use NOM's regular processing following a trading halt is designed to respond to comments from industry participants that options prices are based on the prices of the underlying security.<sup>145</sup>

The Commission believes that NOM's rules for an Opening Cross will help to ensure that the opening of NOM is conducted in a fair and orderly fashion and is consistent with the Act. The Commission further believes that the proposed change to NOM's procedure for re-opening trading in an option following the conclusion of a trading halt in the underlying security is reasonably designed to provide for an orderly re-opening of trading in the option and is consistent with the Act.

#### 5. Closing Cross

At the close of trading, NOM will conduct a single price Closing Cross.<sup>146</sup> One commenter notes that the rules, as originally proposed, provided that the Closing Cross for all options would occur at 4 p.m., although options on fund shares and broad-based indexes trade until 4:15 p.m., and did not indicate when the Closing Cross would terminate.<sup>147</sup> In response, Nasdaq in Amendment No. 2 revised Chapter VI, Section 9(b) of the NOM Rules to indicate that the Closing Cross for options on broad-based indexes and fund shares will occur at 4:15 p.m. In addition, Nasdaq indicated that the Closing Cross occurs automatically and generally takes place in under one second, although the process may take several seconds on high-volume trading days.<sup>148</sup> The Commission believes that these changes adequately clarify the timing of the Closing Cross.<sup>149</sup>

One commenter notes that the NOM Rules indicate that an MOC order might not be executed. The commenter believes that an MOC order is a market order, and the operation of the Closing Cross will alter the nature of a market order as generally understood by market participants. The commenter further

believes that Nasdaq should better explain the operation of MOC orders.<sup>150</sup> In response, Nasdaq acknowledges that MOC orders are not guaranteed to execute during the Closing Cross but notes that MOC orders receive the highest execution priority during the Closing Cross process.<sup>151</sup> Thus, Nasdaq states that MOC orders should execute at the cross price provided that there is adequate trading interest on the other side of the market.<sup>152</sup>

As noted above, the NOM Closing Cross is modeled on the Closing Cross that Nasdaq uses in its equity market.<sup>153</sup> Like the NOM Closing Cross, the Nasdaq Closing Cross includes MOC orders, which might not be executed during the Nasdaq Closing Cross.<sup>154</sup> The Commission believes that NOM's rules adequately explain the operation of MOC orders.

Nasdaq proposes to disseminate in connection with the Opening Cross and Closing Cross an Order Imbalance Indicator.<sup>155</sup> The Order Imbalance Indicator for the Closing Cross will disseminate, in part, the following information: (1) A Current Reference Price, which is the single price that is at or within the current NOM best bid and offer at which the maximum number of contracts of MOC, LOC, IO, and Close Eligible Interest<sup>156</sup> can be paired;<sup>157</sup> (2) a Far Clearing Price, which is an indicative price at which MOC, LOC, and IO orders would execute if the Closing Cross were to occur at that time; and (3) a Near

Clearing Price, which is an indicative price at which MOC, LOC, IO, and Close Eligible Interest would execute if the Closing Cross were to occur at that time.<sup>158</sup>

One commenter notes that the Order Imbalance Indicator would show the price in penny increments at which certain orders would execute at the time the Order Imbalance Indicator is disseminated.<sup>159</sup> The commenter believes that the Order Imbalance Indicator is inconsistent with the options Penny Pilot Program and that the Order Imbalance Indicator should be disseminated in the applicable minimum price variation for an option, rather than in penny increments.<sup>160</sup>

In its response, Nasdaq states that the Order Imbalance Indicator will benefit investors and improve transparency by providing market participants with information that will allow them to route customer orders to the best market.<sup>161</sup> To ensure that the Order Imbalance Indicator fully complies with Rule 602 of Regulation NMS, however, Nasdaq proposes in Amendment No. 2 to modify the proposed NOM Rules relating to the Closing Cross to state that the Current Reference Price and Near Clearing Price<sup>162</sup> will be disseminated in the minimum price increment applicable to the option in question and never at a price that would expose undisplayed trading interest that is available for execution on the NOM Book. Nasdaq states that only the Current Reference Price and Near Clearing Price are affected by this restriction because they are the only aspects of the Order Imbalance Indicator that may include information based on non-displayed orders resting on the NOM book.<sup>163</sup> Nasdaq further states that the remaining data elements of the Order Imbalance Indicator do not transmit information regarding the

<sup>150</sup> See Amex Letter, *supra* note 4, at 3.

<sup>151</sup> See Nasdaq Response, *supra* note 5, at 10 to 11. See also NOM Rules, Chapter VI, Section 9(b)(3).

<sup>152</sup> See Nasdaq Response, *supra* note 5, at 11.

<sup>153</sup> See Nasdaq Rule 4754.

<sup>154</sup> See Nasdaq Rule 4754(b)(3).

<sup>155</sup> See proposed Chapter VI, Sections 8(a)(2) and 9(a)(7) of the NOM Rules. For the Opening Cross, Nasdaq will disseminate the Order Imbalance Indicator every five seconds beginning at 9:25 a.m. For the Closing Cross, Nasdaq will disseminate the Order Imbalance Indicator every five seconds for 10 minutes prior to the Closing Cross. See proposed NOM Rules, Chapter VI, Sections 8(a)(2) and 8(b)(1) and 9(a)(7) and 9(b)(1) for a detailed description of the Order Imbalance Indicator.

<sup>156</sup> Close Eligible Interest is defined to mean any quotation or any order that may be entered into the system and designated with a time-in-force of DAY, GTC, or EXPR. See proposed Chapter VI, Section 9(a)(1) of the NOM Rules.

<sup>157</sup> If more than one price exists pursuant to this calculation, the Current Reference Price is the price that minimizes any Imbalance. If more than one price exists under that calculation, the Current Reference Price is the entered price at which contracts will remain unexecuted in the cross. And, if more than one price exists under that calculation, the Current Reference Price is the price that minimizes the distance from the bid-ask midpoint of the inside quotation prevailing within the NOM System at the time of the order imbalance indicator dissemination. See proposed Chapter VI, Section 9(a)(7)(A) of the NOM Rules.

<sup>158</sup> For the Opening Cross, the Far Clearing Price and Near Clearing Price will be the same as the Current Reference Price. See proposed Chapter VI, Section 8(a)(2)(A) and (E) of the NOM Rules.

<sup>159</sup> See Amex Letter, *supra* note 4, at 2.

<sup>160</sup> *Id.* The Penny Pilot Program of the various options exchanges allows the exchanges to quote certain options classes in one-cent or five-cent increments, depending on the price of the option. See, e.g., Securities Exchange Act Release No. 56567 (September 28, 2007), 72 FR 56396 (October 3, 2007) (order approving File No. SR-Amex-2007-96).

<sup>161</sup> See Nasdaq Response, *supra* note 5, at 9.

<sup>162</sup> See NOM Rules, Chapter VI, Sections 9(a)(7)(A) and 9(a)(7)(E)(ii).

<sup>163</sup> This is because the Current Reference Price and Near Clearing Price take into account the Close Eligible Interest, which is defined as any quotation or any order that may be entered into the System and designated with a time-in-force of DAY, GTC, or EXPR. Thus, Close Eligible Interest includes orders, including non-displayed orders, on the NOM Book.

<sup>144</sup> See NOM Rules, Chapter VI, Section 10(4).

<sup>145</sup> See Amendment No. 2 at 7.

<sup>146</sup> See NOM Rules, Chapter VI, Section 9. See also Trading Rules Proposal Notice, *supra* note 3, for a more detailed description of the proposed Closing Cross.

<sup>147</sup> See Amex Letter, *supra* note 4, at 3.

<sup>148</sup> See Nasdaq Response, *supra* note 5, at 10.

<sup>149</sup> In Amendment No. 2, Nasdaq proposes changes to the definitions of Imbalance Only ("IO"), Market on Close ("MOC"), and Limit on Close ("LOC") orders to replace certain times specified in the rules (e.g., 3:50:00 p.m.) with more general descriptions (e.g., 10 minutes prior to the close).

pricing of specific orders and therefore do not implicate Rule 602 of Regulation NMS.<sup>164</sup>

The Commission agrees with Nasdaq's analysis and believes that the Order Imbalance Indicator, as proposed to be amended in Amendment No. 2, is consistent with Rule 602 of Regulation NMS. Nasdaq will not disseminate the prices of non-displayed orders resting on the NOM book after the Opening Cross<sup>165</sup> and therefore, such non-displayed orders will not be bids or offers<sup>166</sup> required to be made available to vendors by the Exchange under Rule 602. Further, the Commission does not believe that the Order Imbalance Indicator, as amended, is inconsistent with the Penny Pilot because it will not make available during regular trading hours information in a pricing increment other than the MPV.

#### 6. Obvious Errors

The Commission believes that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an "obvious error" may exist, suggesting that it is unlikely that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether an "obvious error" has occurred should be based on specific and objective criteria and subject to specific and objective procedures.<sup>167</sup>

In Amendment No. 2, Nasdaq revised its proposed rule dealing with options obvious errors. Specifically, Nasdaq amended Chapter V, Section 6, Obvious Errors, to: (1) Apply the obvious error rule solely to obvious price errors and to series quoted no bid; (2) streamline the procedures governing review of obvious error requests by the Market Operations Review Committee ("MORC"); and (3) add a provision stating that the MORC must include representatives of one member engaged in market making and two industry

<sup>164</sup> See Nasdaq Response, *supra* note 5, at 6 and 9.

<sup>165</sup> The Commission does not believe that the Order Imbalance Indicator disseminated prior to the Opening Cross (and thus disseminated prior to the 9:30 a.m. EST) raises the same issues under the Quote Rule because the information will be disseminated prior to the commencement of trading on the exchange. See Rule 602(a)(1)(i)(B) of Regulation NMS, 17 CFR 242.602(a)(1)(i)(B).

<sup>166</sup> See Rule 600(b)(8) of Regulation NMS, 17 CFR 242.600(b)(8).

<sup>167</sup> See, e.g., Securities Exchange Act Release Nos. 54608 (October 16, 2006), 71 FR 62021 (October 20, 2006) (File No. SR-Amex-2005-60) (order approving changes to Amex's obvious error rule); 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (File No. SR-CBOE-00-55) (order approving CBOE Direct); and BOX Approval Order, *supra* note 72.

representatives not engaged in market making, and that at no time shall members engaged in market making constitute more than 50% of the MORC. The Commission believes that the provisions of Nasdaq's obvious error rule, as revised by Amendment No. 2, are consistent with the Act and, in particular, with Section 6(b)(5), in that they provide clear and objective standards and procedures for determining whether an obvious error has occurred. The Commission also believes that the revised proposed rule is consistent with obvious error rules previously approved by the Commission for other exchanges.<sup>168</sup>

One commenter seeks clarification as to who will be responsible for trade errors in the context of the Linkage.<sup>169</sup> Nasdaq states that NOM's Rules recognize only Obvious Errors, as defined in Chapter VI, Section 6 of the NOM Rules. If a trade does not meet the definition of an Obvious Error, NOM will take no action with respect to the trade. In the event of an Obvious Error on NOM involving an away market, the away market is authorized as a party to the transaction to file with NOM for review of the Obvious Error. In the event of an Obvious Error on an away market, NOM's Obvious Error rule authorizes NOM to file for review of that Obvious Error on behalf of the NOM Participant. If necessary, NOM will file for such review through NOS or the member of the away market which it used to route the order.<sup>170</sup>

#### 7. Miscellaneous

One commenter believes that, under the NOM Rules, quotes are the same as orders and therefore reads Chapter VI, Section 5(b) of the NOM Rules to mean that Nasdaq proposes to trade all options series on NOM in penny increments, in violation of the Penny Pilot Program.<sup>171</sup>

In response, Nasdaq states that the commenter has misread the proposal and that Nasdaq does not propose to quote all options on NOM in penny increments. In this regard, Nasdaq notes that Chapter VI, Section 5(a) of the NOM

<sup>168</sup> See, e.g., Securities Exchange Release Nos. 54228 (July 27, 2006), 71 FR 44066 (August 3, 2006) (File No. SR-ISE-2006-14) (approving current version of ISE Rule 7.20 (options obvious error rule)); 54070 (June 29, 2006), 71 FR 38441 (July 6, 2006) (File No. SR-Phlx-2005-73) (approving current version of Phlx Rule 1092 (options obvious error rule)); and 56487 (September 20, 2007), 72 FR 54956 (September 27, 2007) (File No. SR-CBOE-2007-04) (approving current version of CBOE Rule 6.25 (options obvious error rule)).

<sup>169</sup> See SIFMA Letter, *supra* note 4 at 2.

<sup>170</sup> See Nasdaq Response, *supra* note 5, at 9, and Amendment No. 2.

<sup>171</sup> See Amex Letter, *supra* note 4, at 2.

Rules governs quotation increments and is consistent with the Penny Pilot Program, while Section 5(b) specifies the minimum trading increment on NOM.<sup>172</sup> The Commission believes that Nasdaq has clarified that it does not propose to quote all options on NOM in penny increments and that the NOM Rules are consistent with the Penny Pilot Program. The Commission also does not believe that trading in penny increments is inconsistent with the Penny Pilot Program.<sup>173</sup>

In response to questions from commenters regarding the NOM closing time,<sup>174</sup> Nasdaq in Amendment No. 2 proposes to modify the NOM Rules to provide that the NOM closing time will be 4 p.m. ET, except for options on broad-based indexes and Fund Shares, which will close at 4:15 p.m. ET.<sup>175</sup> The Commission believes that these modifications will make NOM's closing time consistent with the rules of the other U.S. options exchanges.<sup>176</sup>

#### E. Order Routing

With respect to securities traded on NOM ("System Securities"),<sup>177</sup> Participants may designate orders to be routed to another market center when trading interest is not available on NOM or to execute only on NOM.<sup>178</sup> Orders that are designated to be routed will be routed to another options market when NOM is not at the NBBO, consistent with the locked and crossed market and trade through provisions of the Linkage Plan.<sup>179</sup> Orders routed by the System to other markets do not retain time priority with respect to other orders in the System and the System will continue to execute other orders while routed orders are away at another market center.<sup>180</sup> If a routed order is returned, in whole or in part, that order (or its remainder) will receive a new time stamp reflecting the time of its return to the System.<sup>181</sup> Participants whose orders are routed to

<sup>172</sup> See Nasdaq Response, *supra* note 5, at 7.

<sup>173</sup> See *supra* note 142 and accompanying text.

<sup>174</sup> See Amex Letter, *supra* note 4, at 4, and SIFMA Letter, *supra* note 4, at 2.

<sup>175</sup> See NOM Rules, Chapter VI, Section 2.

<sup>176</sup> See, e.g., ISE Rule 700 and CBOE Rules 6.1 and 24.6. In addition, in Amendment No. 2 Nasdaq proposes to revise Chapter VI, Section 2 of the NOM Rules to indicate that the System will be available to accept bids, offers, and orders beginning at 9 a.m., rather than 8 a.m. Similarly, Nasdaq proposes in Amendment No. 2 to revise Chapter VI, Section 9 of the NOM Rules to indicate that IO orders, LOC orders, and MOC orders may be entered beginning at 9 a.m., rather than 8 a.m.

<sup>177</sup> See NOM Rules, Chapter VI, Section 1(b).

<sup>178</sup> See NOM Rules, Chapter VI, Section 11(a) and Amendment No. 2.

<sup>179</sup> See *id.* and *infra* note 195 and accompanying text.

<sup>180</sup> See NOM Rules, Chapter VI, Section 11(c).

<sup>181</sup> *Id.*

away markets will be obligated to honor such trades to the same extent they will be obligated to honor a trade executed on NOM.<sup>182</sup>

One commenter believes that NOM's rules, as proposed, provided different order routing attributes for "system" and "non-system" securities, but failed to adequately define these terms, resulting in confusion regarding the operation of the order routing mechanism.<sup>183</sup>

In response, Nasdaq, in Amendment No. 2, proposes to revise proposed Chapter VI, Section 1(b) of the NOM Rules to define "System Securities" as all options currently trading on NOM, and to define "Non-System Securities" as all other options. Nasdaq states it will accept orders in Non-System Securities for routing but will not execute these orders in the System.<sup>184</sup> Nasdaq represents that System and Non-System Securities will be identified clearly via the NOM data feed and in a daily list posted on the NOM Web site.<sup>185</sup> Nasdaq further states that the System will be programmed to differentiate between System Securities and Non-System Securities and will process each in accordance with the NOM Rules.<sup>186</sup> The Commission believes that Nasdaq's proposed changes and response adequately clarify the operation of the order routing mechanism for "System Securities" and "Non-System Securities."

In Amendment No. 2, Nasdaq further proposes to amend proposed Chapter VI, Section 11(e) of the NOM Rules to establish Nasdaq Options Services LLC ("NOS") as NOM's exclusive order router. NOS will perform only two functions, the routing of orders with respect to System Securities and the routing of orders with respect to Non-System Securities. Nasdaq states that NOS will be a facility of Nasdaq only with respect to the routing of orders for System Securities.<sup>187</sup> NOS will be programmed to follow the algorithm and order type instructions established in the NOM Rules and will not have discretion to change the terms of an order or the order routing instructions.<sup>188</sup>

NOS will be a member of an SRO unaffiliated with Nasdaq that is its designated examining authority, and NOM will establish and maintain

procedures and internal controls reasonably designed to restrict the flow of confidential and proprietary information between Nasdaq and its facilities, including NOS, and any other entity.<sup>189</sup> In addition, the books, records, premises, officers, directors, agents, and employees of NOS, as a facility of Nasdaq, will be deemed to be those of the Exchange for purposes of and subject to oversight pursuant to the Act.<sup>190</sup> Further, Participants are not required to use NOS to route orders, and a Participant may route its orders through any available router it selects.<sup>191</sup>

The Commission agrees with the Exchange that routing with respect to System Securities will be a "facility" of the Exchange, and, consequently, the operation of NOS in this capacity will be subject to Exchange oversight, as well as Commission oversight. The Commission notes that the functionality to be provided by NOS is not the exclusive means for accessing better-priced orders in other market centers. Accordingly, NOS's routing services are optional, and a NOM Participant is free to route its orders to other market centers through alternative means. In light of the protections discussed above, including the regulation of NOS as a facility of the Exchange with respect to the routing of orders for System Securities, the Commission believes that Nasdaq's rules and procedures regarding the use of NOS to route orders to away markets are consistent with the Act.<sup>192</sup>

#### F. Linkage

As described above, Nasdaq proposes to use NOS to route orders to other options exchanges. NOM will, however, participate in the Linkage Plan to receive orders from options exchanges that use the Linkage to route orders. To receive orders through the Linkage, Nasdaq proposes to adopt rules relating to the Linkage Plan that are substantially similar to the rules of the other options exchanges that participate in the Linkage Plan. In general, the proposed rules include relevant definitions; establish the conditions

pursuant to which Market Makers may enter Linkage orders; impose obligations on the Exchange regarding how it must process incoming Linkage orders; establish a general standard that Participants should avoid trade-throughs; establish potential regulatory liability for Participants that engage in a pattern or practice of trading through other exchanges; and establish obligations with respect to locked and crossed markets.<sup>193</sup>

One commenter questioned how NOM will ensure that orders designated for execution solely on NOM will not create a trade-through or locked or crossed market. In particular, the commenter requests clarification regarding the treatment of an order that locks or crosses the NBBO, NOM's responsibility for such an order, and the action NOM will take if the market already is locked or crossed when it receives an order.<sup>194</sup>

In response, Nasdaq states that Chapter VI, Section 7(b)(3)(C) of the NOM Rules sets forth the procedures that NOM will use to ensure compliance with the trade through and locked and crossed market provisions of the Linkage Plan.<sup>195</sup> Nasdaq proposes in Amendment No. 2 to state explicitly in the NOM Rules that an order will not be executed at a price that trades through another market or displayed at a price that would lock or cross another market. Nasdaq further proposes to add in Amendment No. 2 that an order that is designated as routable will be routed in compliance with applicable trade through and locked and crossed markets restrictions.<sup>196</sup> With respect to non-routable orders, Nasdaq notes that the System will re-price a Displayed Order that, at the time of entry, would cause a locked or crossed market or a trade through violation, to the current national best offer (for bids) or the current national best bid (for offers) and display the order at one minimum price variation below (for bids) or above (for offers) the national best price.<sup>197</sup> These

<sup>193</sup> See NOM Rules, Chapter XII.

<sup>194</sup> See Amex Letter *supra* note 4, at 3.

<sup>195</sup> See Nasdaq Response, *supra* note 5, at 10.

<sup>196</sup> See NOM Rules, Chapter VI, Section 7(b)(3)(C).

<sup>197</sup> See NOM Rules, Chapter VI, Section 7(b)(3)(C). As originally proposed, Chapter VI, Section 7(b)(3)(C) of the NOM Rules provided that if a Displayed Order that the entering party has elected not to make eligible for routing would cause a locked or crossed market or a trade through violation at the time of entry, the System would re-price the order to one minimum price variation ("MPV") below the current national best offer (for bids) or one MPV above the current national best bid (for offers). In Amendment No. 2, Nasdaq proposes to revise the rule to provide that the System will re-price such an order to the current

Continued

<sup>182</sup> See NOM Rules, Chapter VI, Section 11(d).

<sup>183</sup> See Amex Letter, *supra* note 4, at 3.

<sup>184</sup> See Nasdaq Response, *supra* note 5, at 11. See also NOM Rules, Chapter VI, Section 11(a).

<sup>185</sup> See Nasdaq Response, *supra* note 5, at 11.

<sup>186</sup> *Id.*

<sup>187</sup> See NOM Rules, Chapter VI, Section 11(e) and Nasdaq Response, *supra* note 5, at 11.

<sup>188</sup> See Nasdaq Response, *supra* note 5, at 11.

<sup>189</sup> See NOM Rules, Chapter VI, Section 11(e).

<sup>190</sup> *Id.* In addition, the books and records of NOS, as a facility of the Exchange, will be subject at all times to inspection and copying by the Exchange and the Commission. *Id.*

<sup>191</sup> See Nasdaq Response, *supra* note 5, at 11. See also NOM Rules, Chapter VI, Section 1(b) (allowing Participants to designate orders as available for routing or not available for routing).

<sup>192</sup> In addition, the Commission notes that the Nasdaq rules and procedures applicable to NOS are similar to the rules and procedures adopted by other exchanges to govern their order routers. See, e.g., ISE Rule 2108; NYSE Rule 17; and Phlx Rule 185(g).

do-not-ship orders will remain on Nasdaq's book until cancelled or executed by another NOM Participant or market center.<sup>198</sup> Nasdaq states that the System, therefore, will systemically avoid executing an order at a price that would trade through a price on another market and will prevent Nasdaq from displaying a quotation that would lock or cross a quotation displayed by another market.<sup>199</sup> In addition, Nasdaq represents that it will program the System to avoid joining a locked or crossed market when the market is already locked or crossed.<sup>200</sup>

The Commission believes that Nasdaq has responded adequately to the commenter's questions regarding NOM's procedures and rules for complying with the Linkage Plan, and that NOM's rules, as amended, are reasonably designed to comply with the locked and crossed market and trade through provisions of the Linkage Plan.

As noted above, Nasdaq intends to use NOS to route orders to other markets. To allow Nasdaq to use the Linkage to send orders to other markets, if it wanted to do so, NOM Rules provide that one Options Market Maker per eligible series will be designated as the "InterMarket Linkage Market Maker" or "ILM" to be responsible for P/A and Satisfaction orders that would be sent to away markets through the Linkage for options trading on NOM. The ILM responsible for such orders will be required to adhere to the responsibilities of an Eligible Market Maker, as set forth in the Linkage Plan.<sup>201</sup>

The ILM will be required to act with due diligence with regard to the interests of orders entrusted to it and fulfill other duties of an agent, including, but not limited to, ensuring that such orders, regardless of their size or source, receive proper representation and timely execution in accordance with the terms of the orders and the rules of the Exchange. The ILM must provide NOM with written instructions for the routing of any P/A orders it may send through the InterMarket Linkage.

national best offer (for bids) or the current national best bid (for offers) and display the order at one MPV below (for bids) or above (for offers) the national best price. Nasdaq believes that the procedure proposed in Amendment No. 2 is superior to the original procedure, which would have converted the re-priced order into a Non-Displayed Order.

<sup>198</sup> See Nasdaq Response, *supra* note 5, at 10.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> See NOM Rules, Chapter VII, Section 5(a)(ix). The ILM will perform substantially similar functions that the BOX InterMarket Linkage Market Maker performs on BOX. See BOX Rules, Chapter VI, Section 5(a)(ix), and Chapter XII.

NOM will immediately route all P/A orders on behalf of the ILM according to these instructions.<sup>202</sup>

One commenter seeks clarification as to who would fulfill the role of the ILM if the ILM is excused temporarily from its responsibilities, and who would be responsible for trade throughs.<sup>203</sup>

In response, Nasdaq states that it intends to use NOS to fulfill Nasdaq's order routing obligations under the Linkage Plan.<sup>204</sup> Although Nasdaq believes that it therefore will rarely, if ever, need to appoint an ILM, Nasdaq notes that Chapter VII, Rule 5(a)(ix) of the NOM Rules provides Nasdaq with the ability to designate a market maker as the ILM for a particular series.<sup>205</sup> In the event that the ILM substantially fails to engage in a course of dealings under this rule, Nasdaq Regulation may bring a disciplinary action.<sup>206</sup> In addition, Nasdaq states that neither Nasdaq or any Participant will face liability for trade throughs because NOM is programmed to comply with the requirements of the Linkage Plan. If NOM has a System malfunction that results in a trade through, Nasdaq believes that such an occurrence would fall under the exception in Section 8(c)(iii) of the Linkage Plan. If Nasdaq receives a Satisfaction Order from an away market, NOM will execute the order against trading interest available on the NOM Book.<sup>207</sup>

The Commission notes that NOM's rules and the NOM System are designed to comply with the requirements of the Linkage Plan, including the trade through requirements. The Commission believes that the proposed NOM rules regarding the Intermarket Linkage are consistent with the requirements of the Linkage Plan and the Act. The Commission reminds Nasdaq, however, that to the extent trades are executed on NOM that do not comply with the trade through requirements of the Linkage Plan, Nasdaq, as a Plan Participant, will have the obligation to comply with the requirements of the Linkage Plan, including responding to Satisfaction

<sup>202</sup> The order would be generated automatically by NOM and routed to the away exchange with the required clearing information included. Each execution received from an away exchange would result in the automatic generation of a trade execution on NOM between the original order and the ILM.

<sup>203</sup> See SIFMA Letter, *supra* note 4, at 2.

<sup>204</sup> See Nasdaq Response, *supra* note 5, at 4.

<sup>205</sup> See Nasdaq Response, *supra* note 5, at 4. The Commission notes that if there is no Market Maker registered in a particular series, NOM will place that series in a non-regulatory suspension and halt trading until such time as a member registers to make markets in that series. See *supra* note 79 and accompanying text.

<sup>206</sup> See NOM Rules, Chapter VII, Section 5(c).

<sup>207</sup> See Nasdaq Response, *supra* note 5, at 4.

Orders. Further, before Nasdaq can begin operating NOM, Nasdaq must become a participant in the Linkage Plan.

### G. Strike Prices

Nasdaq proposes to participate in the \$2.50 Strike Price Program<sup>208</sup> and in the \$1 Strike Price Program.<sup>209</sup> Amendment No. 2 proposes to amend the NOM Rules to reflect the expansion of the \$2.50 Strike Price Program to include strike prices between \$50 and \$75 under certain conditions and to indicate that NOM's \$1 Strike Price Program will expire on June 5, 2008, rather than June 5, 2007.<sup>210</sup> These changes conform NOM's rules to the existing rules of the other options markets.<sup>211</sup>

One commenter believes that the terms of NOM's participation in the \$2.50 Strike Price Program and the \$1 Strike Price Program are unclear.<sup>212</sup> In particular, the commenter questions whether NOM will trade only those classes currently included in the \$2.50

<sup>208</sup> The \$2.50 strike price program allows the options exchanges to list options in up to 200 classes at \$2.50 strike price intervals for strike prices greater than \$25 but less than \$75. See, e.g., Securities Exchange Act Release Nos. 40662 (November 12, 1998), 63 FR 64297 (November 19, 1998) (order approving File Nos. SR-Amex-98-21; SR-CBOE-98-29; SR-PCX-98-31; and SR-Phlx-98-26) ("1998 Order") and 52893 (December 5, 2005), 70 FR 73488 (December 12, 2005) (order approving File No. SR-Amex-2005-067). The 200 classes eligible for the \$2.50 Strike Price Program were allocated among the options exchanges pursuant to a formula approved by the Commission as part of the permanent approval of the program. Each options exchange may list options with \$2.50 strike price intervals on any options class that another exchange selects as part of its program. Any modification to the \$2.50 Strike Price Program would require the filing of a proposed rule change with the Commission pursuant to Section 19(b) of the Act.

<sup>209</sup> Under the \$1 Strike Price Program, each options exchange may select a total of five individual stocks on which options series may be listed at \$1 intervals, and each exchange may list \$1 strikes on any options class designated by another exchange as part of its \$1 Strikes Program. See, e.g., Securities Exchange Act Release No. 55714 (May 7, 2007), 72 FR 26853 (May 11, 2007). See NOM Rules, Chapter IV, Section 6, Supplementary Material .03 and Supplementary Material .02. The Commission notes that several of the options exchanges have amended their rules, in part, to allow the exchanges to select a total of ten individual stocks on which options series may be listed at \$1 intervals. See, e.g., Securities Exchange Act Release Nos. 57049 (December 27, 2007), 73 FR 528 (January 8, 2008) (order approving File No. SR-CBOE-2007-125) and 57110 (January 8, 2008) (notice of filing and order granting accelerated approval of File No. SR-Amex-2007-141) (together, the "1 Strike Price Orders").

<sup>210</sup> See NOM Rules, Chapter IV, Section 6, Supplementary Material .03(b) and Supplementary Material .02.

<sup>211</sup> The Commission notes that several of the options exchanges have recently amended their rules to make the \$1 Strike Price Program permanent. See, e.g., \$1 Strike Price Orders, *supra* note 209.

<sup>212</sup> See Amex Letter, *supra* note 4, at 3-4.

Strike Price Program and in the \$1 Strike Price Program.<sup>213</sup> NOM's rules provide that it may list \$1 strikes in options classes on five individual stocks, as designated by NOM, as well as any options class specifically designated by another exchange that employs a similar \$1 strike price program.<sup>214</sup> NOM's rules also provide that Nasdaq may list series at \$2.50 strike price intervals in any multiply traded option once another exchange has selected that option to be a part of the program.<sup>215</sup> The Commission believes that Nasdaq's proposal, as amended, makes clear that NOM will participate in the \$2.50 Strike Price Program and the \$1 Strike Price Program on the same terms and conditions as the other options exchanges.<sup>216</sup> The Commission also believes that Nasdaq's proposed rules relating to the \$2.50 Strike Price and \$1 Strike Price Programs will provide investors with flexibility in tailoring their options positions to meet their investment objectives while avoiding the unnecessary proliferation of illiquid options series.<sup>217</sup>

#### H. Securities Traded on NOM

Nasdaq proposes to adopt initial and continued listing standards for equity and index options<sup>218</sup> that are substantially similar to the listing standards adopted by other options exchanges.<sup>219</sup> In Amendment No. 2, Nasdaq proposes to revise proposed

<sup>213</sup> *Id.* at 4.

<sup>214</sup> See NOM Rule, Chapter IV, Section 6, Supplementary Material .02(a).

<sup>215</sup> See NOM Rule, Chapter IV, Section 6, Supplementary Material .03(a).

<sup>216</sup> As noted above, several of the options exchanges have recently expanded and made permanent their \$1 Strike Price Programs. See *supra* notes 209 and 211.

<sup>217</sup> See, e.g. 1998 Order, *supra* note 208, and Securities Exchange Act Release Nos. 47991 (June 5, 2003), 68 FR 35243 (June 12, 2003) (File No. SR-CBOE-2001-60) (order approving CBOE's \$1 Strike Price Program through June 5, 2004) and 48024 (June 12, 2003), 68 FR 36617 (June 18, 2003) (File No. SR-Amex-2003-36) (order approving Amex's \$1 Strike Price Program through June 5, 2004).

<sup>218</sup> See NOM Rules, Chapters IV and XIV.

<sup>219</sup> See, e.g., BOX Rules, Chapters IV and XIV. In response to a commenter's concern that its proposed definition of "index option" could have included exchange-traded funds, as well as index options (see Amex Letter, *supra* note 4, at 4), Nasdaq proposes in Amendment No. 2 to revise its definition "index option" to mean an option on a broad-based, narrow-based, or micro narrow-based index of equity securities prices. See NOM Rules, Chapter I, Section 1(a)(21). The Commission finds that the proposed change is consistent with the Act because it clarifies the definition of "index option." In addition, Nasdaq proposes in Amendment No. 2 to revise Chapter IV, Section 5 of the NOM Rules to indicate that if an options class has been approved for listing on NOM and there is not at least one series in that class open for trading, the listing will be placed in a non-regulatory suspension until a series is opened in that class.

Chapter IV, Section 3 of the NOM Rules to allow NOM to list and trade an option on an underlying equity security that does not satisfy certain of the criteria for initial listing in the NOM Rules provided that: (1) The underlying security meets the criteria for continued listing set forth in the NOM Rules; and (2) options on such underlying security are listed and traded on at least one other registered national securities exchange.<sup>220</sup> This proposed change to the proposed NOM Rules, which is narrowly tailored to address the circumstances where an equity option class is currently ineligible for initial listing on NOM even though it meets NOM's continued listing standards and is trading on another options exchange, is substantially similar to rules adopted by other options exchanges.<sup>221</sup>

The Commission believes that NOM's proposed initial and continued listing standards, as amended, are consistent with the Act, including Section 6(b)(5), in that they are designed to protect investors and the public interest and to promote just and equitable principles of trade. Nasdaq's operation of NOM as an options exchange, however, is conditioned on Nasdaq becoming a Plan Sponsor in the Plan for the Purpose of Developing and Implementing Procedures Designed to Facilitate the Listing and Trading of Standardized Options Submitted Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 ("OLPP"). In addition, Nasdaq will need to become a participant in the Options Clearing Corporation.

#### I. Regulation of NOM and Options Participants

Nasdaq represents that it has the ability to discharge all regulatory functions related to the facility that it has undertaken to perform by virtue of forming NOM as a facility of Nasdaq.<sup>222</sup> In connection with its regulatory functions, the Exchange represents that its regulatory oversight committee and its chief regulatory officer ("CRO") will assume responsibility for regulating quoting and trading on NOM and

<sup>220</sup> See NOM Rules, Chapter IV, Section 3(k) and Amendment No. 2. Nasdaq also proposes to state that it shall employ the same procedures to determine whether a particular underlying security meets NOM's continued equity options listing criteria in this instance as it employs when determining whether an underlying security meets NOM's initial listing criteria. See *id.*

<sup>221</sup> See, e.g., Amex Rule 915, Commentary .01(6); CBOE Rule 5.3, Interpretation and Policy .01(c); and ISE Rule 502(b)(6).

<sup>222</sup> See Corporate Structure Proposal Notice, *supra* note 8, at 58138.

conduct by NOM participants.<sup>223</sup> The Exchange's CRO has general supervision of the regulatory operations of the Exchange, including overseeing surveillance, examination, and enforcement functions, and administers a regulatory services agreement ("Regulatory Contract") between the Exchange and FINRA.<sup>224</sup>

Pursuant to the Regulatory Contract, FINRA will perform many of the initial disciplinary processes on behalf of the Exchange. Additionally, the Exchange's By-Laws and rules provide that it has disciplinary jurisdiction over its members so that it can enforce its members' compliance with its rules and the federal securities laws.<sup>225</sup> The Exchange's rules also permit it to sanction members for violations of its rules and violations of the federal securities laws by, among other things, expelling or suspending members, limiting members' activities, functions, or operations, fining or censuring members, or suspending or barring a person from being associated with a member.<sup>226</sup> Nasdaq's Rules also provide for the imposition of fines for minor rule violations in lieu of commencing disciplinary proceedings.<sup>227</sup>

Furthermore, the Exchange has an independent regulatory department, Nasdaq Regulation, which carries out many of the Exchange's regulatory functions, including administering its membership and disciplinary rules, and is functionally separate from the Exchange's business lines. Nasdaq Regulation includes Market Watch, which performs real-time intraday surveillance over all Exchange-listed companies and all Exchange market participants. The Exchange represents that Nasdaq Regulation, including Market Watch, will perform the same

<sup>223</sup> See Corporate Structure Proposal Notice, *supra* note 8, at 58139.

<sup>224</sup> Pursuant to the RSA, FINRA performs certain regulatory functions on behalf of the Exchange. In addition to performing certain membership functions for the Exchange, FINRA performs certain disciplinary and enforcement functions for the Exchange. Generally, FINRA investigates members, issue complaints, and conducts hearings pursuant to the Exchange's rules. Appeals of disciplinary hearings, however, will be handled by the Nasdaq Review Council. *Id.*

<sup>225</sup> See e.g. Exchange By-Laws, Article IX, Section 2.

<sup>226</sup> See e.g. Exchange Rule 8310. Nasdaq rules apply to Options Participants and the trading of options contracts on NOM. See NOM Rules, Chapter I, Section 2. Prospective Options Participant must, among other things, be an existing member or become a member of the Exchange, pursuant to the Nasdaq 1000 Rule Series, as well as maintain a membership on at least one other options national securities exchange. See NOM Rules, Chapter II, Sections 1(b)(iii) and 2(f).

<sup>227</sup> See *infra* notes 243 to 250 and accompanying text.

regulatory role with respect to NOM, including operating automated detection systems to perform real-time surveillance of quoting and trading on NOM and to maintain a fair and orderly market.<sup>228</sup> Specifically, Nasdaq Regulation will perform options listing regulation and will monitor trading on the NOM on a real-time basis to identify unusual trading patterns and determine whether particular trading activity requires further regulatory investigation by FINRA. In addition, Nasdaq Regulation will oversee the process for determining and implementing trading halts, identifying and responding to unusual market conditions, and administering Nasdaq's process for identifying and remediating "obvious errors" by and among Options Participants. The NOM rules governing halts, unusual market conditions, extraordinary market volatility, and audit trail are modeled on the approved rules of BOX.<sup>229</sup>

The Commission finds that the Exchange's proposed rules and regulatory structure with respect to NOM are consistent with the requirements of the Act, and in particular with Section 6(b)(1) of the Act, which requires an exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to comply, and to enforce compliance by its members and persons associated with its members, with the Act and the rules and regulations thereunder, and the rules of the Exchange,<sup>230</sup> and with Sections 6(b)(6) and 6(b)(7) of the Act,<sup>231</sup> which require an Exchange to provide fair procedures for the disciplining of members and persons associated with members.

### 1. Regulatory Contract

The Exchange represents that the Regulatory Contract between the Exchange and FINRA governs the Exchange and its facilities. Therefore, because NOM will be a facility of Nasdaq, the Regulatory Contract will govern NOM.<sup>232</sup> The Exchange and FINRA, however, have modified the

<sup>228</sup> See Corporate Structure Proposal Notice, *supra* note 8, at 58139.

<sup>229</sup> See BOX Rules, Chapter V.

<sup>230</sup> 15 U.S.C. 78f(b)(1).

<sup>231</sup> 15 U.S.C. 78f(b)(6) and (b)(7).

<sup>232</sup> The Commission notes that the NOM Proposed Rules provide that "NOM rules that refer to Nasdaq Regulation, Nasdaq Regulation staff, NOM staff, and NOM departments should be understood as also referring to [National Association of Securities Dealers, Inc. ("NASD") (n/k/a Financial Industry Regulatory Authority, Inc. or FINRA)], NASD staff, NASD Regulation staff, and NASD departments acting on behalf of Nasdaq pursuant to the Regulatory Contract." See NOM Rules, Chapter 1, Article 3.

Regulatory Contract to capture certain aspects of regulation of NOM and the regulation and discipline of Options Participants.<sup>233</sup> The Commission notes that Nasdaq will continue to bear ultimate regulatory responsibility for functions performed on Nasdaq's behalf under the Regulatory Contract. Further, the Exchange retains ultimate legal responsibility for the regulation of its members (including those members that are NOM Participants) and its market (including its facility, NOM).

The Commission believes that it is consistent with the Act and the public interest to allow the Exchange to contract with FINRA to perform membership, disciplinary, and enforcement functions.<sup>234</sup> Membership, 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 membership, disciplinary and enforcement functions, the Commission noted in the Registration Approval Order its belief that FINRA has the expertise and experience to perform such functions on behalf of the Exchange, and that the contracting of such functions to FINRA is consistent with the Act and the public interest.<sup>235</sup> The Commission continues to believe this is true with respect to the inclusion in the Regulatory Contract of regulation of NOM and the conduct of NOM Participants.

At the same time, the Exchange, unless relieved by the Commission of its responsibility,<sup>236</sup> bears the

<sup>233</sup> Nasdaq and FINRA are parties to an agreement pursuant to Section 17(d) of the Act and Rule 17d-2 thereunder, dated July 11, 2006 ("Bilateral 17d-2 Agreement"). A regulatory matter involving a NOM Participant that is also a FINRA member that is governed by both the Regulatory Contract and the Bilateral 17d-2 Agreement will be administered by FINRA pursuant to the Bilateral 17d-2 Agreement, not the Regulatory Contract. Telephone conversation between Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, and Heather Seidel, Assistant Director, Division of Trading and Markets ("Division"), Commission, on December 21, 2007.

<sup>234</sup> See *e.g.*, Regulation ATS Release, *supra* note 92. See also Securities Exchange Act Release Nos. 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) (approving ISE's registration as a national securities exchange) ("ISE Exchange Registration Order") at III(D)(2); and Registration Approval Order, *supra* note 19.

<sup>235</sup> See Registration Approval Order, *supra* note 19, at notes 10 and 11 and accompanying text.

<sup>236</sup> See Section 17(d)(1) of the Act and Rule 17d-2 thereunder. 15 U.S.C. 78q(d)(1); and 17 CFR

responsibility for self-regulatory conduct and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the Exchange's behalf.<sup>237</sup> In performing these functions, however, FINRA may nonetheless bear liability for causing or aiding and abetting the failure of the Exchange to perform its regulatory functions.<sup>238</sup> Accordingly, although FINRA will not act on its own behalf under its SRO responsibilities in carrying out these regulatory services for Nasdaq relating to the operation of NOM, FINRA also may have secondary liability if, for example, the Commission finds the contracted functions are being performed so inadequately as to cause a violation of the federal securities laws by Nasdaq.<sup>239</sup>

### 2. 17d-2 Agreement

Rule 17d-2 allows SROs to file with the Commission plans under which the SROs allocate among themselves the responsibility to receive regulatory reports from, and examine and enforce compliance with, specified provisions of the Act and rules thereunder and SRO rules by firms that are members of more than one SRO ("common members"). An SRO that is a party to an effective 17d-2 plan is relieved of regulatory responsibility as to any common member for whom responsibility is allocated under the plan to another SRO.<sup>240</sup>

All of the options exchanges, the NASD, and the NYSE have entered into the Options Sales Practices Agreement, a Rule 17d-2 agreement ("17d-2 Agreement" or "Agreement"). This Agreement allocates to certain SROs ("examining SROs") regulatory responsibility for common members with respect to certain options-related sales practice matters. For example, the Agreement allocates responsibility to conduct options-related sales practice examinations of a firm, and investigate

<sup>240</sup> 17d-2. See *also infra* note 240 and accompanying text. The Commission notes that it is not approving the Regulatory Contract.

<sup>237</sup> See Registration Approval Order, *supra* note 19, at notes 112 and 113 and accompanying text; Amex Approval Order, *supra* note 234; and ISE Registration Approval Order, *supra* note 234, at III(D)(2).

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*

<sup>240</sup> Rule 17d-2 provides that any two or more SROs may file with the Commission a plan for allocating among such SROs the responsibility to receive regulatory reports from persons who are members or participants of more than one of such SROs to examine such persons for compliance, or to enforce compliance by such persons, with specified provisions of the Act, the rules and regulations thereunder, and the rules of such SROs, or to carry out other specified regulatory functions with respect to such persons. 17 CFR 240.17d-2.



options-related customer complaints and terminations for cause of associated persons of that firm. The Commission notes that Nasdaq has become a party to the 17d-2 Agreement,<sup>241</sup> which will cover Nasdaq members acting as Options Participants.<sup>242</sup>

### 3. Minor Rule Violation Plan

The Commission approved Nasdaq's Minor Rule Violation Plan ("MRVP") in 2006.<sup>243</sup> Nasdaq's MRVP specifies those uncontested minor rule violations with sanctions not exceeding \$2,500 that would not be subject to the provisions of Rule 19d-1(c)(1) under the Act<sup>244</sup> requiring that an SRO promptly file notice with the Commission of any final disciplinary action taken with respect to any person or organization.<sup>245</sup> Nasdaq's MRVP includes the policies and procedures included in Nasdaq Rule 9216(b), "Procedure for Violations under Plan Pursuant to SEC Rule 19d-1(c)(2)," and the rule violations included in Nasdaq IM-9216, "Violations Appropriate for Disposition Under Plan Pursuant to SEC Rule 19d-1(c)(2)."

The Trading Rules Proposal, as originally filed, included Chapter X, Section 7 of the NOM Rules, "Penalty for Minor Rule Violations," which lists the options rules that Nasdaq intended to include in its MRVP. However, the Trading Rules Proposal did not propose a corresponding amendment to Nasdaq IM-9216 to include the rules in proposed Chapter X, Section 7 of the NOM Rules in Nasdaq's MRVP. Accordingly, in Amendment No. 2, Nasdaq proposes to amend Nasdaq IM-

9216 to include proposed Chapter X, Section 7 of the NOM Rules.<sup>246</sup> The Commission believes that this change is consistent with the Act because it clarifies that the proposed rules listed in Chapter X, Section 7 of the NOM Rules will be included in Nasdaq's MRVP.

The Commission notes that the rules included in Chapter X, Section 7 of the NOM Rules are similar to the rules included in the MRVPs of other options exchanges.<sup>247</sup> The Commission finds that Nasdaq's MRVP, as amended to include the rules listed in Chapter X, Section 7 of the NOM Rules, is consistent with Sections 6(b)(1), 6(b)(5) and 6(b)(6) of the Act, which require, in part, that an exchange have the capacity to enforce compliance with, and provide appropriate discipline for, violations of the rules of the Commission and of the exchange.<sup>248</sup> In addition, because Nasdaq Rule 9216(b) will offer procedural rights to a person sanctioned for a violation listed in Chapter X, Section 7 of the NOM Rules, the Commission believes that Nasdaq's rules provides a fair procedure for the disciplining of members and associated persons, consistent with Section 6(b)(7) of the Act.<sup>249</sup>

The Commission also finds that the proposal to include the rules listed in Chapter X, Section 7 of the NOM Rules in Nasdaq's MRVP is consistent with the public interest, the protection of investors, or otherwise in furtherance of the purposes of the Act, as required by Rule 19d-1(c)(2) under the Act,<sup>250</sup> because it should strengthen Nasdaq's ability to carry out its oversight and enforcement responsibilities as an SRO in cases where full disciplinary proceedings are unsuitable in view of the minor nature of the particular violation.

In approving the proposed change to Nasdaq's MRVP, the Commission in no way minimizes the importance of compliance with NOM rules and all other rules subject to the imposition of fines under Nasdaq's MRVP. The Commission believes that the violation of any SRO rules, as well as Commission rules, is a serious matter. However, the Nasdaq MRVP provides a reasonable means of addressing rule violations that do not rise to the level of

requiring formal disciplinary proceedings, while providing greater flexibility in handling certain violations. The Commission expects that Nasdaq will continue to conduct surveillance with due diligence and make a determination based on its findings, on a case-by-case basis, whether a fine of more or less than the recommended amount is appropriate for a violation under Nasdaq's MRVP or whether a violation requires a formal disciplinary action under the Nasdaq Rule 9200 Series.

### J. Quote Mitigation

Nasdaq originally proposed a rule that would provide for the bundling of certain order and quote updates sent to OPRA for low volume options that have been listed on NOM for more than ten trading days.<sup>251</sup> In Amendment No. 2, Nasdaq proposes to eliminate the rule as proposed and provide that: (1) On a monthly basis, NOM will determine the average daily volume ("ADV") of each series listed on NOM and delist the current series and not list the next series after expiration where the ADV is less than 100 contracts;<sup>252</sup> (2) NOM will implement a "replace on queue" functionality that will monitor outgoing messages and will not send a message that is about to be sent if a more current message for the same series is available for sending;<sup>253</sup> (3) NOM will prioritize price update messages and send out price updates before sending size update messages; and (4) when the size associated with a bid or offer increases by an amount less than or equal to a percentage (never to exceed 20%) of the size associated with a previously disseminated bid or offer, NOM will not disseminate the new bid or offer.<sup>254</sup> Nasdaq also represents that when NOM detects that a Participant is disseminating significantly more quotes than is normal for that Participant, NOM will contact that Participant and alert it to such activity. Such monitoring may reveal that the Participant may have internal system issues or incorrectly-set system parameters that are not immediately apparent. NOM believes that, even without uncovering problems, alerting a Participant to possible excessive quoting will lead the

<sup>241</sup> The Commission today is approving an amendment to the 17d-2 Agreement that adds Nasdaq as a party to the Agreement. See Securities Exchange Act Release No. 57481 (March 12, 2008) (File No. S7-966).

<sup>242</sup> NOM rules contemplate participation in this Agreement by requiring that any Options Participant that transacts business with Public Customers also be a member of at least one of the examining SROs. See NOM Rules, Chapter XI, Section 1.

<sup>243</sup> See Securities Exchange Act Release No. 53623 (April 10, 2006), 71 FR 19769 (April 17, 2006) (File No. 4-514) ("MRVP Order").

<sup>244</sup> 17 CFR 240.19d-1(c)(1).

<sup>245</sup> The Commission adopted amendments to paragraph (c) of Rule 19d-1 to allow SROs to submit for Commission approval plans for the abbreviated reporting of minor disciplinary infractions. See Securities Exchange Act Release No. 21013 (June 1, 1984), 49 FR 23829 (June 8, 1984). Any disciplinary action taken by an SRO against any person for violation of a rule of the SRO which has been designated as a minor rule violation pursuant to such a plan filed with the Commission will not be considered "final" for purposes of Section 19(d)(1) of the Act if the sanction imposed consists of a fine not exceeding \$2,500 and the sanctioned person has not sought an adjudication, including a hearing, or otherwise exhausted his administrative remedies.

<sup>246</sup> In the MRVP Order, the Commission noted that Nasdaq proposed that any amendments to IM-9216 made pursuant to a rule filing submitted under Rule 19b-4 of the Act would automatically be deemed a request by Nasdaq for Commission approval of a modification to its MRVP. See MRVP Order, *supra* note 243, at note 6.

<sup>247</sup> See, e.g., BOX Rules, Chapter X, Section 2, and ISE Rule 1614.

<sup>248</sup> 15 U.S.C. 78f(b)(1), 78f(b)(5) and 78f(b)(6).

<sup>249</sup> 15 U.S.C. 78f(b)(7).

<sup>250</sup> 17 CFR 240.19d-1(c)(2).

<sup>251</sup> The period for which updates would be bundled would not have exceeded one second. This rule was based on a similar rule of BOX. See BOX Rules, Chapter V, Section 32.

<sup>252</sup> The ADV refers to the ADV on NOM. Telephone conversation between Heather Seidel, Assistant Director, Division of Trading and Markets, and Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, on January 9, 2008.

<sup>253</sup> This functionality will be applied in real time and will not delay the sending of any messages.

<sup>254</sup> See NOM Rules, Chapter VI, Section 17.

Participant to take steps to reduce the number of its quotes.<sup>255</sup>

The Commission notes that several of the options exchanges have adopted similar rules that provide for the delisting of options classes when the ADV of the class falls below a certain threshold.<sup>256</sup> In addition, Nasdaq's proposal to not disseminate a new bid or offer when the size associated with a bid or offer increases by an amount less than or equal to a percentage (never to exceed 20%) of the size associated with a previously disseminated bid or offer is substantially similar to a Phlx rule previously approved by the Commission.<sup>257</sup> Further, Nasdaq's monitoring strategy is substantially similar to a policy adopted by ISE.<sup>258</sup> The Commission also believes that Nasdaq's proposed "replace on queue" functionality and its proposal to prioritize price update messages and send out price updates before sending size update messages are reasonable measures to attempt to mitigate quote message traffic because they will more efficiently provide for the dissemination of the most recent quote information.

Although Nasdaq's rules do not include a "holdback timer" or similar quote mitigation strategy like those adopted by four of the other options exchanges,<sup>259</sup> the Commission believes that the totality of Nasdaq's proposed

market structure, market making obligations, and quote mitigation strategies are comparable to the quote mitigation efforts of the other options markets. More specifically, Nasdaq has proposed to allow Market Makers to register by series, as opposed to class. As noted above, the Commission believes that this will permit Market Makers to select the options series in which they are most interested. This is designed to reduce the number of quotes submitted by such Market Makers, and therefore likely will help to mitigate NOM's quote message traffic and capacity.<sup>260</sup> In addition, NOM Rules provide that a market maker's continuous quoting obligations will not be applicable in options series until the time to expiration is less than nine months.<sup>261</sup>

Further, Nasdaq has proposed that it will open at least one expiration month for each class of option open for trading on NOM, and a minimum of one series of options in that class.<sup>262</sup> These requirements provide for fewer mandatory expiration months and series than the rules of other options exchanges, and may therefore contribute to less quote message traffic on NOM to the extent that NOM has fewer series open for trading. And, as detailed above, Nasdaq has proposed four quote mitigation strategies, several of which are substantially similar to those in place at other markets.

#### K. Section 11(a) of the Act

Section 11(a)(1) of the Act<sup>263</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)<sup>264</sup> under the Act, 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>265</sup> (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission, Nasdaq requests that the Commission concur with Nasdaq's conclusion that Participants that enter orders into NOM satisfy the requirements of Rule 11a2-2(T).<sup>266</sup> For the reasons set forth below, the Commission believes that Participants entering orders into NOM 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 NOM 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>267</sup> Because the NOM System receives orders electronically through remote terminals or computer-to-computer interfaces, the Commission

<sup>265</sup> The member may, however, participate in clearing and settling the transaction.

<sup>266</sup> See letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, to Nancy M. Morris, Secretary, Commission, dated December 13, 2007 ("Nasdaq 11(a) Letter").

<sup>267</sup> See, e.g., Registration Approval Order, *supra* note 19; BOX Approval Order, *supra* note 72; and Securities Exchange Act Release Nos. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (order approving the Archipelago Exchange as an electronic trading facility of the Pacific Exchange ("PCX")); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (regarding the American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange's Automated Communications and Execution System ("1979 Release")); and 14563 (March 14, 1978) 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

<sup>255</sup> See Amendment No. 2 at 9.

<sup>256</sup> See Securities Exchange Act Release Nos. 55161 (January 24, 2007), 72 FR 4754 (February 1, 2007) (File No. SR-ISE-2006-62) (ISE Penny Pilot Approval Order) (approving ISE policy to delist equity options with an ADV of less than 20 contracts, but noting that ISE's current policy is to do so for options with an ADV of less than 50 contracts); 55162 (January 24, 2007), 72 FR 4738 (February 1, 2007) (File No. SR-Amex-2006-106) (Amex Penny Pilot Approval Order) (approving Amex policy to delist options classes with an ADV of less than 25 contracts); 55154 (January 23, 2007), 72 FR 4743 (February 1, 2007) (File No. SR-CBOE-2006-92) (CBOE Penny Pilot Approval Order) (approving CBOE policy to delist equity option classes with an ADV of less than 20 contracts); and 56154 (July 27, 2007), 72 FR 43303 (August 3, 2007) (File No. SR-CBOE-2007-85) (approving an exception to CBOE's delisting policy if the option class scheduled for delisting experiences a significant increase in trading volume).

<sup>257</sup> See Securities Exchange Act Release No. 55153 (January 23, 2007), 72 FR 4553 (January 31, 2007) (File No. SR-Phlx-2006-74) (order approving, in part, a Phlx rule providing that it will disseminate an updated bid or offer when, among other things, the size associated with it's bid or offer increases by an amount greater than or equal to a percentage (never to exceed 20%)).

<sup>258</sup> See ISE Penny Pilot Approval Order, *supra* note 256. See also CBOE Penny Pilot Approval Order and Amex Penny Pilot Approval Order, *supra* note 256.

<sup>259</sup> See Amex Penny Pilot Approval Order, CBOE Penny Pilot Approval Order, and ISE Penny Pilot Approval Order, *supra* note 256; and Securities Exchange Act Release No. 55155 (January 23, 2007), 72 FR 4741 (February 1, 2007) (File No. SR-BSE-2006-49) (approving BOX's Penny Pilot program).

<sup>260</sup> See *supra* notes 57 to 58 and accompanying text.

<sup>261</sup> See NOM Rules, Chapter IV, Section 8(a). See also CBOE Rule 8.7; PHLX Rule 1014(b)(ii)(D)(4); and Amex Rules 993-ANTE(c)(ii) and 994-ANTE(c)(iv).

<sup>262</sup> See NOM Rules, Chapter IV, Sections 6(b) and 6(e). In Amendment No. 2, Nasdaq proposes to revise Chapter IV, Section 6(b) of the NOM Rules to provide that at the commencement of trading of an options class, NOM will list a minimum of one options series in that class, rather than a minimum of three series for each expiration month in the class, as originally proposed.

<sup>263</sup> 15 U.S.C. 78k(a)(1).

<sup>264</sup> 17 CFR 240.11a2-2(T).

believes that the NOM System satisfies the off-floor transmission requirement.

Second, the Rule requires that the member not participate in the execution of its order. Nasdaq represented that at no time following the submission of an order is a Participant able to acquire control or influence over the result or timing of an order's execution. According to Nasdaq, the execution of a member's order is determined solely by what other orders, bids, or offers are present in the NOM System at the time the Participant submits the order and on the priority of those orders, bids, and offers.<sup>268</sup> Accordingly, the Commission believes that a Participant does not participate in the execution of an order submitted to the NOM 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 the NOM System, 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>269</sup> Nasdaq has represented that the design of the NOM System ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to the Exchange.<sup>270</sup> Based on Nasdaq's representation, the Commission believes that the NOM System satisfies this requirement.

Fourth, in the case of a transaction effected for an account with respect to

<sup>268</sup> See Nasdaq 11(a) Letter, *supra* note 266, at 7. The Participant 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 1978 Release, *supra* note 267 (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").

<sup>269</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 systems. 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 267.

<sup>270</sup> See Nasdaq 11(a) Letter, *supra* note 266, at 8.

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>271</sup> Nasdaq represents that Participants trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.<sup>272</sup>

### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 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-NASDAQ-2007-004 on the subject line.

#### *Paper Comments*

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

All submissions should refer to File Number SR-NASDAQ-2007-004. 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

<sup>271</sup> 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 267 (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>272</sup> See Nasdaq 11(a) Letter, *supra* note 266, at 8.

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 inspection and copying in the Commission's Public Reference Room, 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 filing also will be available for inspection and copying at the principal office of the Amex. 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-NASDAQ-2007-004 and should be submitted on or before April 8, 2008.

### IV. Exemption From Section 19(b) of the Act With Regard to CBOE, NYSE, and FINRA Rules Incorporated by Reference

Nasdaq proposes to incorporate by reference as NOM Rules certain rules of the CBOE, NYSE, and FINRA.<sup>273</sup> Thus, for certain NOM rules, NOM members will comply with a NOM rule by complying with the CBOE, NYSE, or FINRA rule referenced. In connection with its proposal to incorporate CBOE, NYSE, and FINRA rules by reference, Nasdaq requested, pursuant to Rule

<sup>273</sup> Specifically, Nasdaq proposes to incorporate by reference: (1) CBOE rules governing position and exercise limits for equity and index options, which are cross-referenced in Chapter III, Sections 7 and 9 of the NOM Rules and Chapter XIV, Sections 5 and 7 of the NOM Rules, respectively; (2) the margin rules of the CBOE or the NYSE, which are referenced in Chapter XIII, Section 3 of the NOM Rules; and (3) FINRA's rules governing communications with the public, which are referenced in Chapter XI, Section 22 of the NOM Rules. With respect to position limits, one commenter believes that each options exchange should be required to develop its own expertise and establish specific requirements in its own rules to provide for proper disclosure to members and to further the exchange's compliance and surveillance functions. See Amex Letter, *supra* note 4, at 4. Nasdaq believes that its reliance on the position and exercise limit rules of CBOE assures equal regulation among markets. See Nasdaq Response, *supra* note 5, at 2. The Commission does not believe that requiring each options exchange to develop its own position limits would promote the efficient use of SRO and Commission resources. In addition, as discussed below, Nasdaq will notify Participants whenever the CBOE proposes to change a position limit rule that has been incorporated by reference into the NOM Rules.

240.0–12,<sup>274</sup> an exemption under Section 36 of the Act from the rule filing requirements of Section 19(b) of the Act for changes to those NOM rules that are effected solely by virtue of a change to a cross-referenced CBOE, NYSE, or FINRA rule.<sup>275</sup> Nasdaq proposes to incorporate by reference categories of rules (rather than individual rules within a category) that are not trading rules. Nasdaq agrees to provide written notice to Participants prior to the launch of NOM of the specific CBOE, NYSE, and FINRA rules that it will incorporate by reference.<sup>276</sup> In addition, Nasdaq will notify Participants whenever CBOE, NYSE, or FINRA proposes a change to a cross-referenced CBOE, NYSE, or FINRA rule.<sup>277</sup>

Using its authority under Section 36 of the Act, the Commission previously exempted certain SROs from the requirement to file proposed rule changes under Section 19(b) of the Act.<sup>278</sup> Each such exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify its rules.

In addition, each SRO incorporated by reference only regulatory rules (*e.g.*, margin, suitability, arbitration), not trading rules, and incorporated by reference whole categories of rules (*i.e.*, did not “cherry-pick” certain individual rules within a category). Each exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is proposed to the incorporated rules of another SRO in order to provide its members with notice of a proposed rule change that affects their interests, so that they would have an opportunity to comment on it.

The Commission is granting Nasdaq’s request for exemption, pursuant to Section 36 of the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that

Nasdaq proposes to incorporate by reference into NOM’s Rules.<sup>279</sup> This exemption is conditioned upon Nasdaq providing written notice to NOM participants whenever the CBOE, NYSE, or FINRA proposes to change a rule that NOM has incorporated by reference. The Commission believes that this exemption is appropriate in the public interest and consistent with the protection of investors because it will promote more efficient use of Commission and SRO resources by avoiding duplicative rule filings based on simultaneous changes to identical rule text sought by more than one SRO. Consequently, the Commission grants Nasdaq’s exemption request for NOM.

#### V. Exemption From the Requirement To Register as a SIP

As described above, NOM LLC will be delegated the authority to act as a SIP for quotations and transaction information related to securities traded on NOM and any trading facilities operated by NOM LLC. In a letter dated December 13, 2007 (“Request Letter”)<sup>280</sup> submitted in conjunction with Nasdaq’s proposal, Nasdaq, on behalf of NOM LLC, requested that the Commission grant NOM LLC a permanent exemption from the requirement under Section 11A(b) of the Act and Rule 609 thereunder that a securities information processor acting as an exclusive processor register with the Commission.<sup>281</sup> For the reasons discussed below, the Commission grants the requested exemption, subject to the conditions specified in this order.

##### A. Overview

Pursuant to Nasdaq’s proposal being approved today, NOM LLC will be a wholly owned subsidiary, established for the purpose of operating a Nasdaq facility for the trading of options. Nasdaq will delegate the performance of certain of its market functions to NOM LLC with respect to the quoting and trading of options, including the authority to act as a securities information processor for quoting and trading information related to options traded on NOM and any trading facilities operated by NOM LLC.

<sup>279</sup> As discussed above, Nasdaq has represented that it will notify Participants whenever the CBOE, NYSE, or FINRA proposes a change to a cross-referenced CBOE, NYSE, or FINRA rule. *See supra* note 277 and accompanying text.

<sup>280</sup> *See* letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Dr. Erik Sirri, Director, Division of Trading and Markets, Commission, dated December 13, 2007.

<sup>281</sup> 15 U.S.C. 78k–1(b), Rule 609 under the Act, 17 CFR 242.609, requires that the registration of a securities information processor be on Form SIP, 17 CFR 249.1001.

Because NOM LLC will be engaging, on an exclusive basis on behalf of Nasdaq, in collecting, processing, or preparing for distribution or publication information with respect to transactions or quotations on, or effected or made by means of, a facility of Nasdaq, it will be an exclusive processor required to register pursuant to Section 11A(b) of the Act. Nevertheless, as further described in the Request Letter, Nasdaq and NOM LLC believe that the purposes of Section 11A(b) of the Act are not served by requiring NOM LLC to register as an exclusive processor under Section 11A(b) of the Act because Section 11A(b) subjects registered securities information processor to a regulatory regime to which NOM will be subject in all material respects as a facility of a registered national securities exchange.

##### B. Discussion

Sections 11A(b)(1) and (2) of the Act and Rule 609 thereunder (formerly Rule 11Ab2–1) provide that a securities information processor<sup>282</sup> that is acting as an exclusive processor<sup>283</sup> register with the Commission by filing an application for registration on Form SIP. Section 11A(b)(1) of the Act and Rule 609(c) thereunder allow the Commission, by rule or order, to conditionally or unconditionally exempt any securities information processor from any provision of Section 11A(b) of the Act or the rules or regulations thereunder, if the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of Section 11A(b).<sup>284</sup>

<sup>282</sup> Section 3(a)(22) of the Act, 15 U.S.C. 78c(a)(22)(A), defines the term securities information processor to mean any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations.

<sup>283</sup> Under Section 3(a)(22)(B) of the Act, 15 U.S.C. 78c(a)(22)(B), an exclusive processor is defined as any securities information processor or self-regulatory organization which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities association, or any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf, in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association.

<sup>284</sup> *See* 15 U.S.C. 78k–1(b)(1) and 17 CFR 242.609(c).

<sup>274</sup> 17 CFR 240.0–12.

<sup>275</sup> *See* letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, to Nancy Morris, Secretary, Commission, dated December 13, 2007 (“Nasdaq 19(b) Exemption Letter”).

<sup>276</sup> *See* Nasdaq 19(b) Exemption Letter, *supra* note 275, at 2.

<sup>277</sup> NOM will provide such notice through a posting on the same web site location where NOM will post its own rule filings pursuant to Rule 19b–4(l) under Act, within the time frame required by that Rule. The web site posting will include a link to the location on the CBOE, NYSE, or FINRA web site where those SROs’ proposed rule changes are posted. *See* Nasdaq 19(b) Exemption Letter, *supra* note 275, at note 4 and accompanying text.

<sup>278</sup> *See* Securities Exchange Act Release No. 49260 (February 17, 2004), 69 FR 8500 (February 24, 2004). *See also* Registration Approval Order, *supra* note 19.

In its release adopting Rule 609, the Commission provides a framework for the consideration of exemption requests pursuant to Section 11A(b)(1) of the Act.<sup>285</sup> Specifically, the Commission indicates that the need for registration of an exclusive processor should be considered in respect of Sections 11A(b)(1), (b)(3) and (b)(5) and Sections 17(a) and (b) of the Act, insofar as they provide a framework for the surveillance and regulation of registered securities information processors. The Commission stated that any application for an exemption from registration should show not only how such exemption would be consistent with the statutory purposes discussed in the release, but also should demonstrate why, by virtue of the applicant's organization, operation or other characteristics, the applicant should be exempted from registration, the requirements of Section 11A(b) and the Commission's authority under Sections 17(a) and 17(b) of the Act.<sup>286</sup>

The Commission believes that NOM LLC will be acting as an exclusive processor as defined in Section 3(a)(22)(B) of the Act because it will engage on an exclusive basis on behalf of Nasdaq, in collecting, processing, or preparing for distribution or publication information with respect to transactions or quotations on, or effected or made by means of, a facility of Nasdaq. Further, NOM LLC, in carrying out market functions of Nasdaq, will operate (and will be regulated) as a facility of Nasdaq, which is a national securities exchange registered under Section 6 of the Act and the rules and regulations thereunder.<sup>287</sup> In the Request Letter, Nasdaq represents that NOM LLC will not perform any exclusive processor functions other than in its capacity as a facility for Nasdaq.<sup>288</sup>

As discussed below, with respect to its operation as a facility of a registered national securities exchange, NOM LLC already will be subject to regulation and Commission oversight under the Act as

a facility of a registered exchange.<sup>289</sup> Oversight and regulation of registered exchanges encompass and exceed the oversight and regulation to which NOM LLC will be subject pursuant to registration under Section 11A(b)(1) of the Act and the rules and regulations thereunder. Accordingly, the Commission believes that registration of NOM LLC as an exclusive processor under Section 11A(b)(1) of the Act with respect to those functions that it will carry out as a facility of Nasdaq would not further the purposes of the Act.

#### 1. Denial of Access to Services Provided by a Securities Information Processor or a National Securities Exchange

Section 11A(b)(5)(A) of the Act (1) requires a registered securities information processor to promptly file notice with the Commission if the processor prohibits or limits any person in respect of access to services offered, directly or indirectly, by the processor, and (2) provides that any such prohibition or limitation will be subject to Commission review, on its own motion or upon application by any person aggrieved.<sup>290</sup> If the prohibition or limitation is reviewed, the Commission shall dismiss the proceeding if it finds (after notice and opportunity of a hearing) that such prohibition or limitation is consistent with the provisions of the Act and the rules and regulations thereunder and that such person has not been discriminated against unfairly. If the Commission does not make such a finding, or if it finds that such prohibition or limitation imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Act, the Commission shall set aside the prohibition or limitation and require the securities information processor to permit such person access to services offered by the processor.<sup>291</sup>

NOM LLC, however, will be subject to similar Commission regulation and oversight pursuant to Sections 6(b)(7), 6(d), 19(d), and 19(f) of the Act with respect to its activities as a facility of Nasdaq.<sup>292</sup> Section 19(d)(1) requires, in part, that an exchange promptly file notice with the Commission if the exchange prohibits or limits any person

in respect to access to services offered by such exchange or member thereof.<sup>293</sup> Any such action for which the exchange must file notice is subject to Commission review.<sup>294</sup>

Section 19(f) of the Act, among other things, allows the Commission to set aside an SRO's prohibition or limitation with respect to access to services offered by the SRO if the Commission finds that the prohibition or limitation imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

Section 6(b)(7) of the Act provides that the rules of an exchange, among other things, must provide a fair procedure for the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof.<sup>295</sup>

Section 6(d) of the Act requires, among other things, that a national securities exchange that initiates a proceeding to determine whether to prohibit or limit a person's access to services offered by the exchange notify the person of the specific grounds for the prohibition or limitation and provide an opportunity to be heard. In addition, Section 6(d) provides that an exchange's determination to prohibit or limit a person's access to the exchange's services must be supported by a statement setting for the specific grounds on which the prohibition or limitation is based.

The Commission therefore believes that regulation of Nasdaq as a national securities exchange provides for equivalent regulation and Commission oversight of actions that NOM LLC may take in its capacity as a facility to deny access to services as would be the case were it to register as an exclusive processor under Section 11A(b) of the Act.

#### 2. Limitation on Activities of a Securities Information Processor or a National Securities Exchange

Section 11A(b)(6) of the Act grants the Commission authority to censure or place limitations on the activities, functions, or operations of any registered securities information processor or suspend for a period not exceeding twelve months or revoke the registration of any such processor.<sup>296</sup> Likewise, Section 19(h)(1) of the Act grants the Commission authority to

<sup>285</sup> See Securities Exchange Act Release No. 11673 (September 23, 1975), 40 FR 45422 (October 2, 1975) (adopting Commission Rule 11Ab2-1, which has been redesignated as Rule 609).

<sup>286</sup> *Id.* at 45423.

<sup>287</sup> Section 3(a)(2) of the Act, 15 U.S.C. 78c(a)(2), defines the term facility, with respect to an exchange, to include its premises, tangible or intangible property whether on the premises or not, any right to use such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.

<sup>288</sup> Request Letter, *supra* note 280, at 3.

<sup>289</sup> The definition of an exchange under the Act includes "the market facilities maintained by such exchange." See Section 3(a)(1) of the Act, 15 U.S.C. 78c(a)(1). The functions and operation of a national securities exchange encompass the collection, processing, and dissemination of information related to securities trading.

<sup>290</sup> See 15 U.S.C. 78k-1(b)(5)(A).

<sup>291</sup> See Section 11A(b)(5)(B) under the Act, 15 U.S.C. 78k-1(b)(5)(B).

<sup>292</sup> 15 U.S.C. 78f(b)(7) and (d) and 78s(d) and (f).

<sup>293</sup> 15 U.S.C. 78s(d)(1).

<sup>294</sup> 15 U.S.C. 78s(d)(2). See also Section 19(f) of the Act, 15 U.S.C. 78s(f).

<sup>295</sup> 15 U.S.C. 78f(b)(7). Section 6(d)(2), 15 U.S.C. 78f(d)(2), provides procedural requirements for any such proceeding by an exchange.

<sup>296</sup> 15 U.S.C. 78k-1(b)(6).

suspend for a period not exceeding twelve months or revoke the registration of an exchange, or to censure or impose limitations upon the activities, functions, and operations of an exchange.<sup>297</sup> The Commission therefore has the authority to place limitations on the activities of NOM LLC as a facility of a registered national securities exchange.

### 3. Access to Books and Records of a Securities Information Processor or a National Securities Exchange

Section 17(a)(1) of the Act requires that national securities exchanges and registered securities information processors make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.<sup>298</sup> Section 17(b) of the Act requires that such records be subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission and the appropriate regulatory agency for such persons.<sup>299</sup>

The record retention and production requirements set out in Sections 17(a) and (b) of the Act therefore will be applicable to NOM LLC with respect to its activities as a facility of Nasdaq. Thus, requiring NOM LLC to register as an exclusive processor with respect to its activities as a facility of a registered exchange would serve no additional regulatory purpose in this instance.

### C. Conclusion

On the basis of the foregoing, the Commission finds that, with respect to its activities as a facility of Nasdaq, granting an exemption to NOM LLC

<sup>297</sup> 15 U.S.C. 78s(h)(1). See also Sections 19(h)(2), (h)(3), and (h)(4) of the Act, 15 U.S.C. 78s(h)(2), (h)(3), and (h)(4).

<sup>298</sup> 15 U.S.C. 78q(a). The Commission has promulgated rules pursuant to Section 17(a) of the Act that apply to national securities exchanges, but not registered securities information processors. See, e.g., Rule 17a-1 under the Act, 17 CFR 240.17a-1 (requiring in part a national securities exchange to preserve, for a period of not less than five years, the first two in an easily accessible place, at least one copy of all documents that are made or received by it in the course of its business as such and in the conduct of its self-regulatory activity, and to furnish copies of such records to any representative of the Commission upon request). Form SIP, the application for registration of a securities information processor, does require that a securities information processor provide the Commission with certain information relating to its business organization, financial information, operational capability, and access to services. 17 CFR 249.1001.

<sup>299</sup> 15 U.S.C. 78q(b).

from the requirement to register as a securities information processor pursuant to Section 11A(b) of the Act is consistent with the public interest, the protection of investors, and the purposes of Section 11A(b) of the Act, including maintenance of fair and orderly markets in securities and the removal of impediments to, and perfection of the mechanism of, a national market system. This exemption is limited only to the exclusive processor activities that NOM LLC performs as a facility of Nasdaq.

### VI. Accelerated Approval of the Trading Rules Proposal, as Amended

The Commission finds good cause for approving the Trading Rules Proposal, as amended, prior to the thirtieth day after the date of publication of notice of filing of the amended proposal in the **Federal Register**.

As discussed above, the Commission believes that the changes proposed in Amendment No. 2 strengthen and clarify the Trading Rules Proposal. In addition to making non-substantive and technical changes, Amendment No. 2 incorporates changes designed to make NOM's rules consistent with or substantially similar to rules adopted by the other options exchanges or the provisions of the Linkage Plan.<sup>300</sup> Other changes in Amendment No. 2 are designed to clarify NOM's rules,<sup>301</sup> provide additional protections,<sup>302</sup>

<sup>300</sup> See, e.g., the addition of rules in Chapter II providing for registration as a Limited Principal and as a Limited Representative in options and security futures; changes in Chapter IV, Section 3, to allow NOM to list an option that does not meet its initial listing standards if the option is listed on another national securities exchange and meets certain other conditions (see *supra* notes 220 to 221 and accompanying text); changes to Chapter IV, Commentaries .02 and .03, relating to the \$1 Strike Price Program and the \$2.50 Strike Price Program, respectively (see *supra* notes 208 to 213 and accompanying text); changes to the obvious error provisions of Chapter V, Section 6 (see *supra* note 168 and accompanying text); and changes to various provisions of the Intermarket Linkage Rules in Chapter XII to require a response time of five seconds rather than three seconds.

<sup>301</sup> See, e.g., revisions to Nasdaq IM-9216 to include Chapter X, Section 7 of the NOM Rules in Nasdaq's MRVP (see *supra* notes 243 to 249 and accompanying text); changes to Chapter I, Section 1 to clarify the definition of "primary market;" changes to Chapter III, Section 15 to clarify that the provisions of the rule apply only to options clearing Participants; changes to Chapter VI, Section 10 to more clearly articulate NOM's price/time execution algorithm; the deletion of a proposed provision in Chapter VII relating to short sales by options market makers; and changes to Chapter VIII, Sections 1(b) and 1(d) to require Participants to submit contrary exercise advices to the Options Clearing Corporation rather than to NOM.

<sup>302</sup> See, e.g., changes to Chapter III, Section 4(f) to prohibit a Participant with knowledge of an order being facilitated or submitted to NOM for price improvement (e.g., price improving orders) from entering an order to buy or sell the underlying

address non-substantive issues or address concerns raised by commenters.<sup>303</sup> For these reasons, the Commission finds good cause for approving the Trading Rules Proposal, as amended, on an accelerated basis, pursuant to Section 19(b)(2) of the Act.

### VII. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>304</sup> that the Trading Rules Proposal (SR-NASDAQ-2007-004), as amended, be, and hereby is, approved on an accelerated basis, except for the \$1 Strike Price Program, which is approved on a pilot basis through June 5, 2008; and that the Corporate Structure Proposal (SR-

security, as provided in the rule; a modification to the position and exercise limits in Chapter III, Sections 7 and 9 to clarify that the incorporation of CBOE rules applies to the trading of options listed on both CBOE and Nasdaq; modifications to the Closing Cross procedures in Chapter VI, Section 9 that, among other things, provide that the Current Reference Price and the Near Clearing Price will be disseminated in an option's minimum price variation and never at a price that would expose undisplayed interest on the NOM book (see *supra* notes 162 to 164 and accompanying text); additions to Chapter VI, Section 11 relating to NOS as a facility of Nasdaq, which, among other things, require that an SRO other than Nasdaq be the designated examining authority for NOS, and that NOM establish procedures and controls designed to restrict the flow of confidential and proprietary information between Nasdaq and its facilities, including NOS (see *supra* notes 187 to 191 and accompanying text); the addition to Chapter VI, Section 11 of a requirement that Participants whose orders are routed to away markets honor such trades to the same extent that they would be obligated to honor a trade executed on NOM; a change to Chapter XI, Section 21 to state that a Participant must expedite the transfer of a customer's account pursuant to Nasdaq Rules IM-2110-7 and 11870; changes to Chapter XIV to add position limit provisions for Micro-Narrow Based Index options and to refer to the applicable NOM rules for position limits on broad-based index options traded on NOM but not on the CBOE.

<sup>303</sup> See, e.g., the proposed change to eliminate Non-Displayed Orders (see *supra* notes 100 to 102 and accompanying text); the revised definition of "index option" (see *supra* note 219); the changes in Chapter IV, Section 5 to clarify NOM's procedures and status with respect to the Linkage Plan when an options class that has been approved for listing on NOM has no series open for trading, and when the sole Market Maker in a series withdraws its registration (see *supra* notes 78 to 79 and accompanying text); the changes in Chapter VI to clarify the definitions and order routing procedures for "System Securities" and "Non-System Securities" (see *supra* notes 183 to 186 and accompanying text); the clarification in Chapter VI, Section 9 of the time of the Closing Cross for options on fund shares and broad-based indexes (see *supra* notes 147 to 149 and accompanying text); the change in Chapter VI, Section 10, to identify the taker of liquidity as the party that removes liquidity previously posted to the Book; and the change in Chapter VII, Section 12, Commentary .04 to indicate that a Participant may not inform another Participant or other third party of any of the terms of an order after submitting the order to NOM.

<sup>304</sup> 15 U.S.C. 78s(b)(2).

NASDAQ-2007-080) be, and hereby is, approved.

Although the Commission's approval of the Trading Rules Proposal, as amended, and the Corporate Structure Proposal is final and the proposed rules are therefore effective,<sup>305</sup> it is further ordered that the operation of NOM is conditioned on the satisfaction of the requirements below:

*A. Participation in National Market System Plans Relating to Options Trading.* Nasdaq must join the Options Price Reporting Authority; the OLPP; the Linkage Plan; and the National Market System Plan of the Options Regulatory Surveillance Authority.

*B. Examination by the Commission.* Nasdaq must have, and represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations ("OCIE") that it has, adequate surveillance procedures and programs in place to effectively regulate NOM.

*C. Delegation Agreement.* Nasdaq and NOM LLC must enter into the Delegation Agreement as described above.<sup>306</sup>

*It is further ordered,* pursuant to Section 11A(b) of the Act,<sup>307</sup> that NOM LLC shall be exempt from registering as a securities information processor, subject to the conditions specified in this order.

*It is further ordered,* pursuant to Section 36 of the Act,<sup>308</sup> that Nasdaq shall be exempt from the rule filing requirements of Section 19(b) of the Act<sup>309</sup> with respect to the rules that Nasdaq proposes to incorporate by reference into NOM's Rules, subject to the conditions specified in this order.

By the Commission.

**Nancy M. Morris,**

Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-57469; File No. SR-NYSEArca-2008-08]

### Self-Regulatory Organizations; NYSE Arca, Inc.; Order Approving Proposed Rule Change Pertaining to the Imposition of Fines for Minor Rule Violations

March 11, 2008.

On January 18, 2008, NYSE Arca, Inc. ("NYSE Arca" 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 amend NYSE Arca Rule 6.24, "Exercise of Options Contracts," and NYSE Arca Rule 10.12 "Minor Rule Plan." The proposed rule change was published for comment in the **Federal Register** on February 5, 2008.<sup>3</sup> The Commission received no comments regarding the proposal. This order approves the proposed rule change.

NYSE Arca Rule 6.24 contains special procedures that apply to the exercise of options on the last business day before expiration. The Exchange proposes to amend NYSE Arca Rule 6.24 to: (i) Add a reference to new terminology; (ii) make minor revisions to the procedures related to exercising option contracts; (iii) amend Commentary .08 of NYSE Arca Rule 6.24 to authorize the Exchange to sanction an OTP Holder or OTP Firm that fails to follow NYSE Arca Rule 6.24, pursuant to the Minor Rule Plan ("MRP"); and (iv) add the recommended sanctions to the MRP contained in NYSE Arca Rule 10.12.

An option holder desiring to exercise or not exercise expiring options must either: (i) take no action and allow exercise determinations to be made in accordance with the Options Clearing Corporation's ("OCC") Ex-by-Ex procedures, where applicable; or (ii) submit a Contrary Exercise Advice ("CEA") to the Exchange.<sup>4</sup> A CEA is also referred to within the options industry as an Expiring Exercise Declaration ("EED"). While the form itself may be called by a different name, the purpose and procedure for submitting an EED is identical to that of a CEA. Therefore, the Exchange proposes adding a

parenthetical reference to EEDs within NYSE Arca Rule 6.24.

An OTP Holder or OTP Firm that manually submits a CEA to the Exchange does so by completing a form and putting it in the Exchange's Contrary Exercise Advice Box. Going forward, the Exchange will discontinue the use of the Contrary Exercise Advice Box; and instead, an OTP Holder or OTP Firm will submit a CEA directly to a designated representative of the Exchange's Options Surveillance Department.

Commentary .08 to NYSE Arca Rule 6.24 provides that the failure of any OTP Holder to follow the provisions contained in this rule may be referred to the Ethics and Business Conduct Committee ("EBCC") and result in the assessment of a fine, which may include, but is not limited to, the disgorgement of potential economic gain obtained or loss avoided by the subject exercise. Referral to the EBCC involves a formal disciplinary proceeding. NYSE Arca proposes to add a provision to Commentary .08 that would authorize the Exchange to sanction an OTP Holder or OTP Firm that fails to follow NYSE Arca Rule 6.24, pursuant to the MRP. The Exchange would retain the authority to refer violators to the EBCC for formal disciplinary proceedings.

The Exchange also proposes adding the phrase "or OTP Firm" to Commentary .08 to NYSE Arca Rule 6.24. The Exchange has always intended to apply NYSE Arca Rule 6.24 equally to both OTP Holders and OTP Firms. The addition of OTP Firms will codify the original intent of the NYSE Arca Rule 6.24.

Under this proposal, violators of the NYSE Arca Rule 6.24 may be subject to MRP fines based on the number of violations occurring within a rolling 24-month period. An individual OTP Holder would be subject to a fine of \$500 for the first offense, \$1,000 for the second offense, and \$2,500 for the third offense. An OTP Firm would be subject to a \$1,000 fine for the first offense, \$2,500 for the second offense, and \$5,000 for a third offense.<sup>5</sup> A list of the proposed fines would be added to the MRP fine schedule in NYSE Arca Rule 10.12. The addition of a sanction under the MRP adds an additional method for disciplining violators of NYSE Arca Rule 6.24.<sup>6</sup> The Exchange submits that

<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. 57220 (January 29, 2008), 73 FR 6757.

<sup>4</sup> A CEA is a communication to either: (i) Not exercise an option that would be automatically exercised under OCC's Ex-by-Ex procedure, or (ii) exercise an option that would not be automatically exercised under OCC's Ex-by-Ex procedure.

<sup>5</sup> The Exchange, in its discretion, processes subsequent violations, after the third violation, according to NYSE Arca Rule 10.4. See NYSE Arca Rule 10.12(h), n.1.

<sup>6</sup> In addition, as a member of the Intermarket Surveillance Group, the Exchange, as well as certain other self-regulatory organizations ("SROs")

<sup>305</sup> As noted above, the \$1 Strike Price Program, which is part of the Trading Rules Proposal, is approved on a pilot basis through June 5, 2008.

<sup>306</sup> See *supra* note 15 and accompanying text.

<sup>307</sup> 15 U.S.C. 78k-1(b).

<sup>308</sup> 15 U.S.C. 78mm.

<sup>309</sup> 15 U.S.C. 78s(b).