

Exchange in maintaining a fair and orderly market by allowing market participants who agree to cancel a transaction to do so more efficiently, thereby potentially reducing the likelihood that transactions will be printed to the Tape incorrectly. Therefore, the Commission designates the proposal operative upon filing.<sup>10</sup>

At any time within 60 days of the filing of such proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### IV. Solicitation of Comments

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

##### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NYSEMKT-2012-15 on the subject line.

##### Paper Comments

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

All submissions should refer to File Number SR-NYSEMKT-2012-15. This file number should be included on the subject line if email 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 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 Web site viewing and

<sup>10</sup> For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rules impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

printing 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 Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File Number SR-NYSEMKT-2012-15 and should be submitted on or before July 31, 2012.

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

Kevin M. O'Neill,  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-67347; File Nos. SR-NYSE-2011-55; SR-NYSEAmex-2011-84]

### Self-Regulatory Organizations; New York Stock Exchange LLC; NYSE Amex LLC; Order Granting Approval to Proposed Rule Changes, as Modified by Amendments Nos. 1 and 2, Adopting NYSE Rule 107C To Establish a Retail Liquidity Program for NYSE-Listed Securities on a Pilot Basis Until 12 Months From Implementation Date, and Adopting NYSE Amex Rule 107C To Establish a Retail Liquidity Program for NYSE Amex Equities Traded Securities on a Pilot Basis Until 12 Months From Implementation Date, and Granting Exemptions Pursuant to Rule 612(c) of Regulation NMS

July 3, 2012.

#### I. Introduction

On October 19, 2011, the New York Stock Exchange LLC ("NYSE") and NYSE Amex LLC ("NYSE Amex" and together with NYSE, the "Exchanges") each 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 establish a Retail Liquidity Program ("Program") on a pilot basis for a period of one year from the date of implementation, if

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

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

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

approved. The proposed rule changes were published for comment in the **Federal Register** on November 9, 2011.<sup>3</sup> The Commission received 28 comments on the NYSE proposal<sup>4</sup> and 4 comments on the NYSE Amex proposal.<sup>5</sup> On December 19, 2011, the Commission extended the time for Commission action on the proposed rule changes until February 7, 2012.<sup>6</sup> In connection

<sup>3</sup> See Securities Exchange Act Release Nos. 65671 (November 2, 2011), 76 FR 69774 (SR-NYSE Amex-2011-84); and 65672 (November 2, 2011), 76 FR 69788 (SR-NYSE-2011-55).

On May 14, 2012, NYSE Amex filed a proposed rule change, immediately effective upon filing, to change its name to NYSE MKT LLC. See SR-NYSEAmex-2012-32. To remain consistent with the previous documents that were submitted in connection with these proposals, the Commission will refer to NYSE MKT LLC as NYSE Amex throughout this order.

<sup>4</sup> See Letters to the Commission from Sal Arnuk, Joe Saluzzi and Paul Zajac, Themis Trading LLC, dated October 17, 2011 ("Themis Letter"); Garret Cook, dated November 4, 2011 ("Cook Letter"); James Johannes, dated November 27, 2011 ("Johannes Letter"); Ken Voorhies, dated November 28, 2011 ("Voorhies Letter"); William Wuepper, dated November 28, 2011 ("Wuepper Letter"); A. Joseph, dated November 28, 2011 ("Joseph Letter"); Leonard Amoroso, General Counsel, Knight Capital, Inc., dated November 28, 2011 ("Knight Letter I"); Kevin Basic, dated November 28, 2011 ("Basic Letter"); J. Fournier, dated November 28, 2011 ("Fournier Letter"); Ulrich Fischer, CTO, PairCo, dated November 28, 2011 ("PairCo Letter"); James Angel, Associate Professor of Finance, McDonough School of Business, Georgetown University, dated November 28, 2011 ("Angel Letter"); Jordan Wollin, dated November 29, 2011 ("Wollin Letter"); Aaron Schafter, President, Great Mountain Capital Management LLC, dated November 29, 2011 ("Great Mountain Capital Letter"); Wayne Koch, Trader, Bright Trading, dated November 29, 2011 ("Koch Letter"); Kurt Schact, CFA, Managing Director, and James Allen, CFA, Head, Capital Markets Policy, CFA Institute, dated November 30, 2011 ("CFA Letter I"); David Green, Bright Trading, dated November 30, 2011 ("Green Letter"); Robert Bright, Chief Executive Officer, and Dennis Dick, CFA, Market Structure Consultant, Bright Trading LLC, dated November 30, 2011 ("Bright Trading Letter"); Bodil Jelsness, dated November 30, 2011 ("Jelsness Letter"); Christopher Nagy, Managing Director, Order Routing and Market Data Strategy, TD Ameritrade, dated November 30, 2011 ("TD Ameritrade Letter"); Laura Kenney, dated November 30, 2011 ("Kenney Letter"); Suhas Daftuar, Hudson River Trading LLC, dated November 30, 2011 ("Hudson River Trading Letter"); Bosier Parsons, Bright Trading LLC, dated November 30, 2011 ("Parsons Letter"); Mike Stewart, Head of Global Equities, UBS, dated November 30, 2011 ("UBS Letter"); Dr. Larry Paden, Bright Trading, dated December 1, 2011 ("Paden Letter"); Thomas Dercks, dated December 1, 2011 ("Dercks Letter"); Eric Swanson, Secretary, BATS Global Markets, Inc., dated December 6, 2011 ("BATS Letter"); Ann Vlcek, Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated December 7, 2011 ("SIFMA Letter I"); and Al Patten, dated December 29, 2011 ("Patten Letter").

<sup>5</sup> See Knight Letter I; CFA Letter I; TD Ameritrade Letter; and letter to the Commission from Shannon Jennewein, dated November 30, 2011 ("Jennewein Letter").

<sup>6</sup> See Securities Exchange Act Release No. 66003, 76 FR 80445 (December 23, 2011).

with the proposals, the Exchanges requested exemptive relief from Rule 612 of Regulation NMS,<sup>7</sup> which among other things prohibits a national securities exchange from accepting or ranking orders priced greater than \$1.00 per share in an increment smaller than \$0.01.<sup>8</sup> The Exchanges submitted a consolidated response letter on January 3, 2012.<sup>9</sup> On January 17, 2012, the Exchanges each filed Amendment No. 1 to their proposals.<sup>10</sup>

On February 7, 2012, the Commission instituted proceedings to determine whether to disapprove the proposed rule changes, as modified by Amendments No. 1.<sup>11</sup> On February 16, 2012, the Exchanges each filed Amendment No. 2 to their proposals, which the Commission published for comment in the **Federal Register** on March 1, 2012.<sup>12</sup> In response to the Order Instituting Proceedings and the Notice of Amendments No. 2, the Commission received four additional comment letters on the proposals.<sup>13</sup> On

March 20, 2012, the Exchanges submitted a consolidated response letter to the Commission's Order Instituting Proceedings.<sup>14</sup> Additionally, on April 10, 2012, the Exchanges submitted a consolidated response to the comments concerning Amendments No. 2.<sup>15</sup> Finally, on April 11, 2012, the Exchanges submitted a letter requesting that the staff of the Division of Trading and Markets not recommend any enforcement action under Rule 602 of Regulation NMS ("Quote Rule") based on the Exchanges' and liquidity providers' participation in the Program ("No-Action Request Letter").<sup>16</sup>

This order approves the proposed rule change, as modified by Amendments Nos. 1 and 2, and grants exemptions from the Sub-Penny Rule sought by the Exchanges in relation to the proposed rule changes.

## II. Description of the Proposals

The Exchanges are proposing to establish a Program on a pilot basis to attract retail order flow to the NYSE for NYSE-listed securities, and to NYSE Amex for NYSE Amex-listed securities as well as securities listed on the NASDAQ Stock Market LLC ("Nasdaq") and traded pursuant to unlisted trading privileges ("UTP"). The proposed Program would allow such order flow to receive potential price improvement, and would be limited to trades occurring at prices equal to or greater than \$1.00 per share.

Under the proposed Program, a new class of market participants called Retail Liquidity Providers would be able to provide potential price improvement, in the form of a non-displayed order that is priced better than the Exchange's best protected bid or offer ("PBBO"),<sup>17</sup>

Institute, dated March 21, 2012 ("CFA Letter II"); Ann Vleck, Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated March 23, 2012 ("SIFMA Letter II"); and Jim Toes, President and CEO, and Jennifer Green Setzenfand, Chairman, Security Traders Association, dated April 26, 2012 ("STA Letter").

<sup>14</sup> See Letter to the Commission from Janet McGinnis, Senior Vice President, Legal & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated March 20, 2012 ("Exchanges' Response Letter II").

<sup>15</sup> See Letter to the Commission from Janet McGinnis, Senior Vice President, Legal & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated April 10, 2012 ("Exchanges' Response Letter III").

<sup>16</sup> See Letter from Janet M. McGinnis, Senior Vice President-Legal and Corporate Secretary, Office of the General Counsel, NYSE Euronext to Robert Cook, Director, Division of Trading and Markets, dated April 11, 2012.

<sup>17</sup> The terms protected bid and protected offer would have the same meaning as defined in Rule 600(b)(57) of Regulation NMS. Rule 600(b)(57) of Regulation NMS defines "protected bid" and "protected offer" as "a quotation in an NMS stock that: (i) [i]s displayed by an automated trading

called a Retail Price Improvement Order. Other Exchange member organizations would be allowed, but not required, to submit Retail Price Improvement Orders. When there is a Retail Price Improvement Order in a particular security, the Exchange will disseminate an indicator, known as the Retail Liquidity Identifier, indicating that such interest exists. In response, a new class of market participants known as Retail Member Organizations could submit a new type of order, called a Retail Order, to the Exchange. A Retail Order would interact, to the extent possible, with available contra-side Retail Price Improvement Orders.<sup>18</sup> The Exchanges would approve member organizations to be Retail Liquidity Providers and/or Retail Member Organizations.

### *Types of Orders and Identifier*

A Retail Order would be an agency order that originated from a natural person and not a trading algorithm or any other computerized methodology. A Retail Order would be an immediate or cancel order. The Retail Member Organization submitting the order would not be able to alter the terms of such order with respect to price or side of the market. A Retail Order could be submitted in a round lot, odd lot, or partial round lot amounts.

A Retail Liquidity Provider would be required to submit Retail Price Improvement Orders for securities that are assigned to the Retail Liquidity Provider, as further discussed below. A Retail Price Improvement Order would be required to be priced better than the PBBO by at least \$0.001 per share.

When a Retail Price Improvement Order is available that is priced at least \$0.001 more than the PBBO for a particular security, the Exchange would disseminate an identifier, called a Retail Liquidity Identifier. The Exchanges initially proposed to disseminate the identifier through their proprietary data feeds; they then amended their

center; (ii) [i]s disseminated pursuant to an effective national market system plan; and (iii) [i]s an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best offer of the Nasdaq Stock Market, Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of the Nasdaq Stock Market, Inc." 17 CFR 242.600(b)(57).

<sup>18</sup> As explained further below, the Exchanges have proposed three kinds of Retail Orders, two of which could execute against other interest if they were not completely filled by contra-side Retail Price Improvement Order interest. All Retail Orders would first execute against available contra-side Retail Price Improvement Orders. Any remaining portion of the Retail Order would then either cancel, be executed as an immediate-or-cancel order, or be routed to another market for execution, depending on the type of Retail Order.

<sup>7</sup> 17 CFR 242.612 ("Sub-Penny Rule").

<sup>8</sup> See Letter from Janet M. McGinnis, Senior Vice President-Legal and Corporate Secretary, Office of the General Counsel, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Commission, dated October 19, 2011. The Exchanges amended the exemptive relief request on January 13, 2012. See Letter from Janet M. McGinnis, Senior Vice President-Legal and Corporate Secretary, Office of the General Counsel, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Commission, dated January 13, 2012 ("Amended Request for Sub-Penny Rule Exemption").

<sup>9</sup> See Letter to the Commission from Janet McGinnis, Senior Vice President, Legal & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated January 3, 2012 ("Exchanges' Response Letter I").

<sup>10</sup> In Amendment No. 1, the Exchanges propose to modify the proposals as follows: (1) To state that Retail Member Organizations may receive free executions for their retail orders and the fees and credits for liquidity providers and Retail Member Organizations would be determined based on experience with the Retail Liquidity Program in the first several months; (2) to correct a typographical error referring to the amount of minimum price improvement on a 500 share order; (3) to indicate the Retail Liquidity Identifier would be initially available on each Exchange's proprietary data feeds, and would be later available on the public market data stream; and (4) to limit the Retail Liquidity Program to securities that trade at prices equal to or greater than \$1.00 per share.

<sup>11</sup> See Securities Exchange Act Release No. 66346, 77 FR 7628 (February 13, 2012) ("Order Instituting Proceedings").

<sup>12</sup> See Securities Exchange Act Release No. 66464 (February 24, 2012), 77 FR 12629. In Amendment No. 2, the Exchanges propose to modify the proposals as follows: (1) Limit the definition of "Retail Order"; (2) modify the definition of the Retail Liquidity Identifier; and (3) clarify the treatment of odd lots, round lots, and part of a round lot order.

<sup>13</sup> See Letters to the Commission from Leonard Amoroso, General Counsel, Knight Capital, Inc., dated March 7, 2012 ("Knight Letter II"); Kurt Schacht, CFA, Managing Director, Rhodri Preece, CFA, Director, Capital Markets Policy, and James Allen, CFA, Head, Capital Markets Policy, CFA

proposals to state that they would implement the Program in a manner that allowed the dissemination of the identifier through the consolidated public market data stream as soon as practicable, and they now represent that they will in fact be able to disseminate the identifier through the consolidated public market data stream as soon as the Program is implemented, if it is approved.<sup>19</sup> The identifier would reflect the symbol for a particular security and the side (buy or sell) of the Retail Price Improvement Order, but it would not include the price or size of such interest.

#### *Retail Member Organizations*

In order to become a Retail Member Organization, an Exchange member organization must conduct a retail business or handle retail orders on behalf of another broker-dealer. The member organization must submit an application with supporting documentation and an attestation to the Exchange that the order flow would qualify as Retail Orders.

The Exchange would review the application and notify the member organization of the Exchange's decision in writing. If a member organization did not receive approval to become a Retail Member Organization, then the member organization could appeal as provided below or reapply 90 days after the Exchange issued the disapproval.

The Exchange would require a Retail Member Organization to have written policies and procedures in place to assure that only bona fide retail orders are designated as such. The written policies and procedures would require that the Retail Member Organization exercise due diligence to assure that entry of a Retail Order is in compliance with the proposed rule, prior to entry of that Retail Order. In addition, the Retail Member Organization must monitor whether the Retail Order meets the requirements of the proposed rule.

If the Retail Member Organization represented the Retail Order from another broker-dealer, then the Retail Member Organization must have adequate supervisory procedures to assure that the Retail Order meets the proposed definition. Every year, the Retail Member Organization must obtain

from each broker-dealer a written representation that the Retail Orders the broker-dealer sends comply with the proposed rule and must monitor the broker-dealer's order flow to meet the requirements of the proposed rule.

#### *Retail Order Interactions*

Under the proposal, a Retail Member Organization submitting a Retail Order could choose one of three ways for the Retail Order to interact with available contra-side interest. First, a Retail Order could interact only with available contra-side Retail Price Improvement Orders. The Exchange would label this a Type 1 Retail Order and such orders would not interact with other available contra-side interest in Exchange systems or route to other markets. Portions of a Type 1 Retail Order that are not executed would be cancelled.

Second, a Retail Order could interact first with available contra-side Retail Price Improvement Orders and any remaining portion would be executed as a non-routable Regulation NMS-compliant Immediate or Cancel Order.<sup>20</sup> The Exchange would label this a Type 2 Retail Order.

Finally, a Retail Order could interact first with available contra-side Retail Price Improvement Orders and any remaining portion would be executed as a routable NYSE Immediate or Cancel Order.<sup>21</sup> The Exchange would label this a Type 3 Retail Order.

#### *Priority and Allocation*

The Exchange would follow price-time priority, ranking Retail Price Improvement Orders according to price and then time of entry, without regard to the size of the order. Executions would occur at the best price that completes the incoming Retail Order, unless there was not sufficient Retail Price Improvement interest to fill such order, in which case the Retail Order would be executed at the price that results in the greatest fill for that order, consistent with its terms. If there are remaining Retail Price Improvement Orders, they would be available for further incoming Retail Orders. As noted above, Retail Orders not executed would be cancelled.

#### *Retail Liquidity Provider Qualifications and Admission*

To qualify, a member organization must be approved as a Designated

Market Maker<sup>22</sup> or Supplemental Liquidity Provider<sup>23</sup> on the Exchange and demonstrate an ability to meet the requirements of a Retail Liquidity Provider. Moreover, the member organization must have mnemonics or the ability to accommodate other Exchange-supplied designations that identify to the Exchange Retail Liquidity Provider trading activity in assigned securities.<sup>24</sup>

A member organization must submit an application with supporting documentation to the Exchange. Thereafter, the Exchange would notify the member organization as to whether it is approved as a Retail Liquidity Provider. More than one member organization could act as a Retail Liquidity Provider for a security, and a member organization could act as a Retail Liquidity Provider for more than one security. A member organization could request the Exchange to be assigned certain securities. Once approved, the member organization must establish connectivity with relevant Exchange systems prior to trading.

The Exchange would notify a member organization in writing if the Exchange does not approve the member organization's application to be a Retail Liquidity Provider. Such member organization could request an appeal as provided below. The member organization could also reapply 90 days after the Exchange issues the disapproval notice.

Once approved as a Retail Liquidity Provider, a member organization could withdraw by providing notice to the Exchange. The withdrawal would become effective when the Exchange reassigns the securities to another Retail Liquidity Provider, but no later than 30 days after the Exchange receives the withdrawal notice. In the event that the Exchange takes longer than 30 days to reassign the securities, the withdrawing Retail Liquidity Provider would have no further obligations under the proposed rule.

#### *Retail Liquidity Provider Requirements*

The proposed rule changes would impose several requirements on Retail Liquidity Providers. First, a Retail Liquidity Provider could enter a Retail

<sup>19</sup> See Exchanges' Response Letter III. For UTP eligible securities traded on NYSE Amex, however, the Exchanges represented that the identifier will only be available through the Exchanges' proprietary data feeds until on or about October 1, 2012, at which time NASDAQ will make the identifier for UTP eligible securities available through the consolidated public market data stream. See email from Brendon Weiss, NYSE Euronext, to Steve Kuan, Division of Trading and Markets, Commission, dated June 26, 2012.

<sup>20</sup> Such order would sweep the Exchange's book without being routed to other markets, and any remaining portion would be cancelled.

<sup>21</sup> Such order would sweep the Exchange's book and be routed to other markets and any remaining portion would be cancelled.

<sup>22</sup> See NYSE Rule 103 and NYSE Amex Rule 103.

<sup>23</sup> See NYSE Rule 107B and NYSE Amex Rule 107B.

<sup>24</sup> The member organization would not be allowed to use the mnemonic or designation for non-Retail Liquidity Provider trading activities. Further, the member organization would not receive credit for trading activity as a Retail Liquidity Provider if the member organization did not use such mnemonic or designation.

Price Improvement Order electronically into Exchange systems only in its assigned securities. A Retail Liquidity Provider must maintain Retail Price Improvement Orders that are better than the PBBO at least 5% of the trading day for each assigned security.

To calculate the 5% quoting requirement, the Exchange would determine the average percentage of time a Retail Liquidity Provider maintains a Retail Price Improvement Order in each assigned security during the regular trading day on a daily and monthly basis. The Exchange would use the following definitions. The "Daily Bid Percentage" would be calculated by determining the percentage of time a Retail Liquidity Provider maintains a Retail Price Improvement Order priced higher than the best protected bid during each trading day for a calendar month. The "Daily Offer Percentage" would be calculated by determining the percentage of time a Retail Liquidity Provider maintains a Retail Price Improvement Order priced lower than the best protected offer during each trading day for a calendar month. The "Monthly Average Bid Percentage" would be calculated for each security by summing the security's "Daily Bid Percentages" for each trading day in a calendar month, then dividing the resulting sum by the total number of trading days in such month. The "Monthly Average Offer Percentage" would be calculated for each security by summing the security's "Daily Offer Percentages" for each trading day in a calendar month, then dividing the resulting sum by the total number of trading days in such month.

The proposed rule changes specify that only Retail Price Improvement Orders entered through the trading day would be used when calculating the 5% quoting requirements. Further, a Retail Liquidity Provider would have an initial two-month grace period from the 5% quoting requirement, so that the Exchange would impose the 5% quoting requirements on the first day of the third consecutive calendar month after the member organization began operation as a Retail Liquidity Provider.

#### *Penalties for Failure to Meet Requirements*

The proposed rule changes provide for penalties when a Retail Liquidity Provider or a Retail Member Organization fails to meet the requirements of the rule.

If a Retail Liquidity Provider fails to meet the 5% quoting requirements in any assigned security for three consecutive months, the Exchange, in its sole discretion, may: (1) Revoke the

assignment of any or all of the affected securities; (2) revoke the assignment of unaffected securities; or (3) disqualify the member organization to serve as a Retail Liquidity Provider. If the Exchange moves to disqualify a Retail Liquidity Provider's status, then the Exchange would notify, in writing, the Retail Liquidity Provider one calendar month prior to the determination. Likewise, the Exchange would notify the Retail Liquidity Provider in writing if the Exchange ultimately determined to disqualify the status of that Retail Liquidity Provider. As noted earlier, a Retail Liquidity Provider that is disqualified may appeal as provided below or reapply.

With respect to Retail Member Organizations, the Exchange could disqualify a Retail Member Organization if the Retail Orders submitted by the Retail Member Organization did not comply with the requirements of the proposed rule. The Exchange would have sole discretion to make such a determination. The Exchange would provide written notice to the Retail Member Organization when disqualification determinations are made. Similar to a disqualified Retail Liquidity Provider, a disqualified Retail Member Organization could appeal as provided below or reapply.

#### *Appeal Process*

Under the proposals, the Exchange would establish a Retail Liquidity Program Panel to review disapproval or disqualification decisions. An affected member organization would have five business days after notice to request review. If a member organization is disqualified as a Retail Liquidity Provider and has appealed, the Exchange would stay the reassignment of securities pending completion of the appeal process.

The Panel would consist of the Exchange's Chief Regulatory Officer or his or her designee, and two officers of the Exchange as designated by the co-head of U.S. Listings and Cash Execution. The Panel would review the appeal and issue a decision within the time frame prescribed by the Exchange. The Panel's decision would constitute final action by the Exchange, and the Panel could modify or overturn any Exchange action taken under the proposed rule.

#### **III. Comment Letters and the Exchanges' Responses**

As noted above, the Commission received a total of 32 comment letters concerning the NYSE proposal and 7 comment letters concerning the NYSE Amex proposal, including letters

submitted after the Commission published the Order Instituting Proceedings and Notice of Amendments No. 2. Several commenters expressed support for some or all elements of the Exchanges' proposed Program.<sup>25</sup> For instance, one commenter expressed general support for the proposals<sup>26</sup> and another commenter offered support for the Exchanges' efforts to enhance price competition for retail customer order flow.<sup>27</sup> Another commenter was supportive of the proposals to the extent they promoted transparency, competition, efficiency, and greater investor choice in the capital markets.<sup>28</sup> Two other commenters expressed broad support for the proposals' potential to benefit individual retail investors.<sup>29</sup>

However, a number of commenters raised concerns about the proposed rule changes. The main areas of concern were: (1) The time and manner of the Commission's action on the proposed rule changes, given the potential impact on overall market structure; (2) the proposals' impact on the Sub-Penny Rule; (3) whether the proposals impede fair access; and (4) whether the proposals implicate rules and standards relating to best execution and order protection.

#### *1. Time and Manner of Commission Action*

Several commenters requested that the Commission delay taking action on the proposals until the Commission has had additional time to examine the proposals' potential impact on market structure.<sup>30</sup> For example, several commenters stated that the issues raised by the proposals should be considered through Commission rulemaking, rather than through a self-regulatory organization's proposed rule change, because of the proposals' impact on the Sub-Penny Rule<sup>31</sup> as well as the

<sup>25</sup> See Johannes Letter; Knight Letter I; Angel Letter; TD Ameritrade Letter; UBS Letter; Dercks Letter; and BATS Letter.

<sup>26</sup> See TD Ameritrade Letter (stating that the proposals are "quite appealing" to the interests of "fair and transparent markets that benefit retail investors" although there were still specific issues to be addressed).

<sup>27</sup> See BATS Letter.

<sup>28</sup> See UBS Letter.

<sup>29</sup> See Johannes Letter and Dercks Letter.

<sup>30</sup> In contrast, one commenter requested the Commission to expedite approval of the proposals. See Johannes Letter. Other commenters did not address issues that specifically related to the proposals but rather offered general comments about market structure, particularly computer or high frequency trading. See Wuepper Letter; Fischer Letter; Cook Letter; Voorhies Letter; Joseph Letter; Basic Letter; and Jelsness Letter.

<sup>31</sup> See Knight Letter I; SIFMA Letter I; SIFMA Letter II; and STA Letter.

competitive landscape of the markets.<sup>32</sup> Commenters questioned whether the standard action period applicable to self-regulatory organizations' proposed rule changes was enough time for the Commission to analyze relevant data and sufficiently consider the effects the proposals might have on the equities markets.<sup>33</sup> Another commenter did not expressly oppose Commission approval of the proposals on a pilot basis, but cautioned that to the extent the Commission approves an effective reduction in the minimum price variation, or "tick size," below \$0.01, the Commission should do so on the basis of industry-wide pilot studies that test various tick sizes and publish the studies' data for public review and comment.<sup>34</sup> Lastly, a commenter requested that the Commission consider disapproving the proposals while it carefully studies the potential market impact of the Program; this commenter felt such delay was warranted in this case because it felt the Program is not designed to cure a market deficiency, but rather to help the Exchanges acquire market share.<sup>35</sup>

The Exchanges responded that the proposed Program is designed to attract retail order flow to the Exchanges by competing with the current practices of broker-dealers that internalize much of the market's retail order flow. Additionally, the Exchanges responded that the fees and credits they would implement as part of the Program would be similar to those used by investors in the over-the-counter ("OTC") market with retail order flow providers.<sup>36</sup>

## 2. Impact on the Sub-Penny Rule

A number of commenters raised concerns about the proposed Program's use of sub-penny orders, and its implications with respect to the Sub-Penny Rule.<sup>37</sup> One commenter noted that, by accepting and ranking non-displayed orders in sub-penny increments, the proposals could discourage liquidity by allowing "dark" liquidity to step ahead of posted limit

orders for only a trivial amount.<sup>38</sup> The same commenter observed that allowing non-displayed liquidity to gain an execution advantage over displayed limit orders for trivial per share amounts could result in wider bid-ask spreads.<sup>39</sup>

Other commenters articulated similar concerns about protecting public limit orders and public price discovery,<sup>40</sup> particularly with respect to institutional and retail investors,<sup>41</sup> and one commenter stated that the proposals might lead to a potential increase in sub-penny trading.<sup>42</sup> In addition, one commenter pointed out the potential technical systems and capacity issues that could result from effectively reducing the minimum price increment from \$0.01 to \$0.001, thereby substantially increasing the number of price points between each dollar level.<sup>43</sup> Lastly, a commenter stated that any study of the data generated while the Program was operating on a limited pilot basis would not be sufficiently meaningful in assessing the broader market structure impact of these types of proposals.<sup>44</sup>

In response, the Exchanges stated that currently, OTC market makers internalize retail order flow at negotiated sub-penny prices and not at their publicly displayed quotes. The Exchanges agree that the market structure impact of sub-penny executions may warrant further Commission consideration. However, the Exchanges also believe that the Program does not raise any new issues with respect to sub-penny executions; rather it simply seeks to compete for retail order flow within the current market landscape, while offering potentially greater price improvement to retail investors and transparency to the marketplace.

The Exchanges also rejected commenters' concerns about non-displayed liquidity stepping ahead of displayed limit orders for insignificant amounts. According to the Exchanges, the Commission's guidance with respect

to the Sub-Penny Rule concerns market professionals using displayed sub-penny orders to gain execution priority over customer limit orders. The Exchanges distinguished the proposed Program by noting that the Retail Liquidity Identifier would not be priced and Retail Price Improvement Orders would not be displayed. Accordingly, the Exchanges stated that the Program would limit its sub-penny activity to sub-penny executions. Similarly, in response to comments about the consequences of moving the "tick size" to \$0.001, the Exchanges stated that the "tick size" would not in fact be altered because the sub-penny components of the Program would not be displayed.

Finally, in response to the concern that the proposals might lead to more sub-penny trading, the Exchanges stated that they do not anticipate such a result because they believe instead that the proposals would likely reallocate existing retail order flow from internalizing broker-dealers to the Exchanges. Moreover, the Exchanges stated that, if the proposals led to additional sub-penny executions for retail order flow, it would benefit retail investors by creating additional price competition, and, therefore, greater opportunity for price improvement, for such retail order flow.

## 3. Fair Access

Commenters also highlighted several elements of the Program that potentially implicate the Commission's rules governing fair access. First, several commenters raised questions about whether the proposals would, in essence, create a private market. Some commenters wrote that the proposed segmentation of retail order flow could amount to unfair discrimination,<sup>45</sup> for example, by creating trading interest that would not be accessible by institutional investors.<sup>46</sup> One commenter suggested that the proposed Program would be akin to operating a limited access dark pool that could have the effect of creating a two-tiered market.<sup>47</sup>

Some commenters also took issue with the proposals to the extent that the

<sup>32</sup> See Knight Letter I; Hudson River Trading Letter; Knight Letter II; and STA Letter.

<sup>33</sup> See Knight Letter I and SIFMA Letter I.

<sup>34</sup> See Angel Letter. Expressing similar general concerns but not offering specific comment on the proposal, one commenter urged the Commission to exercise caution when considering expert testimony offered by for-profit industry participants as it relates to market structure regulation. See Themis Letter.

<sup>35</sup> See Knight Letter II.

<sup>36</sup> See also UBS Letter (stating that the proposed programs would not necessarily lead to more sub-penny activity, but would rather shift some of that activity from the over-the-counter markets to the Exchanges).

<sup>37</sup> The Sub-Penny Rule is codified at 17 CFR 242.612. See *supra* note 7.

<sup>38</sup> See Angel Letter.

<sup>39</sup> See *id.*

<sup>40</sup> See Voorhies Letter; Joseph Letter; Fournier Letter; PairCo Letter; Wollin Letter; Great Mountain Capital Letter; Koch Letter; CFA Letter I; Green Letter; Bright Trading Letter; TD Ameritrade Letter; Kenney Letter; Parsons Letter; and BATS Letter.

<sup>41</sup> See TD Ameritrade Letter; Knight Letter II; CFA Letter II; and SIFMA Letter II.

<sup>42</sup> See TD Ameritrade Letter.

<sup>43</sup> See Knight Letter I. In a second comment letter, Knight asked whether eliminating the proposed Retail Liquidity Identifier might remedy the Regulation NMS issues it felt could be implicated by the dissemination of a message that would signal the presence of sub-penny quotes on the Exchanges' books. See Knight Letter II.

<sup>44</sup> See Knight Letter II.

<sup>45</sup> See CFA Letter I and Hudson River Trading Letter. At least one commenter took the opposite view and supported market participant segmentation programs so long as such segmentation is done in an objective and transparent manner. See UBS Letter.

<sup>46</sup> See SIFMA Letters I and II; see also STA Letter (expressing concern over the program's differentiation between retail and institutional order flow, particularly since some individual investors may utilize managed funds—which may not be classified as "Retail Member Organizations"—as an investment vehicle).

<sup>47</sup> See Knight Letter I.

Retail Liquidity Identifier would be disseminated only through a proprietary data feed rather than the public market data stream.<sup>48</sup> These commenters felt that limiting dissemination of the Retail Liquidity Identifier to a proprietary data feed could unfairly harm small firms who do not pay for the proprietary feed<sup>49</sup> or create a private, two-tiered market where those who can afford the proprietary feed can view and potentially obtain the best prices.<sup>50</sup> Another commenter suggested that the Program could undermine the Commission's policies underlying the Quote Rule because the Exchanges would not be displaying the "best" orders they receive, *i.e.*, the sub-penny Retail Price Improvement Orders that the Exchanges would accept and rank under the Program.<sup>51</sup>

The Exchanges responded that the proposals do not create a fair access issue because, in their view, the Retail Liquidity Identifier does not meet the definition of "quotation" under Regulation NMS. In essence, the Exchanges believe that the Retail Liquidity Identifier cannot be considered a "bid" or "offer" because the identifier would not contain a price. According to the Exchanges, there would be no fairness issue in signifying the presence of liquidity by distributing the Retail Liquidity Identifier through a proprietary data feed, especially because participation in the proposed program would be discretionary. However, in response to concerns about the dissemination of the Retail Liquidity Identifier, the Exchanges represented in their third consolidated response letter that the Retail Liquidity Identifier would be available through the consolidated public market data stream immediately upon implementation of the Program, if approved.

Another issue raised by the commenters relates to the clarity and transparency of certain defined terms in the proposals. Specifically, some commenters expressed concern that, under the proposals, the Exchanges would have too much discretion to certify or approve Retail Member Organizations and Retail Liquidity Providers, creating the potential for discriminatory treatment.<sup>52</sup> Two

commenters also stated that the definition of "Retail Order," which relies on the representation of the broker sending the order, may not be sufficiently clear.<sup>53</sup> One commenter noted that the definition may impose too great of an administrative burden on participants in the Program, as participants would be required to surveil their Retail Orders to ensure that they comply with the proposed requirements.<sup>54</sup> In response to the Exchanges' Amendments No. 2, which narrowed the definition of "Retail Order," one commenter posited that the re-proposed definition was vague because the phrase providing that orders "cannot originate from a trading algorithm or any computerized methodology" is unclear in scope.<sup>55</sup>

The Exchanges responded that they would continually monitor and evaluate all aspects of the Retail Member Organization certification process during the pilot period. The Exchanges disagreed that the definition of "Retail Order" and the Retail Member Organization certification process are unclear or not subject to enforcement. According to the Exchanges, the authentication and certification procedures, together with the requirement that Retail Member Organizations have written policies and procedures to assure that they only submit qualifying retail orders, would result in reliable identification and segmentation of retail order flow. The Exchanges also did not believe there were ambiguities in defining a Retail Order to exclude orders originating from a trading algorithm or computerized methodology; however, the Exchanges committed to providing interpretive guidance to any firms that have questions about the definition. Finally, the Exchanges stated that the Program would be subject to regulatory review by FINRA pursuant to a regulatory services agreement with the Exchanges.

Commenters also raised issues related to access fees. One commenter suggested that the appropriate amount of access fees would need to be revisited if the "tick size" is reduced from \$0.01 to \$0.001 because the maximum allowable fee of \$0.003 per share would significantly increase in relation to the minimum pricing increment.<sup>56</sup> Another commenter noted that the proposals could open the door to revisiting whether access fees may be included in quotes, assuming the Program leads to

sub-penny quotations.<sup>57</sup> Finally, one commenter questioned whether the proposals would result in true price competition because non-Retail Liquidity Providers would likely be charged higher access fees for executions with Retail Orders than Retail Liquidity Providers, and would most likely not be able to quote as aggressively as Retail Liquidity Providers as a result.<sup>58</sup>

The Exchanges responded that approval of the proposals does not require reexamination of any access fee issue. The Exchanges noted that there would be no visible prices disseminated as part of the program and expressed the view that the proposals did not contemplate "quotes" subject to the Commission's fair access rules. Given that the proposals did not contemplate "quotes," the Exchanges also contended that a broker's obligations under Regulation NMS would not require it to route a retail order to the Exchanges to interact with a Retail Price Improvement Order. Finally, the Exchanges believe that the proposals comport with the principles behind the Commission's access rules because they intend to welcome broad participation in the Program.

#### 4. Best Execution

Several commenters took the position that the Program would complicate broker-dealers' best execution duties. According to one commenter, the Exchanges' dissemination of the Retail Liquidity Identifier would raise a number of issues, including whether broker-dealers would be required to route to the Exchanges when they see a Retail Liquidity Identifier; whether, if other exchanges were to adopt similar proposals and disseminate flags similar to the Retail Liquidity Identifier, a broker-dealer would be required to sweep all liquidity inside the spread before executing at the NBBO; whether the Exchanges would be required to route Retail Orders they receive to other market centers if those away markets offered the possibility of further price improvement; and whether broker-dealers would be required to subscribe to the Exchanges' proprietary feeds to be able to receive the Retail Liquidity Identifier.<sup>59</sup>

Another commenter questioned whether, if other exchanges were to adopt competing programs and disseminate flags similar to the Retail

<sup>48</sup> See SIFMA Letters I and II and BATS Letter.

<sup>49</sup> See SIFMA Letter I.

<sup>50</sup> See BATS Letter.

<sup>51</sup> See Knight Letter II; see also SIFMA Letter II (stating that the Identifier would constitute a "de facto" quote, and contending that the Commission should address the Identifier, along with actionable indications of interest, through Commission rulemaking).

<sup>52</sup> See Hudson River Trading Letter; BATS Letter; and SIFMA Letter II.

<sup>53</sup> See Hudson River Trading Letter and Knight Letter I.

<sup>54</sup> See Knight Letter I.

<sup>55</sup> See SIFMA Letter II.

<sup>56</sup> See Knight Letter I.

<sup>57</sup> See SIFMA Letter I.

<sup>58</sup> See BATS Letter.

<sup>59</sup> See Knight Letter I; see also SIFMA Letter II (raising similar questions about broker-dealers' best execution obligations).

Liquidity Identifier over their proprietary feeds, a broker-dealer would be required to subscribe to each proprietary feed in order to fill its best execution obligations.<sup>60</sup> Relatedly, another commenter stated that the proposals would result in confusion among broker-dealers unsure of how the dissemination of the Retail Liquidity Identifier would affect their smart order routing.<sup>61</sup> Finally, one commenter suggested that FINRA's best execution and interpositioning rules would need to be updated to reflect the fact that Retail Liquidity Identifiers would be widely disseminated yet not accessible by non-retail clients.<sup>62</sup>

The Exchanges responded that they believe the proposals do not raise any best execution challenges that are not already confronted by broker-dealers in the current market environment. The Exchanges stated that best execution is a facts and circumstances determination and requires many factors to be considered.<sup>63</sup>

One commenter also raised related concerns about the proposals' potential impact on broker-dealer obligations under FINRA Rule 5320, also known as the "Manning" rule.<sup>64</sup> FINRA Rule 5320 generally prohibits broker-dealers from trading ahead of their customer orders. The commenter noted that firms that both offer Retail Price Improvement Orders and accept customer orders will likely find themselves in a position where they must fill the customer order at a loss, assuming their Retail Price Improvement Orders get executed before the customer order.<sup>65</sup>

In response to this comment, the Exchanges stated that the Manning obligations of a Retail Liquidity Provider would be no different from the obligations on an OTC market maker that internalizes orders. The Exchanges stated that OTC market makers commonly rely on the "no-knowledge"

exception contained in Supplementary Material .02 of FINRA Rule 5320 to separate their proprietary trading from their handling of customer orders. The Exchanges expressed their view that this exception should be equally applicable to Retail Liquidity Providers participating in the Program.

#### IV. Discussion and Commission Findings

After careful review of the proposals, the comment letters received, and the Exchanges' responses, the Commission finds that the proposed rule changes are consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange. In particular, the Commission finds that the proposed rule changes, subject to their terms as pilots, are consistent with Section 6(b)(5) of the Act,<sup>66</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, 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; and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

The Commission finds that the Program, as it is proposed on a pilot basis, is consistent with the Act because it is reasonably designed to benefit retail investors by providing price improvement to retail order flow. The Commission also believes that the Program could promote competition for retail order flow among execution venues, and that this could benefit retail investors by creating additional price improvement opportunities for their order flow. Currently, most marketable retail order flow is executed in the OTC markets, pursuant to bilateral agreements, without ever reaching a public exchange. The Commission recently noted that "a very large percentage of marketable (immediately executable) order flow of individual investors" is executed, or "internalized," by broker-dealers in the OTC markets.<sup>67</sup> A recent review of the order flow of eight retail brokers

revealed that nearly 100% of their customer market orders were routed to OTC market makers.<sup>68</sup> The same review found that such routing is often done pursuant to arrangements under which retail brokers route their order flow to certain OTC market makers in exchange for payment for such order flow.<sup>69</sup> To the extent that the Program may provide price improvement to retail orders that equals what would be provided under such OTC internalization arrangements, the Program could benefit retail investors. To better understand the Program's potential impact, data concerning such potential investor benefit, including the level of price improvement provided by the Program, will be submitted by the Exchanges and would be reviewed by the Commission prior to any extension of the Program beyond the proposed one-year pilot term, or permanent approval of the Program.

The Program proposes to create additional price improvement opportunities for retail investors by segmenting retail order flow on the Exchanges and requiring liquidity providers that want to interact with such retail order flow to do so at a price at least \$0.001 per share better than the Protected Best Bid or Offer. As noted above, some commenters questioned the fairness of treating retail order flow differently from other order flow on an exchange by offering price improvement opportunities only to retail orders. Commenters also raised several concerns relating to the way the Program proposes to define and identify retail order flow.

In this case, the Commission finds that while the Program would treat retail order flow differently from order flow submitted by other market participants, such segmentation would not be inconsistent with Section 6(b)(5) of the Act, which requires that the rules of an exchange are not designed to permit unfair discrimination.<sup>70</sup> The Commission has previously recognized that the markets generally distinguish between individual retail investors, whose orders are considered desirable

<sup>60</sup> See BATS Letter.

<sup>61</sup> See SIFMA Letters I and II.

<sup>62</sup> See UBS Letter.

<sup>63</sup> See Exchanges' Response Letter I (citing Securities Exchange Act Release No. 43590 (November 17, 2000)), 65 FR 75414 (December 1, 2000) (Disclosure of Order Execution and Routing Practices Adopting Release)).

<sup>64</sup> See Knight Letter I.

<sup>65</sup> See *id.* In an example offered by the commenter, assume the NYSE best bid and offer is 10.01 x 10.02. A non-Retail Liquidity Provider, that also handles retail customer orders, posts a Retail Price Improvement bid at \$10.015 for 500 shares. The Retail Price Improvement order executes against an eligible Retail Order, and buys 500 shares at \$10.015. If that non-Retail Liquidity Provider also holds a customer limit order to buy 500 shares at \$10.01, the commenter states that the non-RLP would be obligated, under the current Manning rule, to sell the 500 shares to its client at \$10.01—losing \$0.005 per share in the process.

<sup>68</sup> See *id.*

<sup>69</sup> See *id.*

<sup>70</sup> The comment letters and the Exchanges' responses contained extensive discussion of whether the Program's proposed Retail Liquidity Identifier constitutes a "quote" which would be subject to Rule 610 of Regulation NMS. That rule, known as the "Fair Access Rule," contains a similar prohibition on unfair discrimination. The Commission finds that the Program is not unfairly discriminatory under both Section 6(b)(5) of the Act and Rule 610 of Regulation NMS. Because the Commission has determined that the Program is not unfairly discriminatory pursuant to Rule 610, it need not determine whether the Retail Liquidity Identifier is a "quote" for purposes of Rule 610.

<sup>66</sup> 15 U.S.C. 78f(b)(5).

<sup>67</sup> See Securities Exchange Act Release No. 61358 (Jan. 14, 2010), 75 FR 3594, 3600 (Jan. 21, 2010) ("Concept Release on Equity Market Structure").

by liquidity providers because such retail investors are presumed on average to be less informed about short-term price movements, and professional traders, whose orders are presumed on average to be more informed.<sup>71</sup> The Commission has further recognized that, because of this distinction, liquidity providers are generally more inclined to offer price improvement to less informed retail orders than to more informed professional orders.<sup>72</sup> Absent opportunities for price improvement, retail investors may encounter wider spreads that are a consequence of liquidity providers interacting with informed order flow. By creating additional competition for retail order flow, the Program is reasonably designed to attract retail order flow to the exchange environment, while helping to ensure that retail investors benefit from the better price that liquidity providers are willing to give their orders. Certain commenters also expressed concern that the Program could create a private market or otherwise impede fair access.<sup>73</sup> In this regard, the Commission notes that the Retail Liquidity Identifier will be disseminated through the consolidated public market data stream, and thus be widely viewable by market participants, and that members of the Exchanges that would not otherwise participate as Retail Liquidity Providers would be able to participate in the Program by

<sup>71</sup> See Concept Release on Equity Market Structure, *supra* note 67; see also Securities Exchange Act Release No. 64781 (June 30, 2011), 76 FR 39953 (July 7, 2011) (approving a program proposed by an options exchange that would provide price improvement opportunities to retail orders based, in part, on questions about execution quality of retail orders under payment for order flow arrangements in the options markets).

While certain commenters expressed concern that institutional investors, including those that invest money on behalf of individual retail clients, would not be eligible to qualify as Retail Member Organizations and submit Retail Orders, the Commission notes that institutional investors tend to be more informed than retail investors. See *supra* note 46.

<sup>72</sup> See Securities Exchange Act Release No. 64781 (June 30, 2011), 76 FR 39953 (July 7, 2011) (noting that "it is well known in academic literature and industry practice that prices tend to move against market makers after trades with informed traders, often resulting in losses for market makers," and that such losses are often borne by uninformed retail investors through wider spreads (citing H.R. Stoll, "The supply of dealer services in securities markets," *Journal of Finance* 33 (1978), at 1133–51; L. Glosten & P. Milgrom, "Bid ask and transaction prices in a specialist market with heterogeneously informed agents," *Journal of Financial Economics* 14 (1985), at 71–100; and T. Copeland & D. Galai, "Information effects on the bid-ask spread," *Journal of Finance* 38 (1983), at 1457–69)).

<sup>73</sup> See *supra* notes 45 through 51 and accompanying text.

submitting Retail Price Improvement Orders.

As noted above, certain commenters questioned the fairness of preventing institutional investors from submitting Retail Orders, and thus receiving price improvement on their orders.<sup>74</sup> In this regard, the Commission notes that the Program might create a desirable opportunity for institutional investors to interact with retail order flow that they are not able to reach currently. Member organizations that are not Retail Liquidity Providers can seek to interact with Retail Orders by submitting Retail Price Improvement Orders. Today, institutional investors often do not have the chance to interact with marketable retail orders that are executed pursuant to internalization arrangements. Thus, institutional investors, if they participate in the Program by submitting Retail Price Improvement Orders, may be able to reduce their possible adverse selection costs by interacting with retail order flow previously unavailable to them.

The Commission does not share the concern expressed by several commenters that the Program will cause a major shift in market structure. Instead, the Commission believes the Program should closely replicate the trading dynamics that exist in the OTC markets and will simply present another competitive venue for retail order flow execution. While some commenters stated that the Program would potentially increase sub-penny trading, the Commission believes that the Program will likely reallocate existing retail order flow from the OTC markets to the Exchanges, and is not likely to alter the incentives for market participants to post limit orders in a material way, given that liquidity providers already interact with most retail order flow in non-displayed markets.<sup>75</sup> In this regard, however, the

<sup>74</sup> See *supra* notes 45 through 47 and accompanying text.

<sup>75</sup> For the same reasons, the Commission does not believe that the Program will create any best execution challenges that are not already present in today's markets. A broker's best execution obligations are determined by a number of facts and circumstances, including (1) The character of the market for the security (e.g., price, volatility, relative liquidity, and pressure on available communications); (2) the size and type of transaction; (3) the number of markets checked; (4) accessibility of the quotation; and (5) the terms and conditions of the order which result in the transaction. See FINRA Rule 5310; see also Disclosure of Order Execution and Routing Practices Adopting Release, *supra* note 633. A broker would consider the Program when conducting this analysis.

Furthermore, with respect to the scope of FINRA Rule 5320 (the "Manning" rule), the Commission notes that the Manning obligations of a Retail Liquidity Provider likely would not be appreciably

Commission notes that it is approving the Program on a pilot basis, and will monitor the Program throughout the pilot period for its potential effects on public price discovery, and on the broader market structure.

When the Commission is engaged in rulemaking or the review of a rule filed by a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>76</sup> As discussed above, the Commission believes that this Program will promote competition for retail order flow, by allowing Exchange members, either as Retail Liquidity Providers, or on an ad hoc basis, to submit Retail Price Improvement Orders to interact with Retail Orders. Such competition may promote efficiency by facilitating the price discovery process. Moreover, the Commission does not believe that the Program will have a significant effect on market structure, or will create any new inefficiencies in current market structure. Finally, to the extent the Program is successful in attracting retail order flow, it may generate additional investor interest in trading securities, thereby promoting capital formation.

The Commission also believes that the Program is sufficiently tailored to provide the benefits of potential price improvement only to bona fide retail order flow originating from natural persons.<sup>77</sup> The Commission finds that the Program provides an objective process by which a member organization could become a Retail Member Organization or a Retail Liquidity Provider, and for appropriate oversight by the Exchanges to monitor for continued compliance with the terms of these provisions. The Exchanges have limited the definition of Retail Order to an agency order that originates from a natural person and not a trading algorithm or any other computerized methodology.

different from the current obligations of an OTC market maker that internalizes orders.

<sup>76</sup> See 15 U.S.C. 78c(f).

<sup>77</sup> In addition, the Commission believes that the Program's provisions concerning the certification, approval, and potential disqualification of Retail Member Organizations and Retail Liquidity Providers are not inconsistent with the Act. These provisions, which contain appeal procedures for adverse decisions against those who seek to become Retail Member Organizations or who are disqualified from their status as such, are substantially similar to provisions in the Exchanges' rules establishing the Supplemental Liquidity Provider Program. See NYSE Rule 107B(j)–(k) and NYSE Amex Rule 107B(i)–(j).



Furthermore, a Retail Order must be submitted by a Retail Member Organization that is approved by the Exchanges. In addition, Retail Member Organizations would be required to maintain written policies and procedures to help ensure that they designate as Retail Orders only those orders which qualify under the Program. If a member's application to become a Retail Member Organization or a Retail Liquidity Provider is denied by the Exchange, that member may appeal that determination or re-apply. Similarly, a Retail Liquidity Provider that is disqualified for failing to meet its quoting requirements may appeal or re-apply to the Program. The Commission believes that these standards should help ensure that only retail order flow is submitted into the Program and thereby promote just and equitable principles of trade and protect investors and the public interest, while also providing an objective process through which members may become Retail Member Organizations or Retail Liquidity Providers. The Commission also notes that the Exchanges have represented that they would continually monitor all aspects of the Retail Member Organization certification process during the pilot period, and that the Program would be subject to regulatory review by FINRA pursuant to a regulatory services agreements with the Exchanges.

In addition, the Commission finds that the Program's proposed dissemination of a Retail Liquidity Identifier would increase the amount of pricing information available to the marketplace and is consistent with the Act. The identifier would be disseminated through the consolidated public market data stream<sup>78</sup> to advertise the presence of a Retail Price Improvement Order with which Retail Orders could interact. The identifier would reflect the symbol for a particular security and the side of the Retail Price Improvement Order interest, but it would not include the price or size of such interest. The identifier would alert market participants to the existence of a Retail Price Improvement Order and

<sup>78</sup> Certain commenters expressed concerns that the original proposals' plan to limit dissemination of the Retail Liquidity Identifier to the Exchanges' proprietary data feeds was unfair. See *supra* notes 48 through 50 and accompanying text. In this regard, the Commission notes that the Exchanges have committed to making the Retail Liquidity Identifier immediately available through the consolidated public market data stream for securities listed on NYSE and NYSE Amex, and have represented that the Retail Liquidity Identifier for UTP eligible securities should be available through the consolidated public market data stream in on or about October 1, 2012. See *supra* note 19.

should provide market participants with more information about the availability of price improvement opportunities for retail orders than is currently available.<sup>79</sup> Given the benefits of adding this information to the marketplace, the Commission believes that the Identifier is an appropriate part of the Program.<sup>80</sup>

Lastly, some commenters questioned whether the exchange rule filing process was an appropriate means to introduce the Program, given the Program's impact on broader market structure, and the limited timeframe in which the Commission would be able to consider the Program and comments thereto. Given that the Program involves modifying the Exchanges' trading rules to create new order types and categories of members, however, the Commission believes that the Program was appropriately proposed through the rule filing process pursuant to Section 19(b)(1) of the Act. In addition, the Commission does not believe that the Program is likely to significantly impact market structure because the Program is designed to replicate the trading dynamics that exist in the OTC markets and will simply present another competitive venue for retail order flow execution.

Furthermore, the Commission notes that it is approving the Program on a pilot basis. Approving the Program on a pilot basis will allow the Exchanges and market participants to gain valuable practical experience with the Program during the pilot period. This experience

<sup>79</sup> As noted above, certain commenters questioned whether dissemination of the Retail Liquidity Identifier would be compatible with the Quote Rule. See *supra* note 51. In connection with the proposals, the Exchanges have requested that the staff of the Commission not recommend enforcement action to the Commission, either against the Exchanges or Retail Liquidity Providers, under the Quote Rule relating to the kind of information disseminated through Retail Liquidity Identifier. See Letter from Janet M. McGinness, Senior Vice President—Legal and Corporate Secretary, Office of the General Counsel, NYSE Euronext to Robert Cook, Director, Division of Trading and Markets, dated April 11, 2012. The staff has determined to grant the Exchanges' No Action request pursuant to a letter which is also being issued today. See Letter from David Shillman, Associate Director, Division of Trading and Markets, to Janet McGinness, Senior Vice President—Legal and Corporate Secretary, Office of the General Counsel, NYSE Euronext, dated July 3, 2012.

<sup>80</sup> Although one commenter stated that the Retail Liquidity Identifier should be eliminated from the Program, as it was "tantamount to displaying sub-penny quotations in the lit markets," see Knight Letter II, for the reasons discussed below, the Commission believes that the benefits of the Program justify granting exemptive relief from Rule 612(c) of Regulation NMS. See also SIFMA Letter II (urging the Commission to address sub-penny quoting through the rulemaking process rather than an exemptive request specific to a market participant).

should allow the Exchanges and the Commission to determine whether modifications to the Program are necessary or appropriate prior to any Commission decision to approve the Program on a permanent basis. The Exchanges also have agreed to provide the Commission with a significant amount of data that should assist the Commission in its evaluation of the Program. Specifically, the Exchanges have represented that they "will produce data throughout the pilot, which will include statistics about participation, the frequency and level of price improvement provided by the Program, and any effects on the broader market structure." The Commission expects that the Exchanges will monitor the scope and operation of the Program and study the data produced during that time with respect to such issues, and will propose any modifications to the Program that may be necessary or appropriate.

The Commission also welcomes additional comments, and empirical evidence, on the Program during the pilot period to further assist the Commission in its evaluation of the Program.<sup>81</sup> The Commission notes that any permanent approval of the Program would require a proposed rule change by the Exchanges, and such rule change will provide an opportunity for public comment prior to further Commission action.<sup>82</sup>

## V. Exemption From the Sub-Penny Rule

Pursuant to its authority under Rule 612(c) of Regulation NMS,<sup>83</sup> the Commission hereby grants each Exchange a limited exemption from the Sub-Penny Rule to operate the Program. For the reasons discussed below, the Commission determines that such action is necessary or appropriate in the public interest, and is consistent with the protection of investors. The exemptions shall operate for a period of 12 months, coterminous with the effectiveness of the proposed rule changes approved today.

When the Commission adopted the Sub-Penny Rule in 2005, it identified a

<sup>81</sup> For instance, one commenter noted the need for market participants to consider the impact that the Program will have on a number of factors, including trading technologies and capacity, operational costs, execution quality, liquidity, and gaming. See Knight Letter I. The Commission would welcome data from market participants on these topics, as well as any others, during the pilot period.

<sup>82</sup> One comment suggested that the Program should only be considered in tandem with industry-wide pilot studies on tick size. See Angel Letter. As discussed above, the Commission believes that the proposals are properly considered through the rule filing process, and expects to monitor and study data produced during the Program's pilot term.

<sup>83</sup> 17 CFR 242.612(c).

variety of problems caused by sub-pennies that the Sub-Penny Rule was designed to address:

- If investors' limit orders lose execution priority for a nominal amount, investors may over time decline to use them, thus depriving the markets of liquidity.
- When market participants can gain execution priority for a nominal amount, important customer protection rules such as exchange priority rules and the Manning Rule could be undermined.
- Flickering quotations that can result from widespread sub-penny pricing could make it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities.
- Widespread sub-penny quoting could decrease market depth and lead to higher transaction costs.
- Decreasing depth at the inside could cause institutions to rely more on execution alternatives away from the exchanges, potentially increasing fragmentation in the securities markets.<sup>84</sup>

At the same time, the Commission "acknowledge[d] the possibility that the balance of costs and benefits could shift in a limited number of cases or as the markets continue to evolve."<sup>85</sup> Therefore, the Commission also adopted Rule 612(c), which provides that the Commission may grant exemptions from the Sub-Penny Rule, either unconditionally or on specified terms and conditions, if it determined that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

The Commission believes that the Exchanges' proposal raises such a case. As described above, under the current market structure, few marketable retail orders in equity securities are routed to exchanges. The vast majority of marketable retail orders are internalized by OTC market makers, who typically pay retail brokers for their order flow. Retail investors can benefit from such arrangements to the extent that OTC market makers offer them price improvement over the NBBO. Price improvement is typically offered in sub-penny amounts.<sup>86</sup> An internalizing

broker-dealer can offer sub-penny executions, provided that such executions do not result from impermissible sub-penny orders or quotations. Accordingly, OTC market makers typically select a sub-penny price for a trade without quoting at that exact amount or accepting orders from retail customers seeking that exact price. Exchanges—and exchange member firms that submit orders and quotations to exchanges—cannot compete for marketable retail order flow on the same basis, because it would be impractical for exchange electronic systems to generate sub-penny executions without exchange liquidity providers or retail brokerage firms having first submitted sub-penny orders or quotations, which the Sub-Penny Rule expressly prohibits.

The limited exemptions granted today should promote competition between exchanges and OTC market makers in a manner that is reasonably designed to minimize the problems that the Commission identified when adopting the Sub-Penny Rule. Under the Program, sub-penny prices will not be disseminated through the consolidated quotation data stream, which should avoid quote flickering and its reduced depth at the inside quotation. Furthermore, while the Commission remains concerned about providing enough incentives for market participants to display limit orders, the Commission does not believe that granting this exemption (and approving the accompanying proposed rule changes) will reduce such incentives. Market participants that display limit orders currently are not able to interact with marketable retail order flow because it is almost entirely routed to internalizing OTC market makers that offer sub-penny executions. Consequently, enabling the Exchanges to compete for this retail order flow through the Program should not materially detract from the current incentives to display limit orders, while potentially resulting in greater order interaction and price improvement for marketable retail orders. To the extent that the Program may raise Manning and best execution issues for broker-dealers, these issues are already presented by the existing practices of OTC market makers.

The exemptions being granted today are limited to a one-year pilot. The Exchanges have stated that "sub-penny trading and pricing could potentially result in undesirable market behavior,"

not raise the same concerns as sub-penny quoting" and that "sub-penny executions due to price improvement are generally beneficial to retail investors." *Id.* at 37556.

and therefore they will "monitor the Program in an effort to identify and address any such behavior."<sup>87</sup> Furthermore, the Exchanges have represented that they "will produce data throughout the pilot, which will include statistics about participation, the frequency and level of price improvement provided by the Program, and any effects on the broader market structure."<sup>88</sup> The Commission expects to review the data and observations of the Exchanges before determining whether and, if so, how to extend these exemptions from the Sub-Penny Rule.<sup>89</sup>

## VI. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>90</sup> that the proposed rules changes (SR-NYSE-2011-55; SR-NYSEAmex-2011-84), as modified by Amendments Nos. 1 and 2, be and hereby are, approved on a one-year pilot basis.

*It is also hereby ordered* that, pursuant to Rule 612(c) of Regulation NMS, each Exchange is given a limited exemption from Rule 612 of Regulation NMS allowing it to accept and rank orders priced equal to or greater than \$1.00 per share in increments of \$0.001, in the manner described in the proposed rule changes above, on a one-year pilot basis coterminous with the effectiveness of the proposed rule changes.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>91</sup>

**Elizabeth M. Murphy,**

*Secretary.*

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<sup>87</sup> Amended Request for Sub-Penny Rule Exemption, *supra* note 8, at 4, n. 6.

<sup>88</sup> *Id.*

<sup>89</sup> In particular, the Commission expects the Exchanges to observe how maker/taker transaction charges, whether imposed by the Exchanges or by other markets, might impact the use of the Program. Market distortions could arise where the size of a transaction rebate, whether for providing or taking liquidity, is greater than the size of the minimum increment permitted by the Program (\$0.001 per share).

<sup>90</sup> 15 U.S.C. 78s(b)(2).

<sup>91</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(83).

<sup>84</sup> See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37551-52 (June 29, 2005).

<sup>85</sup> *Id.* at 37553.

<sup>86</sup> When adopting the Sub-Penny Rule, the Commission considered certain comments that asked the Commission to prohibit broker-dealers from offering sub-penny price improvement to their customers, but declined to do so. The Commission stated that "trading in sub-penny increments does