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For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>57</sup>

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–68937; File No. SR–NASDAQ–2012–129]

### Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Granting Approval to Proposed Rule Change, as Modified by Amendment No. 1, To Establish the Retail Price Improvement Program on a Pilot Basis until 12 Months From the Date of Implementation

February 15, 2013.

#### I. Introduction

On November 19, 2012, The NASDAQ Stock Market LLC (the “Exchange” or “NASDAQ”) 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 Price Improvement Program (“Program”) on a pilot basis for a period of 12 months from the date of implementation, if approved. The proposed rule change was published for comment in the **Federal Register** on December 7, 2012.<sup>3</sup> The Commission did not receive any comments on the proposed rule change. On February 13, 2013, the Exchange filed Amendment No. 1 to its proposal.<sup>4</sup>

In connection with the proposal, the Exchange requested exemptive relief from Rule 612 of Regulation NMS,<sup>5</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>6</sup> On January 14, 2013, the Exchange 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 Exchange’s and its Members’ participation in the Program.<sup>7</sup>

This order approves the proposed rule change and grants the exemption from the Sub-Penny Rule sought by the Exchange in relation to the proposed rule change.

#### II. Description of the Proposal

The Exchange is proposing a 12-month pilot program to attract additional retail order flow to the Exchange, while also providing the potential for price improvement to such retail order flow. The Program would be limited to trades occurring at prices equal to or greater than \$1.00 per share.<sup>8</sup> All Regulation NMS securities traded on the Exchange would be eligible for inclusion in the Program.

Under the Program, a new class of market participants called Retail Member Organizations (“RMOs”) <sup>9</sup> would be eligible to submit certain retail order flow (“Retail Orders”) to the Exchange. All Exchange Members would be permitted to provide potential price improvement for Retail Orders in the form of designated non-displayed interest, called a Retail Price Improvement Order (“RPI Order” or “RPI interest”), that is priced more aggressively than the Protected National Best Bid or Offer (“Protected NBBO”) <sup>10</sup>

<sup>6</sup> See Letter from Jeffrey Davis, Deputy General Counsel, The NASDAQ Stock Market LLC, to Elizabeth M. Murphy, Secretary, Commission, dated November 19, 2012 (“Request for Sub-Penny Rule Exemption”).

<sup>7</sup> See Letter from Jeffrey Davis, Deputy General Counsel, The NASDAQ Stock Market LLC, to John Ramsay, Division of Trading and Markets, Commission, dated January 14, 2013.

<sup>8</sup> The Exchange notes that certain orders submitted to the Program designated as eligible to interact with liquidity outside of the Program—Type 2 Retail Orders, discussed below—could execute at prices below \$1.00 if they do in fact execute against liquidity outside of the Program.

<sup>9</sup> A RMO would be a Member (or a division thereof) that has been approved by the Exchange to submit Retail Orders. See Nasdaq Rule 4780. A “Member” is any registered broker or dealer that has been admitted to membership in the Exchange. See Nasdaq Rule 0120(i).

<sup>10</sup> The terms Protected Bid and Protected Offer are defined in Rule 600(b)(57) of Regulation NMS. 17 CFR 242.600(b)(57). The Exchange represents that, generally, the Protected Bid and Protected Offer, and the national best bid (“NBB”) and national best offer (“NBO,” together with the NBB, the “NBBO”), will be the same. However, it further represents that a market center is not required to route to the NBB or NBO if that market center is subject to an

exception under Regulation NMS Rule 611(b)(1) or if such NBB or NBO is otherwise not available for an automatic execution. In such case, the Exchange states that the Protected NBBO would be the best-priced protected bid or offer to which a market center must route interest pursuant to Rule 611 of Regulation NMS.

by at least \$0.001 per share. When RPI interest priced at least \$0.001 per share better than the Protected Bid or Protected Offer for a particular security is available in the system, the Exchange would disseminate an identifier, known as the Retail Liquidity Identifier, indicating that such interest exists. A Retail Order would interact, to the extent possible, with available contra-side RPI Orders.<sup>11</sup>

The Exchange represents that its proposed rule change is based on rules recently adopted by other exchanges. The NASDAQ proposal is virtually identical to BATS Y-Exchange Rule 11.24, which sets forth the BATS Y-Exchange’s Retail Price Improvement Program.<sup>12</sup> It is also highly similar to New York Stock Exchange LLC’s (“NYSE”) Rule 107C, which governs NYSE’s Retail Liquidity Program,<sup>13</sup> with three distinctions. First, the NYSE’s Retail Liquidity Program creates a category of members, Retail Liquidity Providers, who are required to maintain a retail price-improving order that betters the protected best bid or offer at least 5% of the trading day in each assigned security and who receive lower execution fees as a result. Under the NASDAQ proposal, the Exchange would not create such a category of Members. Second, NASDAQ’s proposal would permit executions in all cases against resting RPI Orders and, additionally, other non-displayed liquidity resting on the Exchange’s System.<sup>14</sup> In contrast,

exception under Regulation NMS Rule 611(b)(1) or if such NBB or NBO is otherwise not available for an automatic execution. In such case, the Exchange states that the Protected NBBO would be the best-priced protected bid or offer to which a market center must route interest pursuant to Rule 611 of Regulation NMS.

<sup>11</sup> As explained further below, the Exchange has proposed two types of Retail Orders, one of which could execute against other interest if it was not completely filled by contra-side RPI Interest or other price-improving liquidity. All Retail Orders would first execute against available contra-side RPI Orders or other price-improving liquidity. 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>12</sup> See Securities Exchange Act Release No. 68303 (November 27, 2012), 77 FR 71652 (December 3, 2012) (SR–BYX–2012–019) (“BATS RPI Approval Order”).

<sup>13</sup> See Securities Exchange Act Release No. 67347 (July 3, 2012), 77 FR 40673 (July 10, 2012) (SR–NYSE–2011–55; SR–NYSEAmex–2011–84) (“NYSE RLP Approval Order”). In the RLP Approval Order, the Commission also approved a Retail Liquidity Program for NYSE Amex LLC (now known as NYSE MKT LLC) (“NYSE MKT”).

<sup>14</sup> The Exchange notes that other price improving liquidity may include, but is not limited to: booked non-displayed orders with a limit price that is more aggressive than the then-current NBBO; midpoint-pegged orders (which are by definition non-displayed and priced more aggressively than the

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<sup>57</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.

<sup>3</sup> See Securities Exchange Act Release No. 68336 (December 3, 2012), 77 FR 73097 (SR–NASDAQ–2012–129) (“Notice”).

<sup>4</sup> In Amendment No. 1, the Exchange proposes to clarify that, to qualify as a “Retail Order,” a “riskless principal” order must satisfy the criteria for riskless principal orders set forth in FINRA Rule 5320.03. Because the changes made in Amendment No. 1 do not materially alter the substance of the proposed rule change or raise any novel regulatory issues, Amendment No. 1 is not subject to notice and comment.

<sup>5</sup> 17 CFR 242.612 (“Sub-Penny Rule”).

pursuant to NYSE Rule 107C(k)(1), a Type 1-designated Retail Order, “will interact only with available contra-side Retail Price Improvement Orders and will not interact with other available contra-side interest in Exchange systems.”<sup>15</sup> Finally, under the NYSE’s Retail Liquidity Program, Retail Orders execute at the single price at which the order will be fully executed. Pursuant to NASDAQ’s proposal, Retail Orders execute at multiple price levels rather than a single price level.<sup>16</sup>

#### *Types of Orders and Identifier*

A Retail Order would be an agency or riskless principal<sup>17</sup> order that originates from a natural person and is submitted to the Exchange by a RMO, provided that no change is made to the terms of the order with respect to price (except in the case of a market order being changed to a marketable limit order) or side of market and the order does not originate from a trading algorithm or any other computerized methodology. As discussed in greater detail below, Retail Orders may be designated as Type 1 or Type 2. Retail Orders, regardless of Type, may be entered in sizes that are odd lots, rounds lots, or mixed lots.

An RPI Order would be non-displayed liquidity on the Exchange that is priced more aggressively than the Protected NBBO by at least \$0.001 per share and that is identified as an RPI Order in a manner prescribed by the Exchange. RPI interest can be priced either as an explicitly priced limit order or implicitly priced as relative to the NBBO with an offset of at least \$0.001. The price of an RPI Order with an offset would be determined by a Member’s entry of the following into the Exchange: (1) RPI buy or sell interest; (2) an offset from the Protected NBBO, if any; and (3) a ceiling or floor price. RPI Orders submitted with an offset would

NBBO); non-displayed orders pegged to the NBBO with an aggressive offset. Orders that do not constitute other price improving liquidity include, but are not limited to: orders with a time-in-force instruction of IOC; displayed orders; limit orders priced less aggressively than the NBBO.

<sup>15</sup> Additionally, pursuant to NYSE Rules 107C(k)(2) and 107C(k)(3), a Type 2-designated Retail Order and a Type 3-designated Retail Order can interact with other non-RPI interest in the NYSE systems; however, such interaction only occurs after a Retail Order first executes against RPI Orders.

<sup>16</sup> See Notice, *supra* note 3, 77 FR at 73100–01 (explaining the three distinctions in detail).

<sup>17</sup> In order to qualify as a “Retail Order,” a “riskless principal” order must satisfy the criteria set forth in FINRA Rule 5320.03. RMOs that submit riskless principal orders as Retail Orders must maintain supervisory systems to reconstruct such orders in a time-sequenced manner, and the RMOs must submit reports contemporaneous with the execution of the facilitated orders that identify such trades as riskless principal.

be similar to other peg orders available to Members in that the order is tied or “pegged” to a certain price, and would have its price automatically set and adjusted upon changes in the Protected NBBO, both upon entry and any time thereafter.

RPI Orders in their entirety (the buy or sell interest, the offset, and the ceiling or floor) will remain non-displayed. The Exchange will also allow Members to enter RPI Orders which establish the exact limit price, which is similar to a non-displayed limit order currently accepted by the Exchange today, except the Exchange will accept sub-penny limit prices on RPI Orders in increments of \$0.001.<sup>18</sup> The Exchange will monitor whether RPI buy or sell interest, adjusted by any offset and subject to the ceiling or floor price, is eligible to interact with incoming Retail Orders.

When RPI interest priced at least \$0.001 better than the Exchange’s Protected Bid or Protected Offer for a particular security is available in the System, the Exchange would disseminate an identifier, known as the Retail Liquidity Identifier, indicating that such interest exists. The Exchange would implement the Program in a manner that allowed the dissemination of the identifier through consolidated data streams (*i.e.*, pursuant to the Consolidated Tape Association Plan/Consolidated Quotation Plan (“CTA/CQ Plan”) for Tape A and Tape B securities, and the Nasdaq UTP Plan for Tape C securities as well as through proprietary Exchange data feeds). The Retail Liquidity Identifier would reflect the symbol and the side (buy or sell) of the RPI Order, but it would not include the price or size. In particular, the consolidated quoting outputs would include a field for codes related to the Retail Liquidity Identifier. The codes will indicate RPI interest that is priced better than the Protected Bid or Protected Offer by at least the minimum level of price improvement as required by the Program.

#### *Retail Member Organizations*

In order to become a RMO, a Member must conduct a retail business or handle retail orders on behalf of another broker-dealer. Any Member that wishes to obtain RMO status would be required to submit: (1) An application form; (2) an

<sup>18</sup> As noted above, *supra* note 6 and accompanying text, in connection with the Program, the Exchange requested exemptive relief from the Sub-Penny Rule of Regulation NMS, 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.

attestation, in a form prescribed by the Exchange, that any order submitted by the Member as a Retail Order would meet the qualifications for such orders under proposed Nasdaq Rule 4780(b); and (3) supporting documentation sufficient to demonstrate the retail nature and characteristics of the applicant’s order flow.<sup>19</sup> If the Exchange disapproves the application, it would provide a written notice to the Member. The disapproved applicant could appeal the disapproval as provided below and/or re-apply 90 days after the disapproval notice is issued by the Exchange. An RMO also could voluntarily withdraw from such status at any time by giving written notice to the Exchange.

The Exchange would require an RMO to have written policies and procedures reasonably designed to assure that it will only designate orders as Retail Orders if all the requirements of a Retail Order are met. Such written policies and procedures would have to require the Member to exercise due diligence before entering a Retail Order to assure that entry as a Retail Order is in compliance with the proposed rule, and monitor whether orders entered as Retail Orders meet the applicable requirements. If the RMO represents Retail Orders from another broker-dealer customer, the RMO’s supervisory procedures must be reasonably designed to assure that the orders it receives from such broker-dealer customer that it designates as Retail Orders meet the definition of a Retail Order. The RMO must obtain an annual written representation, in a form acceptable to the Exchange, from each broker-dealer customer that sends it orders to be designated as Retail Orders that entry of such orders as Retail Orders will be in compliance with the requirements of this rule, and monitor whether its broker-dealer customer’s Retail Order flow continues to meet the applicable requirements.<sup>20</sup>

#### *Retail Order Designations*

Under proposed Nasdaq Rule 4780(f), a RMO submitting a Retail Order could choose one of two designations dictating how it would interact with available

<sup>19</sup> For example, a prospective RMO could be required to provide sample marketing literature, Web site screenshots, other publicly disclosed materials describing the retail nature of their order flow, and such other documentation and information as the Exchange may require to obtain reasonable assurance that the applicant’s order flow would meet the requirements of the Retail Order definition.

<sup>20</sup> The Exchange represents that it or another self-regulatory organization on behalf of the Exchange will review a RMO’s compliance with these requirements through an exam-based review of the RMO’s internal controls. See Notice, *supra* note 3, 77 FR at 73099 n.7.

contra-side interest. First, a Retail Order could interact only with available contra-side RPI interest and other price-improving liquidity. The Exchange would label this a Type 1 Retail Order and such orders would not interact with available non-price-improving, 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 immediately and automatically.

Second, a Retail Order could interact first with available contra-side RPI Orders and other price-improving liquidity, and any remaining portion would be eligible to interact with other interest in the System and, if designated as eligible for routing, would route to other markets in compliance with Regulation NMS and pursuant to Nasdaq Rule 4758. The shares remaining from a Type 2-designated Retail Order that do not fully execute against contra-side RPI Orders or other price improving liquidity, if any, would execute against other liquidity available on the Exchange or be routed to other market centers for execution. The remaining unexecuted portion would then be cancelled.

#### *Priority and Allocation*

Under proposed Nasdaq Rule 4780(g), the Exchange would follow price-time priority, ranking RPI interest in the same security according to price and then time of entry into the System.<sup>21</sup> Any remaining unexecuted RPI Orders would remain available to interact with other incoming Retail Orders if such interest is at an eligible price. Any remaining unexecuted portion of a Retail Order would cancel or execute in accordance with proposed Nasdaq Rule 4780(f).<sup>22</sup>

#### *Failure of RMO To Abide by Retail Order Requirements*

Proposed Nasdaq Rule 4780(c) addresses an RMO's failure to abide by Retail Order requirements. If an RMO were to designate orders submitted to the Exchange as Retail Orders and the Exchange determined, in its sole discretion, that those orders failed to meet any of the requirements of Retail Orders, the Exchange could disqualify a Member from its status as a RMO. When disqualification determinations are made, the Exchange would provide a written disqualification notice to the Member. A disqualified RMO could appeal the disqualification as provided

<sup>21</sup> See also Nasdaq Rule 4757 (setting forth the Exchange's price-time priority methodology).

<sup>22</sup> The Exchange provides three examples of how the priority and ranking of RPI Orders would operate. See Notice, *supra* note 3, 77 FR at 73100.

below and/or re-apply 90 days after the disqualification notice is issued by the Exchange.

#### *Appeal of Disapproval or Disqualification*

Under Proposed Rule 4780(d), the Exchange would establish a Retail Price Improvement Program Panel ("RPI Panel") to review disapproval or disqualification decisions. If a Member disputes the Exchange's decision to disapprove or disqualify it as a RMO, such Member could request, within five business days after notice of the decision is issued by the Exchange, that the RPI Panel review the decision to determine if it was correct. The RPI Panel would consist of the Exchange's Chief Regulatory Officer or his or her designee, and two officers of the Exchange designated by the Exchange's Chief Operating Officer, and it would review the facts and render a decision within the timeframe prescribed by the Exchange. The RPI Panel could overturn or modify an action taken by the Exchange and all determinations by the RPI Panel would constitute final action by the Exchange on the matter at issue.

#### **III. Discussion and Commission Findings**

After careful review of the proposal, the Commission finds that the proposed rule change is 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 change, subject to its term as a pilot, is consistent with Section 6(b)(5) of the Act,<sup>23</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 requirements of the Act because the Program is reasonably designed to benefit retail investors by providing

price improvement to retail order flow.<sup>24</sup> 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 over-the-counter ("OTC") markets, pursuant to bilateral agreements, without ever reaching a public exchange. The Commission has 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>25</sup> A 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>26</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>27</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, the Exchange represents that it "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, 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."<sup>28</sup>

The Program proposes to create additional price improvement opportunities for retail investors by segmenting retail order flow on the Exchange 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. 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

<sup>24</sup> The Commission recently approved similar Programs for BATS-Y Exchange, NYSE and NYSE MKT. See BATS RPI Approval Order, *supra* note 12, and NYSE RLP Approval Order, *supra* note 13.

<sup>25</sup> See Securities Exchange Act Release No. 61358 (Jan. 14, 2010), 75 FR 3594, 3600 (Jan. 21, 2010) ("Concept Release on Equity Market Structure").

<sup>26</sup> See *id.*

<sup>27</sup> See *id.*

<sup>28</sup> See Notice, *supra* note 3, 77 FR at 73100.

<sup>23</sup> 15 U.S.C. 78f(b)(5).

with Section 6(b)(5) of the Act, which requires that the rules of an exchange are not designed to permit unfair discrimination. The Commission previously has recognized that the markets generally distinguish between individual retail investors, whose orders are considered desirable 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>29</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>30</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.

The Commission notes that the Program might also create a desirable opportunity for institutional investors to interact with retail order flow that they are not able to reach currently. Today, institutional investors often do not have the chance to interact with marketable retail orders that are executed pursuant to internalization arrangements. Thus, by submitting RPI Orders, institutional investors may be able to reduce their

possible adverse selection costs by interacting with retail order flow.

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>31</sup> As discussed above, the Commission believes this Program will promote competition for retail order flow by allowing Exchange Members to submit RPI 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>32</sup> The Commission finds that the Program provides an objective process by which a Member organization could become a RMO, and for appropriate oversight by the Exchange to monitor for continued compliance with the terms of these provisions. The Exchange has limited the definition of Retail Order to an agency or riskless principal order that originates from a natural person and not a trading algorithm or any other computerized methodology.

Furthermore, a Retail Order must be submitted by a RMO that is approved by the Exchange. In addition, RMOs 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 RMO is denied by the Exchange, that Member may appeal the determination or re-apply. 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 RMOs.

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 to advertise the presence of a RPI Order with which Retail Orders could interact. The identifier would reflect the symbol for a particular security and the side of the RPI 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 RPI Order and should provide market participants with more information about the availability of price improvement opportunities for retail orders than is currently available.<sup>33</sup>

The Exchange believes that the proposed Program, which will operate virtually the same as the BATS RPI Program, and similar to, but with distinctions from, the NYSE RLP Program, should both enhance competition among market participants and encourage competition among exchange venues.<sup>34</sup> Specifically, the Exchange believes that: allowing all Members to enter RPI Orders, as opposed to adopting a special category of retail liquidity provider, as NYSE did with its RLP Program, could result in a higher level of competition and could maximize price improvement to incoming Retail Orders; the Program will provide the maximum price improvement available to incoming Retail Orders because they will always interact with available contra-side RPI Orders and any other price-improving contra-side interest; and the Program will provide all of the price improvement available to incoming Retail Orders by allowing executions at multiple price levels, as opposed to a

<sup>29</sup> See BATS RPI Approval Order, *supra* note 12 and NYSE RLP Approval Order, *supra* note 13. See also Concept Release on Equity Market Structure, *supra* note 25; 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).

<sup>30</sup> See BATS RPI Approval Order, *supra* note 12, and NYSE RLP Approval Order, *supra* note 1313. See also 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>31</sup> See 15 U.S.C. 78c(f).

<sup>32</sup> In addition, the Commission believes that the Program's provisions concerning the approval and potential disqualification of RMOs are not inconsistent with the Act. See, e.g., NYSE RLP Approval Order, *supra* note 13, 77 FR at 40680 & n.77.

<sup>33</sup> As the Commission noted when approving the comparable BATS and NYSE programs, the Commission believes that the Program will not create any best execution challenges for brokers 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 BATS RPI Approval Order, *supra* note 12, 77 FR at 71657, and NYSE RLP Approval Order, *supra* note 13, 77 FR at 40680 n.75 (both citing FINRA Rule 5310).

<sup>34</sup> See Notice, *supra* note 3, 77 FR at 73102.

single clearing price level.<sup>35</sup> The Commission finds that the Program is reasonably designed to enhance competition among market participants and encourage competition among exchange venues. The Commission also finds that the distinctions between the Exchange's Program and the approved NYSE and NYSE MKT programs are reasonably designed to enhance the Program's price-improvement benefits to retail investors and, therefore, are consistent with the Act.

The Commission notes that it is approving the Program on a pilot basis. Approving the Program on a pilot basis will allow the Exchange and market participants to gain valuable practical experience with the Program during the pilot period. This experience should allow the Exchange 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 Exchange also has agreed to provide the Commission with a significant amount of data that should assist the Commission in its evaluation of the Program. Specifically, the Exchange has represented that it "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>36</sup> The Commission expects that the Exchange 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 comments, and empirical evidence, on the Program during the pilot period to further assist the Commission in its evaluation of the Program. The Commission notes that any permanent approval of the Program would require a proposed rule change by the Exchange, and such rule change will provide an opportunity for public comment prior to further Commission action.

#### IV. Exemption From the Sub-Penny Rule

Pursuant to its authority under Rule 612(c) of Regulation NMS,<sup>37</sup> the Commission hereby grants the 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 exemption shall operate for a period of 12 months, coterminous with the effectiveness of the proposed rule change approved today.

When the Commission adopted the Sub-Penny Rule in 2005, it identified a 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>38</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>39</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 an exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

The Commission believes that the Exchange's 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>40</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 exemption 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 change) 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

<sup>35</sup> See *supra* notes 14 to 16 and accompanying text.

<sup>36</sup> See *supra* note 28 and accompanying text.

<sup>37</sup> 17 CFR 242.612(c).

<sup>38</sup> See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37551–52 (June 29, 2005).

<sup>39</sup> *Id.* at 37553.

<sup>40</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 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.

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 exemption being granted today is limited to a one-year pilot. The Exchange has stated that “sub-penny trading and pricing could potentially result in undesirable market behavior,” and, therefore, it will “monitor the Program in an effort to identify and address any such behavior.”<sup>41</sup> Furthermore, the Exchange has represented that it “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>42</sup> The Commission expects to review the data and observations of the Exchange before determining whether and, if so, how to extend the exemption from the Sub-Penny Rule.<sup>43</sup>

**V. Conclusion**

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>44</sup> that the proposed rule change (SR-NASDAQ-2012-129) be, and hereby is, approved on a one-year pilot basis.

*It is also hereby ordered* that, pursuant to Rule 612(c) of Regulation NMS, the 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 change above, on a one-year pilot basis coterminous with the effectiveness of the proposed rule change.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>45</sup>

**Kevin O’Neill,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-68941; File No. SR-CBOE-2013-022]

**Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change To Amend the CBOE Stock Exchange Fees Schedule**

February 15, 2013.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 12, 2013, Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to amend the Fees Schedule of its CBOE Stock Exchange (“CBSX”). The text of the proposed rule change is available on the Exchange’s Web site (<http://www.cboe.com/AboutCBOE/CBOELegalRegulatoryHome.aspx>), at the Exchange’s Office of the Secretary, and at the Commission.

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

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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).

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

1. Purpose

The Exchange proposes to make a number of changes to the CBSX Fees Schedule. First, the Exchange proposes to amend the reference in Section 10 of the CBSX Fees Schedule to CBOE*direct* to refer to CBOE Command, as the manner through which CBSX Traders connect to the CBSX System is now called CBOE Command.

Second, CBSX proposes eliminate the distinction between Sponsored Users and non-Sponsored Users as they relate to CBOE Command Connectivity Charges. Currently, Sponsored Users are charged twice the regular monthly fees for such charges, with the types and amounts of such fees described in the chart below:

Description	Regular monthly fee	Sponsored user monthly fee
Network Access Port (1 Gbps)	\$250	\$500
Network Access Port (10 Gbps) .....	1,000	2,000
Network Access Port (Disaster Recovery) .....	250	500
CMI Login ID ....	100	200
FIX Login ID .....	100	200

Going forward, the Exchange proposes to assess to Sponsored Users and all other non-Trading Permit Holders the same CBOE Command Connectivity Charges as are assessed to Trading Permit Holders (“TPHs”), and to state that all such fees apply to non-TPHs as well as TPHs. The purpose of the proposed change is to simplify the Exchange’s fees structure for connectivity to the Exchange and have a standard set of connectivity fees that apply to both TPHs and non-TPHs.

CBSX also proposes to amend the manner in which it determines which fee tiers apply for Maker transactions in securities priced \$1 or greater. Currently, fees for such transactions are assessed depending on the amount of shares of liquidity that a Maker adds in one day, with the fee amount lowering based on a Maker adding higher levels of liquidity in one day. The current tiers

<sup>41</sup> See Request for Sub-Penny Rule Exemption, *supra* note 6, at 3, n.6.

<sup>42</sup> See *supra* note 28 and accompanying text.

<sup>43</sup> In particular, the Commission expects the Exchange to observe how maker/taker transaction charges, whether imposed by the Exchange or by

<sup>44</sup> 15 U.S.C. 78s(b)(2).

<sup>45</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(83).

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

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