

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-69032; File No. SR-NYSEArca-2013-10]

### Self-Regulatory Organizations; NYSE Arca, Inc.; Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 1, Adopting New Exchange Rule 6.65A To Provide for How the Exchange Proposes to Treat Orders, Market-Making Quoting Obligations, and Errors in Response to the Regulation NMS Plan To Address Extraordinary Market Volatility; and Amending Exchange Rule 6.65 To Codify That the Exchange Shall Halt Trading in All Options Overlying NMS Stocks When the Equities Markets Initiate a Market-Wide Trading Halt Due to Extraordinary Market Volatility

March 4, 2013.

Pursuant to Section 19(b)(1)<sup>1</sup> of the Securities Exchange Act of 1934 (the “Act”)<sup>2</sup> and Rule 19b-4 thereunder,<sup>3</sup> notice is hereby given that, on February 26, 2013, NYSE Arca, Inc. (the “Exchange” or “NYSE Arca”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the self-regulatory organization. On March 1, 2013, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes (i) to adopt new Exchange Rule 6.65A to provide for how the Exchange proposes to treat orders, market-making quoting obligations, and errors in response to the Regulation NMS Plan to Address Extraordinary Market Volatility; and (ii) to amend Exchange Rule 6.65 to codify that the Exchange shall halt trading in all options overlying NMS stocks when the equities markets initiate a market-wide trading halt due to extraordinary market volatility. The text of the proposed rule change is available on the Exchange’s Web site at [www.nyse.com](http://www.nyse.com), at the principal office of the Exchange, on the Commission’s Web site at

[www.sec.gov](http://www.sec.gov), and at the Commission’s Public Reference Room.

#### 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 self-regulatory organization 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 those 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 parts of such statements.

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

###### 1. Purpose

The Exchange proposes (i) to adopt Exchange Rule 6.65A to provide for how the Exchange proposes to treat orders, market-making quoting obligations, and errors in response to the Regulation NMS Plan to Address Extraordinary Market Volatility (the “Plan”), which is applicable to all NMS stocks, as defined in Regulation NMS Rule 600(b)(47); and (ii) to amend Exchange Rule 6.65 to codify that the Exchange shall halt trading in all options when the equities markets initiate a market-wide trading halt due to extraordinary market volatility. The Exchange proposes to adopt new Rule 6.65A for a pilot period that coincides with the pilot period for the Plan, which is currently scheduled as a one-year pilot to begin on February 4, 2013 [sic].

###### Background

Since May 6, 2010, when the markets experienced excessive volatility in an abbreviated time period, *i.e.*, the “flash crash,” the equities exchanges and FINRA have implemented market-wide measures designed to restore investor confidence by reducing the potential for excessive market volatility. The measures adopted include pilot plans for stock-by-stock trading pauses,<sup>5</sup> related changes to the equities market clearly erroneous execution rules,<sup>6</sup> and more stringent equities market maker quoting requirements.<sup>7</sup> On May 31, 2012, the Commission approved the

Plan, as amended, on a one-year pilot basis.<sup>8</sup> In addition, the Commission approved changes to the equities market-wide circuit breaker rules on a pilot basis to coincide with the pilot period for the Plan.<sup>9</sup>

The Plan is designed to prevent trades in individual NMS stocks from occurring outside of specified Price Bands.<sup>10</sup> As described more fully below, the requirements of the Plan are coupled with Trading Pauses to accommodate more fundamental price moves (as opposed to erroneous trades or momentary gaps in liquidity). All trading centers in NMS stocks, including both those operated by Participants and those operated by members of Participants, are required to establish, maintain, and enforce written policies and procedures that are reasonably designed to comply with the requirements specified in the Plan.<sup>11</sup>

As set forth in more detail in the Plan, Price Bands consisting of a Lower Price Band and an Upper Price Band for each NMS Stock are calculated by the Processors.<sup>12</sup> When the National Best Bid (Offer) is below (above) the Lower (Upper) Price Band, the Processors shall disseminate such National Best Bid (Offer) with an appropriate flag identifying it as unexecutable. When the National Best Bid (Offer) is equal to the Upper (Lower) Price Band, the Processors shall distribute such National Best Bid (Offer) with an appropriate flag identifying it as a Limit State Quotation.<sup>13</sup> All trading centers in NMS stocks must maintain written policies and procedures that are reasonably designed to prevent the display of offers below the Lower Price Band and bids above the Upper Price Band for NMS stocks. Notwithstanding this requirement, the Processor shall display an offer below the Lower Price Band or a bid above the Upper Price Band, but with a flag that it is non-executable. Such bids or offers shall not

<sup>8</sup> See Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) (File No. 4-631) (Order Approving, on a Pilot Basis, the Plan).

<sup>9</sup> See Securities Exchange Act Release No. 67090 (May 31, 2012), 77 FR 33531 (June 6, 2012) (SR-BATS-2011-038; SR-BYX-2011-025; SR-BX-2011-068; SR-CBOE-2011-087; SR-C2-2011-024; SR-CHX-2011-30; SR-EDGA-2011-31; SR-EDGX-2011-30; SR-FINRA-2011-054; SR-ISE-2011-61; SR-NASDAQ-2011-131; SR-NSX-2011-11; SR-NYSE-2011-48; SR-NYSEAmex-2011-73; SR-NYSEArca-2011-68; SR-Phlx-2011-129).

<sup>10</sup> Unless otherwise specified, capitalized terms used in this rule filing are based on the defined terms of the Plan.

<sup>11</sup> The Exchange is a participant in the Plan through its wholly-owned subsidiary, NYSE Arca Equities, Inc., which operates an equities market.

<sup>12</sup> See Section V(A) of the Plan.

<sup>13</sup> See Section VI(A) of the Plan.

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

<sup>2</sup> 15 U.S.C. 78a.

<sup>3</sup> 17 CFR 240.19b-4.

<sup>4</sup> See email from Brian O’Neill, Chief Counsel, NYSE Regulation, to Andrew Madar, Assistant Director, Division of Trading and Markets, dated March 1, 2013 (“Amendment No. 1”).

<sup>5</sup> See, e.g., NYSE Rule 80C, NYSE Arca Equities Rule 7.11.

<sup>6</sup> See, e.g., NYSE Rule 128, NYSE Arca Equities Rule 7.10.

<sup>7</sup> See, e.g., NYSE Rule 104(a)(1)(B), NYSE Arca Equities Rule 7.23(a)(1).

be included in the National Best Bid or National Best Offer calculations.<sup>14</sup>

Trading in an NMS stock immediately enters a Limit State if the National Best Offer (Bid) equals but does not cross the Lower (Upper) Price Band.<sup>15</sup> Trading for an NMS stock exits a Limit State if, within 15 seconds of entering the Limit State, all Limit State Quotations were executed or canceled in their entirety. If the market does not exit a Limit State within 15 seconds, then the Primary Listing Exchange would declare a five-minute trading pause pursuant to Section VII of the LULD Plan, which would be applicable to all markets trading the security.<sup>16</sup> In addition, the Plan defines a Straddle State as when the National Best Bid (Offer) is below (above) the Lower (Upper) Price Band and the NMS stock is not in a Limit State. For example, assume the Lower Price Band for an NMS Stock is \$9.50 and the Upper Price Band is \$10.50, such NMS stock would be in a Straddle State if the National Best Bid were below \$9.50, and therefore non-executable, and the National Best Offer were above \$9.50 (including a National Best Offer that could be above \$10.50). If an NMS stock is in a Straddle State and trading in that stock deviates from normal trading characteristics, the Primary Listing Exchange may declare a trading pause for that NMS stock if such Trading Pause would support the Plan's goal to address extraordinary market volatility.

#### Proposed New Rule 6.65A

The Exchange proposes to adopt new Exchange Rule 6.65A to provide for how the Exchange shall treat orders and quotes in options overlying NMS stocks when the Plan is in effect.

First, the Exchange proposes rules regarding the treatment of certain orders or quotes if the underlying NMS stock is in a Limit State and Straddle State. Whenever an NMS stock is in a Limit State or Straddle State, trading continues, however, there will not be a reliable price for a security to serve as a benchmark for the price of the option. For example, if the underlying NMS stock is in a Limit State, while trading in that stock continues, by being in a Limit State, there will be either cancellations or executions at that price, and if the Limit State is not resolved in

15 seconds, the NMS Stock will enter a Trading Pause. If an NMS stock is in a Straddle State, that means that there is either a National Best Bid or National Best Offer that is non-executable, which could result in limited price discovery in the underlying NMS stock. In addition to the lack of a reliable underlying reference price, the Exchange is concerned about the width of the markets and quality of the execution for market participants during Limit or Straddle States. While the Exchange recognizes the importance of continued trading in options overlying NMS stocks during Limit States and Straddle States, the Exchange believes that certain types of orders increase the risk of errors and poor executions and therefore should be not allowed during these times when there may not be a reliable underlying reference price, there may be a wide bid/ask quotation differential, and lower trading liquidity in the options markets. Specifically, the Exchange proposes that if the underlying NMS stock is in a Limit State or Straddle State, the Exchange shall reject all incoming Market Orders and will not elect Stop Orders.<sup>17</sup> The Exchange believes that permitting these order types to execute when the underlying NMS stock is in a Limit State or Straddle State would add to the volatility in the options markets during times of extraordinary market volatility and could have the potential to lead to unwanted executions. The Exchange believes that adding certainty to the treatment of Market Orders and Stop Orders when the underlying NMS stock is in these situations will encourage market participants to continue to provide liquidity to the Exchange and thus promote a fair and orderly market.

Second, the Exchange proposes to adopt subsection (b) to provide that when evaluating whether a Lead Market Maker has met its market-making quoting requirement pursuant to Rule 6.37B(b) or a Market Maker has met its market-making quoting requirement pursuant to Rule 6.37B(c) in options overlying NMS stocks, the Exchange shall consider as a mitigating circumstance the frequency and duration of occurrences when an underlying NMS stock is in a Limit State or a Straddle State. This is

necessary given the direct relationship between an options price and the price of the underlying security. During a Limit or Straddle State, the bid price, offer price or both of the underlying security will be unexecutable [sic]. With the bid and or offer flagged unexecutable, the ability to hedge the purchase or sale of an option will be jeopardized and in fact it may not be possible to purchase or sell shares of the underlying security at any price to offset the risk created by either buying or selling calls and/or put options during a Limit State or a Straddle State. The Exchange expects that its Market Makers will need to modify their quoting behavior as a result. For the reasons described below the Exchange feels that the proposed change to consider as a mitigating circumstance the frequency and duration of periods during which an underlying NMS stock is in a Limit State or a Straddle State is the appropriate approach until such a time as the Exchange has more experience with the impact of the Plan on the options marketplace, particularly the impact on Market Makers' ability to provide liquidity in an option when unknown (and possibility very limited) liquidity exists in the underlying security.

The Exchange has settled on this approach after analyzing in detail the alternatives. An undesirable alternative for the Exchange would be to propose to relax the quoting obligations. The relaxed quoting obligations could apply to the full trading day or just during the periods of extraordinary market volatility in the underlying NMS stock during a Straddle State or Limit State. The Exchange could, for example, have proposed to adopt the same market maker quoting obligations that apply to market makers another options market that only required its market makers to provide a two-sided continuous quote, without any \$5 or tighter bid-ask differential.<sup>18</sup> Absent the \$5 bid-ask differential requirement, the Exchange believes there would be no issue with Market Makers meeting their continuous quoting obligations during periods of extraordinary market volatility in the underlying stock because Market Makers could continuously quote a \$.01 bid and a \$1000 offer, for example. However, the Exchange believes that relaxing the quoting obligations only during Straddle States and Limit States would cause significant technical problems for Market Makers, Exchange systems, and surveillance monitoring. Underlying NMS stocks will likely flicker in and out of a Straddle State or

<sup>14</sup> See Section VI(A)(3) of the Plan.

<sup>15</sup> See Section VI(B)(1) of the Plan.

<sup>16</sup> The primary listing market would declare a Trading Pause in an NMS stock; upon notification by the primary listing market, the Processor would disseminate this information to the public. No trades in that NMS stock could occur during the trading pause, but all bids and offers may be displayed. See Section VII(A) of the Plan.

<sup>17</sup> See Rule 6.62(d)(1). Stop Orders when elected create a Market Order to buy or sell the option. In contrast, the Exchange is not proposing to prohibit the election of Stop Limit Orders. Stop Limit Orders when elected create a Limit Order to buy or sell the option at a specific price. See Rule 6.62(d)(2). The Exchange believes that Stop Limit Orders do not raise the same risks during periods of extraordinary volatility, because once elected the associated limit orders would not race through the order book in the manner that an elected Market Order would.

<sup>18</sup> See BATS Options Rule 22.6(d).

Limit State throughout the day. Programming systems to adjust the quoting obligations to constant changes in a Straddle State or Limit State would likely be technologically difficult and economically prohibitive. The only real practical solution would be for the Exchange to relax the quoting obligations for the full trading day by eliminating the \$5 bid-ask differential requirement. The Exchange believes that eliminating the \$5 bid-ask differential requirement is also an undesirable alternative. The Exchange values the role of Market Makers in the options market and believes that existing quoting requirements should be maintained in order to facilitate transactions, preserve market liquidity, and ensure the fair and orderly trading of options on the Exchange.

Therefore, in lieu of these alternatives, the Exchange proposes to adopt subsection (b) to provide that when evaluating whether a Specialist has met its market-making quoting requirement pursuant to Rule 925.1NY(b) [sic] or a Market Maker has met its market-making quoting requirement pursuant to Rule 925.1NY(c) [sic] in options overlying NMS stocks, the Exchange shall consider as a mitigating circumstance the frequency and duration that an underlying NMS stock is in a Limit State or a Straddle State. For example, if an OTP Holder fails to meet its monthly quoting obligations, and during the review, it is determined that the quoting that failed to meet the obligation was for options that overlay NMS stocks with a significant number of Straddle States and Limit States, then pursuant to proposed Rule 6.65A(c), that would be considered a mitigating circumstance that would entitle the OTP Holder to relief. The Exchange will work with FINRA to monitor the impact of Straddle States and Limit States on a Lead Market Maker or Market Maker's ability to meet its market-maker quoting requirements. The Exchange notes that it does not believe that it needs to modify the existing quoting obligations for Market Markers in Rules 6.37, 6.37A, and Rule 6.37B to reflect how such quoting requirements may interact with how underlying NMS stocks trade during a Straddle State or Limit State. Rather, during periods of extraordinary market volatility in the underlying NMS stock, the Exchange believes that the existing quoting requirements should be maintained in order to facilitate transactions, preserve market liquidity, and ensure the fair and orderly trading of options on the Exchange. This change is also designed to eliminate the

technologically difficult and economically prohibitive systems programming that would be required if the Exchange eliminated the \$5 bid-ask differential requirement only during Straddle States or Limit States.

Finally, the Exchange proposed to adopt subsection (c) to provide that electronic transactions in stock options that occur during a Limit State or a Straddle State would not be subject to review under Rule 6.87(a) for Obvious Errors or Rule 6.87(d) for Catastrophic Errors. In addition, subsection (c) will provide that electronic transactions in options that overlay an NMS stock that occur during a Limit State or a Straddle State may be reviewed on Exchange motion pursuant to 6.87(b)(3).<sup>19</sup> For the reasons described below the Exchange feels that the proposal to allow review of electronic transactions in options that overlay an NMS stock that occur during a Limit State or a Straddle State only on Exchange motion is the appropriate approach until such a time as the Exchange has more experience with the impact of the Plan on the options marketplace. In particular, the Exchange notes that other protections will continue to exist to safeguard Customers as discussed further below. The Exchange proposes to review the operation of this provision during the one year Pilot period for the proposal and analyze the impact of Limit and Straddle States accordingly.<sup>20</sup> In addition, the Exchange will provide

<sup>19</sup> Rule 6.87(b)(3) provides that in the interest of maintaining a fair and orderly market and for the protection of investors, the Chief Executive Officer of NYSE Arca, Inc. ("CEO") or designee thereof, who is an officer of the Exchange (collectively "Exchange officer"), may, on his or her own motion or upon request, determine to review any transaction occurring on the Exchange that is believed to be erroneous. A transaction reviewed pursuant to this provision may be nullified or adjusted only if it is determined by the Exchange officer that the transaction is erroneous as provided in Rules 6.87(a)(3), (a)(4), (a)(5) or (a)(6). A transaction would be adjusted or nullified in accordance with the provision under which it is deemed an erroneous transaction. The Exchange officer may be assisted by a Trading Official in reviewing a transaction. In addition, the Exchange officer shall act pursuant to Rule 6.87(b)(3) as soon as possible after receiving notification of the transaction, and ordinarily would be expected to act on the same day as the transaction occurred. In no event shall the Exchange officer act later than 9:30 a.m. (ET) on the next trading day following the date of the transaction in question. An ATP [sic] Holder affected by a determination to nullify or adjust a transaction pursuant to this paragraph (3) may appeal such determination in accordance with Rule 6.87(c); however, a determination by an Exchange officer not to review a transaction, or a determination not to nullify or adjust a transaction for which a review was requested or conducted, is not appealable. If a transaction is reviewed and a determination is rendered pursuant to Rules 6.87(a)(3), (a)(4), (a)(5) or (a)(6), no additional relief may be granted under this provision.

<sup>20</sup> See Amendment No. 1, *supra* note 4.

data analysis during the duration of the Pilot to the Commission so that the Commission may analyze the operation of the Pilot and evaluate with the Exchange whether the Pilot should be continued or be modified.<sup>21</sup>

The Exchange has settled on this approach after analyzing in detail the alternatives. An undesirable alternative for the Exchange would be to maintain the current operation of Rule 6.87(a) for Obvious Errors or 6.87(d) for Catastrophic Errors during the Limit State or Straddle State. Pursuant to Rules 6.87(a), market participants may have up to 30 minutes to review a transaction as an Obvious Error. Pursuant to 6.87(d), market participants may have up to 8:30 a.m. e.t. on the first trading day following a transaction to review it as a Catastrophic Error. The Exchange believes that during periods of extraordinary volatility, the review period for transactions under the Obvious Error and Catastrophic Error provisions would allow market participants a second look at transactions during a Limit State or a Straddle State that is potentially unfair to other market participants. For example, thirty minutes after a transaction that occurs during extraordinary volatility that triggers a Limit State or a Straddle State the market could look drastically different from a price and liquidity level. The Exchange believes that market participants should not be able to benefit from the time frame to review their transactions in these situations. This change would ensure that limit orders that were filled during a Limit or Straddle State would have certainty of execution. As noted above with respect to the treatment of Market Orders and Stop Orders when the underlying NMS Stock is in a Limit or Straddle State, the Exchange believes that adding certainty to the execution of orders in these situations will encourage market participants to continue to provide liquidity to the Exchange and thus promote a fair and orderly market. Barring this change, the provisions of Rule 6.87(a)(2)(B) would likely apply in many instances during Limit or Straddle States. This Rule provides that, "if there are not quotes for comparison purposes, or if bid/ask differential for the national best bid or offer for the effected series just prior to the transaction was at least two times the permitted bid/ask differential pursuant to Rule 6.37(b)(1)(A–E), as determined by a designated trading official." The Exchange believes this provision would give rise to much uncertainty for market

<sup>21</sup> *Id.*

participants as there is no bright line definition of what “theoretical value” should be for an option when the underlying NMS stock has an unexecutable bid or offer or both. Determining “theoretical value” in such a situation would be often times very subjective as opposed to an objective determination giving rise to additional uncertainty and confusion for investors. For example:

- A \$500 security enters a Straddle State resulting in un-executable bids and offers.
- Consequently the market for the options on that security widens to reflect the uncertainty surrounding what price the stock may be sold at to hedge the sale of puts or purchase of calls. Prior to entering the Straddle State, the 22 day at the money \$500 strike put options were trading at \$24.45–\$24.65.<sup>22</sup> Upon entering the Straddle State the market for those options widens to \$24.45–\$35.00.
- A limit order to pay \$32 for 10 is entered resulting in a new market of \$32.00–\$35.00. 14 seconds after entering the Limit State in the underlying security, a limit order to sell 10 contracts at \$32 is received and trades with the posted \$32 limit order to buy. Immediately after the trade is consummated, the Straddle State in the underlying security has not resolved and consequently the underlying security is halted. Upon resumption of trading in the underlying security, consider two possible scenarios:

- Scenario 1—The market for the security is \$450–\$452. The puts which traded immediately prior to the trading halt are now worth at least their intrinsic value of \$50 and quite likely are trading with some time premium as well. The seller of 10 contracts at \$32 immediately requests an Obvious Error review under the provisions of Rule 975NY [sic].

- Scenario 2—The market for the security is now \$550–\$552. The puts which traded immediately prior to the trading halt are now worth an estimated \$8.<sup>23</sup> The buyer of 10 contracts at \$32 immediately requests an Obvious Error review under the provisions of Rule 965NY [sic].

Under both scenarios the bid/ask spread in the option was \$2 at the time of the trade and as such it now falls to a designated trading official to determine what the “theoretical value” of the option is. Absent the ability to ascertain prices at which the stock could have been bought or sold *at the time* the option traded, the designated official would be at best guessing what the “theoretical value” should have been. Such uncertainty in how the transaction will be resolved will only discourage participants from entering executable interest during Limit and Straddle States. The impossibility of ascribing “theoretical value” to an option, whose price is directly affected by the ability to buy and sell shares of the underlying security, gives rise to the Exchange need to make clear that trades

during Limit and Straddle states will stand irrespective of subsequent price moves in the underlying security. Absent this bright line guidance, the Exchange expects the entry of executable interest in the options market to be severely curtailed as securities approach and enter Limit and Straddle States, decreasing the opportunity to foster price discovery and transparency at a time when it is most needed. In contrast, if participants know in advance that trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security, they will be much more likely to submit such limit prices.

Another undesirable alternative for the Exchange would be to propose to always use the prevailing NBBO as the metric to decide whether an error has occurred, irrespective of how wide the NBBO was at the time of the execution. This approach alleviates the burden on the Exchange of having to ascribe a Theoretical Price to an option when the stock has an un-executable bid, offer or both but it still presents significant problems. For example, in a Limit or Straddle State it is likely that there will be less depth of book—both on an intra as well as an inter-market basis. This gives rise to the potential for gaming of the Obvious Error Rule which mandates that Market Maker to Market Maker trades are always adjusted. For example, consider this scenario:

Exchange	Bid size	Bid price	Ask price	Ask size
NYSE Arca .....	50	\$5	\$7	1
NYSE Amex .....	5	6	15	100

An NYSE Amex Market Maker is offering 100 contracts at \$15. Another NYSE Amex Market Maker enters an ISO order to buy 100 contracts at \$15. Immediately after the execution the same NYSE Amex Options Market Maker requests a review under Rule 6.87. Simply using the NBBO, in this case \$7, would mean that as required under Rule 6.87, the Exchange would rule to adjust that trade to \$7.30, essentially forcing the NYSE Amex Market Maker who was willing to provide liquidity at \$15 to instead provide liquidity at the much worse price of \$7.30. Such an outcome would undoubtedly result in fewer Market Makers willing to post any liquidity for fear of having the same thing happen to

them. The Exchange notes that, if instead of a Market Maker offering 100 contracts at \$15, it was a Customer with a resting order in the Consolidated Book the outcome of a review under Rule 6.87 would have been to bust the trade. The time permitted to request a review, conduct the review and issue notification to the affected parties can be substantial, particularly in light of a Limit or Straddle State where the underlying security price is likely to be moving considerably. So we have a Customer who having sold options at \$15 which (for example) they bought earlier for \$10 finds themselves without a profit but instead with an open position. Obviously should the stock move adversely during the time taken to

review the trade it is even possible for the option to be worth less than where the Customer who was offering at \$15 purchased it. The Exchange strongly believes that certainty of trade during periods of market volatility is vital in order to operate a fair and orderly market.

Therefore, in lieu of these alternatives, the Exchange proposes to provide that the electronic transactions in stock options that occur during a Limit State or a Straddle State would not be subject to review under Rule 6.87(a) for Obvious Errors or Rule 6.87(d) for Catastrophic Errors. The Exchange would still review transactions in the interest of maintaining a fair and orderly market

<sup>22</sup> Calculated using a binomial pricing model for American style options with an interest rate of .25%, no dividends, and an implied volatility of 50.

<sup>23</sup> See *supra* note 19.

and for the protection of investors, on its own motion, determine to review any transaction occurring on the Exchange that is believed to be erroneous that occurs during a Limit State or a Straddle State in accordance with Rule 6.87(b)(3). The Exchange believes that this safeguard will provide the flexibility for the Exchange to act when necessary and appropriate to nullify or adjust a transaction, while also providing market participants with certainty that trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security. By limiting the erroneous trade review to only via Exchange motion, the Exchange believes that the proposal mitigates two of the undesirable aspects of the alternatives described above—(i) the moral hazard associated with granting a second look to trades that went against the market participant after market conditions have changed and (ii) gaming of the Obvious Error Rule to adjust Market Makers—while also limiting the discretion of determining Theoretical Value to only those situations that the Exchange determines is necessary in the interest of maintaining a fair and orderly market and for the protection of investors. The right to review on Exchange motion electronic transactions that occur during a Limit State or Straddle State under this provision would also allow the Exchange to account for unforeseen circumstances that result in Obvious Errors such as technological or systems malfunctions of which a nullification or adjustment may be necessary in order to preserve the interest of maintaining a fair and orderly market and for the protection of investors.

The Exchange notes that there are additional protections in place outside of the Obvious Error Rule, specifically pre-trade protections. First, SEC Rule 15c3-5 requires that, “financial risk management controls and supervisory procedures must be reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous.”<sup>24</sup> Secondly, the Exchange has price checks applicable to limit orders that rejects limit orders that are priced sufficiently far through the NBBO that it seems likely an error occurred. The requirements placed upon broker dealers to adopt controls to prevent the entry of orders that appear to be erroneous, coupled with Exchange functionality that filters out orders that appear to be erroneous serve to sharply reduce the incidence of errors arising

from situations, for example, where a participant mistakenly enters an order to pay \$20 for an option that is offered at \$2.

#### Proposed Amendment to Rule 6.65

The Exchange proposes to amend Rule 6.65 so that the Exchange, as an options market, can better respond to the manner by which the equities markets declare a market-wide trading halt, also known as a market-wide circuit breaker,<sup>25</sup> and to delete current Rule 7.5. Currently, Rule 7.5 simply restates the equities rule regarding market-wide trading halts, including references to halting trading in “stocks,” without reference to halting trading in options. In its current form,<sup>26</sup> Rule 7.5 provides for Level 1, 2, and 3 declines and specified trading halts following such declines. The values of Levels 1, 2 and 3 are calculated at the beginning of each calendar quarter, using 10%, 20% and 30%, respectively, of the average closing value of the DJIA for the month prior to the beginning of the quarter. Each percentage calculation is rounded to the nearest fifty points to create the Levels’ trigger points. The NYSE distributes new trigger levels quarterly to the media and via an NYSE Information Memo, and the new trigger levels are also available on the NYSE Web site.<sup>27</sup> The values then remain in effect until the next quarterly calculation, notwithstanding whether the DJIA has moved and a Level 1, 2, or 3 decline is no longer equal to an actual 10%, 20%, or 30% decline in the most recent closing value of the DJIA. Once a market-wide circuit breaker is in effect, trading in all securities on the Exchange, including stock options on NYSE Arca Options and stocks on NYSE Arca Equities, halt for the specified times in the Rule.

As noted above, the Commission has approved changes to the equities exchanges and FINRA rules regarding

market-wide trading halt rules, which are currently scheduled to go into effect on a one-year pilot basis beginning February 4, 2013 [sic]. The Exchange proposes to amend Rule 7.5 to reflect the changes approved for the equities markets by deleting the text that restates the former equities rule on halting trading in stocks and replace it with a new provision in Rule 6.65 that provides more generally that if the equities markets initiate a market-wide trading halt in response to extraordinary market volatility, the Exchange would likewise halt trading in all options. The proposed rule change is similar to a recently approved rule adopted by CBOE.<sup>28</sup> However, unlike the CBOE rule, the Exchange does not need to restate the equities rule on halting trading in stocks in the Exchange’s Rule set for options trading, because NYSE Arca Equities Rules already cover market-wide trading halts in stocks.<sup>29</sup> In addition, the Exchange is proposing to add Commentary .05 to provide that reopening of trading following a trading halt under this Rule shall be conducted pursuant to procedures adopted by the Exchange and communicated by notice to its OTP Holders and OTP Firms. This Commentary is nearly identical to that found in CBOE Rule 6.3B and current Commentary .03 to Exchange Rule 7.5 that is being deleted.<sup>30</sup>

The proposed rule change provides that whenever the equities markets halt trading in all NMS stocks due to extraordinary market volatility, the Exchange will similarly halt trading in all options. The Exchange believes that the proposed rule change can be adopted on a permanent basis notwithstanding that the equities market version of the market-wide circuit breakers has been adopted on a pilot basis. In particular, the Exchange believes that the proposed rule provides the Exchange with flexibility to halt trading in options whenever the equities markets halt trading in all stocks, regardless of what triggers that the equities markets may use for halting trading in all stocks. Accordingly, if the equities market pilot rules were to expire and revert back to the pre-February 4, 2013 [sic] version of market-wide trading halts, or if the equities markets again amend the triggers for their market-wide circuit breaker rule, the proposed Exchange rule would have sufficient flexibility to work with the revised equities rule without requiring an additional rule change by the Exchange. The Exchange also notes that

<sup>24</sup> See Securities Exchange Act Release No. 63241, 75 FR 69791 (November 15, 2010) (S7-03-10).

<sup>25</sup> Market-wide circuit breakers in the equities market are different than trading halt during a Trading Pause in the underlying pursuant to the LULD Plan. Market-wide circuit breakers for equities are currently covered by NYSE Arca Equities Rule 7.12. See NYSE Arca Equities Rule 7.12. The Exchange’s Rule regarding trading pauses (also known as “single stock circuit breakers”) is found in Rule 6.65(b) for options and NYSE Arca Equities Rule 7.11(b) for equities.

<sup>26</sup> The methodology for calculating market-wide trading halts was last amended in 1998, when declines based on specified point drops in the DJIA were replaced with the current methodology of using a percentage decline that is recalculated quarterly. See Securities Exchange Act Release No. 39846 (April 9, 1998), 63 FR 18477 (April 15, 1998) (SR-NYSE-98-06, SR-Amex-98-09, SR-BSE-98-06, SR-CHX-98-08, SR-NASD-98-27, and SR-Phlx-98-15).

<sup>27</sup> See, e.g., NYSE Regulation Information Memos 11-19 (June 30, 2011) and 11-10 (March 31, 2011).

<sup>28</sup> See CBOE Rule 6.3B.

<sup>29</sup> See NYSE Arca Equities Rule 7.12.

<sup>30</sup> See CBOE Rule 6.3B.

in addition to amended Rule 6.65, that the remaining provisions in existing Rule 6.65 regarding Trading Halts and Suspensions remain unchanged and provides a means to halt or suspend trading in options contracts whenever the Exchange deems such action appropriate in the interests of a fair and orderly market and to protect investors.

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act<sup>31</sup> in general, and furthers the objectives of Section 6(b)(5),<sup>32</sup> in particular, in that it is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system and, in general, to protect investors and the public interest. Specifically, this rule proposal supports the objectives of perfecting the mechanism of a free and open market and the national market system because it promotes uniformity across markets concerning when and how to halt trading in all stock options as a result of extraordinary market volatility.

The proposal to add Rule 6.65A will ensure that trading in options that overlay NMS stocks is appropriately modified to reflect market conditions that occur during a Limit State or a Straddle State in a manner that promotes just and equitable principles of trade and removes impediments to, and perfects the mechanism of, a free and open market and a national market system. Specifically, the proposal will help allow market participants to continue to trade stock options during times of extraordinary market conditions without the added risk of certain orders that may increase volatility in the options markets during times of extraordinary market volatility and may potentially lead to errors and poor executions due to the lack of reliable reference prices for the options and the width of the markets. Thus, reducing these risks should help encourage market participants to continue to provide liquidity during extraordinary market volatility.

The proposal to consider the frequency and duration of Straddle States and/or Limit States in the underlying NMS stock as mitigating circumstance in determining whether the Market Maker has met their quoting obligations will help ensure Market Makers continue to provide their necessary role in helping to facilitate transactions, to preserve market

liquidity, and to help ensure the fair and orderly trading of stock options on the Exchange during periods of extraordinary market volatility while also providing reasonable relief when necessary.

In addition, the proposal to not allow electronic transactions in stock options that occur during a Limit State or a Straddle State to be subject to review under Rule 6.87(a) for Obvious Errors or Rule 6.87(d) for Catastrophic Errors is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system and, in general, to protect investors and the public interest, by ensuring that Exchange officials do not have discretion to cancel trades. This change would ensure that limit orders that are filled during a Limit or Straddle State would have certainty of execution in a manner that promotes just and equitable principles of trade and removes impediments to, and perfects the mechanism of, a free and open market and a national market system. The proposal to allow electronic transactions in options that occur during a Limit State or a Straddle State may be reviewed on Exchange motion pursuant to 6.87(b)(3) is designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system and, in general, to protect investors and the public interest, by providing the flexibility for the Exchange to still review transactions for Obvious Error treatment when in the interest of maintaining a fair and orderly market and for the protection of investors.

Finally, the proposal to amend Rule 6.65 and delete current Rule 7.5 will ensure that the Exchange halts trading in all options whenever the equities markets initiate a market-wide trading halt circuit breaker in response to extraordinary market conditions in a manner that promotes just and equitable principles of trade and removes impediments to, and perfects the mechanism of, a free and open market and a national market system because the proposed rule change will assure that the Exchange will halt options trading regardless of the triggers that the equities markets use to initiate a market-wide halt in trading.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance

of the purposes of the Act. The proposed changes are being made to provide for how the Exchange shall treat orders and quotes in options overlying NMS stocks when the Plan is in effect and will not impose any burden on competition while providing certainty of treatment and execution of options orders during periods of extraordinary volatility in the underlying NMS stock, and facilitating appropriate liquidity during a Limit State or Straddle State.

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

No written comments were solicited or received with respect to the proposed rule change.

### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) By order approve or disapprove such proposed rule change, or
- (B) Institute proceedings to determine whether the proposed rule change should be disapproved.

### **IV. Solicitation of Comments**

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

#### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NYSEArca-2013-10 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-NYSEArca-2013-10. This file number should be included on the subject line if email is used. To help the Commission process and review your

<sup>31</sup> 15 U.S.C. 78f(b).

<sup>32</sup> 15 U.S.C. 78f(b)(5).

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 printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NYSEArca-2013-10 and should be submitted on or before March 29, 2013.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>33</sup>

**Kevin M. O'Neill,**  
Deputy Secretary.

[FR Doc. 2013-05418 Filed 3-7-13; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-69028; File No. SR-NASDAQ-2013-035]

### Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change To Assess a Fee for the Limit Locator Service

March 4, 2013.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 21, 2013, The NASDAQ Stock Market LLC ("NASDAQ" or the "Exchange") filed with the Securities and Exchange Commission ("Commission") a 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

NASDAQ proposes to assess a fee for the Limit Locator service under Rule 7061. NASDAQ will begin assessing the proposed fee on April 8, 2013.

The text of the proposed rule change is below. Proposed new language is in italics; proposed deletions are in brackets.

##### 7061. Limit Locator

Limit Locator is a tool to assist a member firm in monitoring its trades reported into the FINRA/NASDAQ TRF for compliance with the requirements of the National Market System Plan to Address Extraordinary Market Volatility. The service provides a subscribing member firm with an overview of its trades reported at, or outside of, a designated Limit Up/Limit Down pricing band. The service will provide a total count of the subscribing member firm's trades in each category as well as present this information graphically, on a rolling month basis. A subscribing member firm is able to create custom email alerts to notify users when a trade is reported at, or outside of, a Limit Up/Limit Down pricing band. Limit Locator is accessed through the NASDAQ Workstation or Weblink ACT 2.0 and is offered *for a fee of \$750 per month/per MPID beginning April 8, 2013* [at no cost at this time].

\* \* \* \* \*

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

In its filing with the Commission, NASDAQ 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 those 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 parts of such statements.

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

##### 1. Purpose

NASDAQ is proposing to amend Rule 7061 to establish fees for the Limit Locator service. Limit Locator is an add on tool to the NASDAQ Workstation and Weblink ACT 2.0 that assists a member firm that is a FINRA/NASDAQ TRF ("TRF") participant in monitoring its trades reported into the TRF for compliance with the requirements of the National Market System Plan to Address Extraordinary Market Volatility (the "Plan").<sup>3</sup> The Plan provides a limit up/limit down mechanism designed to prevent trades in NMS securities from occurring outside of specified price bands. Limit Locator assists member firms in complying with the Plan by tracking trades reported to the TRF that occur at, or outside of, the limit up/limit down bands and providing notice thereof.<sup>4</sup>

NASDAQ implemented Limit Locator on February 4, 2013<sup>5</sup> at no cost so that member firms could become familiar with the service using the test securities of the Plan.<sup>6</sup> Phase I of the Plan will be implemented on April 8, 2013 and will apply the limit up/limit down bands only to Tier 1 NMS Stocks, which are defined as all NMS Stocks included in the S&P 500 Index, the Russell 1000 Index, and a list of exchange-traded products. Accordingly, NASDAQ is proposing to offer the service for a monthly fee of \$750 per member MPID concurrent with the Phase I

<sup>3</sup> On April 5, 2011, the Exchange, together with other self-regulatory organizations, filed with the Commission a national market system plan to adopt a market-wide limit up/limit down system to reduce the negative impacts of sudden, unanticipated price movements in NMS Stocks, like that which was experienced on May 6, 2010. Securities Exchange Act Release No. 64547 (May 25, 2011), 76 FR 31647 (June 1, 2011) (File No. 4-631). The Plan was approved by the Commission on May 31, 2012. Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012).

<sup>4</sup> The Commission notes that every member firm has obligations under the Plan to establish, maintain, and enforce written policies and procedures that are reasonably designed to comply with the limit up/limit down and trading pause requirements. Use of Limit Locator may assist a member firm in complying with these requirements, but use of Limit Locator alone does not satisfy a member firm's obligation under the plan. See Securities Exchange Act Release No. 68841 (February 6, 2013), 78 FR 9966 (February 12, 2013) (SR-NASDAQ-2013-020) footnote 4.

<sup>5</sup> Securities Exchange Act Release No. 68841 (February 6, 2013), 78 FR 9966 (February 12, 2013) (SR-NASDAQ-2013-020).

<sup>6</sup> Beginning on February 4, 2013, the Securities Information Processors began transmitting limit up/limit down data in select securities to allow participants to develop and test their systems in preparation for the implementation of the Plan.

<sup>33</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.