



8011-01p
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67256; File No. SR-BX-2012-030)

June 26, 2012

Self-Regulatory Organizations; NASDAQ OMX BX, Inc.; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, Relating to the Establishment of a New Options Market, NASDAQ OMX BX Options

I. Introduction

On May 1, 2012, NASDAQ OMX BX, Inc. (“Exchange” or “BX”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² to adopt rules governing the trading of options on NASDAQ OMX BX Options (“BX Options”), which will be an options trading facility of the Exchange. On May 8, 2012, BX filed Amendment No. 1 to the proposed rule change.³ The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on May 18, 2012.⁴ The Commission received one comment letter on the proposal.⁵ The Exchange responded to the comment letter on June 15, 2012.⁶ On June 22, 2012, BX filed Amendment No. 2 to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 made several technical and clarifying changes to the proposal, as well as minor changes to the definition of the terms “primary market” and “Intermarket Sweep Order.”

⁴ See Securities Exchange Act Release No. 66983 (May 14, 2012), 77 FR 29730. (“Notice”).

⁵ See Letter from Edward T. Tilly, President and Chief Operating Officer, Chicago Board Options Exchange, Incorporated (“CBOE”), to Elizabeth M. Murphy, Secretary, Commission, dated June 5, 2012 (“CBOE Letter”).

⁶ See Letter from Thomas Wittman, Senior Vice President, NASDAQ OMX, to Elizabeth M. Murphy, Secretary, Commission, dated June 15, 2012 (“BX Response”).

proposed rule change.⁷ This order approves the proposed rule change, as modified by Amendment Nos. 1 and 2 thereto.

II. Discussion and Commission Findings

After careful review of the proposal, as modified by Amendment Nos. 1 and 2, and consideration of the comment letter and the Exchange's response thereto, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.⁸ Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,⁹ which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers. Further, the Commission finds that the proposal is consistent with Sections 6(b)(1) of the Act,¹⁰ which requires, among other things, that a national securities exchange be so organized and have the

⁷ Amendment No. 2 clarified the Exchange's status with respect to its participation in various national market system plans, and clarified representations with respect to its regulatory agreements. Because Amendment No. 2 is technical in nature, the Commission is not required to publish it for public comment.

⁸ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ 15 U.S.C. 78f(b)(1).

capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulation thereunder, and the rules of the exchange.

This discussion does not review every detail of the proposal, but focuses on the most significant rules and policy issues considered in review of the proposal.

A. BX Options Participants

BX Options will operate a fully automated electronic trading system for trading options (“System” or “BX Options System”).¹¹ BX Options will have only one category of members, known as “Options Participants” or “Participants.”¹² Only Options Participants will be permitted to transact business on the BX Options System.¹³ There will be two categories of Options Participants: (1) Options Order Entry Firms (“OEFs”) and (2) Options Market Makers. An Options Participant must be a member of the Exchange and another registered options exchange that is not registered solely under Section 6(g) of the Act¹⁴ or the Financial Industry Regulatory

¹¹ The proposed rules of BX Options are based on, and virtually identical to, the rules of the NASDAQ Options Market (“NOM”), the options trading facility of The NASDAQ Stock Market LLC (“NASDAQ”). See Notice, supra note 4, at 29731.

¹² The term “Options Participant” or “Participant” means a firm, or organization that is registered with the Exchange pursuant to Chapter II of BX Options proposed rules for purposes of participating in options trading on BX Options as a BX Options Order Entry Firm or BX Options Market Maker. See proposed BX Options Rules, Chapter I, Section 1(a)(41). All BX members will be eligible to participate in BX Options provided that BX specifically authorizes them to trade in the System and they become Options Participants. Existing BX members that will become Options Participants will be required to comply with the incremental requirements of the proposed BX Options Rules. New BX members will be required to fulfill the requirements of the BX Rule 1000 Series to become a BX member as well as the incremental requirements set forth in the proposed BX Options Rules to become an Options Participant.

¹³ See proposed BX Options Rules, Chapter II and Chapter V, Section 1.

¹⁴ 15 U.S.C. 78f(g).

Authority (“FINRA”).¹⁵ Further, an OEF may only transact business with public customers if such Options Participant also is a member of another registered national securities exchange or association with which the Exchange has entered into an agreement under Rule 17d-2 under the Act pursuant to which such other exchange or association shall be the designated options examining authority for the OEF.¹⁶ In addition, Options Participants that transact business with Public Customers must at all times be members of FINRA.¹⁷

Among other things, each Options Participant must be registered as a broker-dealer and have as the principal purpose of being an Options Participant the conduct of a securities business, which shall be deemed to exist if and so long as: (1) The Options Participant has qualified and acts in respect of its business on BX Options as either an OEF or an Options Market Maker or both; and (2) all transactions effected by the Options Participant are in compliance with Section 11(a) of the Act¹⁸ and the rules and regulation adopted thereunder.¹⁹ Options Participants may trade options for their own proprietary accounts or, if authorized to do so under applicable law, may conduct business on behalf of customers.²⁰

OEFs are Options Participants representing customer orders as agent on BX Options or trading as principal on BX Options.²¹ Options Market Makers are Options Participants registered with the Exchange as Options Market Makers and registered with the Exchange in one

¹⁵ See proposed BX Options Rules, Chapter II, Section 2(f).

¹⁶ See proposed BX Options Rules, Chapter XI, Section 1.

¹⁷ See proposed BX Options Rules, Chapter II, Section 2(f).

¹⁸ 15 U.S.C. 78k(a).

¹⁹ See proposed BX Options Rules, Chapter II, Section 2(e).

²⁰ See proposed BX Options Rules, Chapter II, Section 1(a).

²¹ See proposed BX Options Rules, Chapter VII, Section 1.

or more options listed on BX Options.²² A Market Maker that engages in specified Other Business Activities, or that is affiliated with a broker-dealer that engages in Other Business Activities, including functioning as an OEF, must have an Information Barrier between the market making activities and the Other Business Activities.²³ To become an Options Market Maker, an Options Participant is required to register by filing a written application with BX Regulation, which will consider an applicant's market making ability and such other factors as it deems appropriate in determining whether to approve an applicant's registration as a Market Maker.²⁴ BX Options will not place any limit on the number of entities that may become Options Market Makers.²⁵ BX Regulation, which is a department of the Exchange that supervises and administers the regulatory functions of the Exchange, may suspend or terminate any registration of an Options Market Maker when, in BX's judgment, the interest of a fair and orderly market are best served by such action.²⁶

Options Market Makers are required to electronically engage in a course of dealings to enhance liquidity available on BX Options and to assist in the maintenance of fair and orderly

²² See proposed BX Options Rules, Chapter VII. All Market Makers are designated as specialists on BX Options for all purposes under the Act or the rules thereunder. See proposed BX Options Rules, Chapter VII, Section 2.

²³ See proposed BX Options Rules, Chapter VII, Section 10(a).

²⁴ See proposed BX Options Rules, Chapter VII, Section 2(a).

²⁵ See proposed BX Options Rules, Chapter VII, Section 2(c). However, the Board of Directors of BX may limit access to the System based on system constraints, capacity restrictions, or other factors relevant to protecting the integrity of the System, pending action required to address the issue of concern. To the extent the Exchange places limitations on access to the System on any Participant(s), such limits shall be objectively determined and submitted to the Commission for approval pursuant to a rule change filed under Section 19(b) of the Act. See proposed BX Options Rules, Chapter VII, Section 2(c).

²⁶ See proposed BX Options Rules, Chapter VII, Section 2(b).

markets.²⁷ Among other things, an Options Market Maker must: (1) On a daily basis participate in the pre-opening phase and thereafter maintain a two-sided market on a continuous basis in at least 60% of the options series in which it is registered; (2) enter a size of at least one contract for its best bid and its best offer; and (3) maintain minimum net capital in accordance with Commission and Exchange rules.²⁸ Substantial or continued failure by an Options Market Maker to meet any of its obligations and duties would subject the Options Market Maker to disciplinary action, suspension, or revocation of the Options Market Maker's registration in one or more options series.²⁹

The Commission finds that the BX Options Market Maker qualification requirements are consistent with the Act and notes that they are similar to those of other options exchanges.³⁰ The Commission also finds that the BX Options Market Maker participation requirements are consistent with the Act. Market makers receive certain benefits for carrying out their responsibilities. For example, a broker-dealer or other lender may extend "good faith" credit to a member of a national securities exchange or registered broker-dealer to finance its activities as a market maker or specialist.³¹ In addition, market makers are exempted from the prohibition in Section 11(a) of the Act. The Commission believes that a market maker must have sufficient affirmative obligations, including the obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis, to justify this favorable treatment.

²⁷ See proposed BX Options Rules, Chapter VII, Section 5(a).

²⁸ See, e.g., proposed BX Options Rules, Chapter VII, Sections 5 and 6.

²⁹ See proposed BX Options Rules, Chapter VII, Section 4(b).

³⁰ See, e.g., Rules of NOM, Chapter VII, Sections 4, 5, and 6; and BATS Rules 22.4, 22.5 and 22.6.

³¹ See 12 CFR 221.5 and 12 CFR 220.7; see also 17 CFR 240.15c3-1(a)(6) (capital requirements for market makers).

The Commission believes that BX Options Market Maker participation requirements impose sufficient affirmative obligations on BX Options Market Makers and, accordingly, that these BX Options requirements are consistent with the Act.³²

B. BX Options Trading System

The BX Options System will leverage current technology, including customer connectivity, messaging protocols, quotation and execution engine, order router, data feeds, and network infrastructure of the various markets owned by The NASDAQ OMX Group, Inc. (“NASDAQ OMX”). As a result, BX Options System will closely resemble NOM.³³ As noted above, the BX Options System will be an electronic trading system to trade options that will provide for the electronic display and automatic execution of orders in price/time priority, without regard to the status of the entities that are entering orders.³⁴ The System will include two proprietary data feeds. BX Depth of Market (“BX Depth”) will be a data feed that provides quotation information for individual orders on the BX Options book, last-sale information for trades executed on BX Options, and order imbalance information as set forth in BX Options

³² The Commission notes that the participation requirements are similar to those of other options exchanges. See, e.g., NOM Rules, Chapter VII, Sections 5 and 6; and BATS Rules 22.5 and 22.6.

³³ See Notice, supra note 4, at 29731.

³⁴ The System includes: (1) An order execution service that enables Options Participants to automatically execute transactions in securities listed and traded on BX Options; (2) a trade reporting service that submits “locked-in” trades for clearing to a registered clearing agency for clearance and settlement, transmits last-sale reports of transactions automatically to the Options Price Reporting Authority (“OPRA”) for dissemination to the public and industry, and provides participants with monitoring and risk management capabilities to facilitate participation in a “locked-in” trading environment; and (3) two proprietary data feeds. See proposed BX Options Rules, Chapter VI, Section 1(a). See Notice, supra note 4, for a more complete description of BX Options operation and rules. The Commission notes that the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information (“OPRA Plan”) requires each party to the Plan to collect and promptly transmit to the OPRA all last sale reports relating to its market. See OPRA Plan, Article V, Section 5.2(a).

Rules Chapter VI, Section 8.³⁵ In addition, BX Top of Market (“BX Top”) will be a data feed that provides the BX Options best bid and offer and last-sale information for trades executed on BX Options.³⁶

Options Participants will be able to enter the following types of orders into the System: Limit Orders;³⁷ Minimum Quantity Orders;³⁸ Market Orders;³⁹ Price Improving Orders;⁴⁰ Intermarket Sweep Orders;⁴¹ One-cancels-the-other Orders;⁴² All-or-none Orders;⁴³ and Post

³⁵ See proposed BX Options Rules, Chapter VI, Section 1(a)(3). See also proposed BX Options Rules, Chapter VI, Section 8.

³⁶ See proposed BX Options Rules, Chapter VI, Section 1(a)(3).

³⁷ Limit Orders are orders to buy or sell an option at a specified price or better. A limit order is marketable when, for a limit order to buy, at the time it is entered into the System, the order is priced at the current inside offer or higher, or for a limit order to sell, at the time it is entered into the System, the order is priced at the inside bid or lower. See proposed BX Options Rules, Chapter VI, Section 1(e)(2).

³⁸ Minimum Quantity Orders are orders that require that a specified minimum quantity of contracts be obtained, or the order is cancelled. Minimum Quantity Orders are treated as having a time-in-force designation of Immediate or Cancel. Minimum Quantity Orders received prior to the opening cross or after market close will be rejected. See proposed BX Options Rules, Chapter VI, Section 1(e)(3).

³⁹ Market Orders are orders to buy or sell at the best price available at the time of execution. Options Participants can designate that their Market Orders not executed after a pre-established period of time, as established by the Exchange, will be cancelled back to the Participant. See proposed BX Options Rules, Chapter VI, Section 1(e)(5).

⁴⁰ Price Improving Orders are orders to buy or sell an option at a specified price at an increment smaller than the minimum price variation in the security. Price Improving Orders may be entered in increments as small as one cent. Price Improving Orders that are available for display shall be displayed at the minimum price variation in that security and shall be rounded up for sell orders and rounded down for buy orders. See proposed BX Options Rules, Chapter VI, Section 1(e)(6).

⁴¹ Intermarket Sweep Orders (“ISOs”) means a limit order for an options series that: (1) when routed to an eligible exchange, the order is identified as an ISO; and (2) simultaneously with the routing of the order, one or more additional ISOs, as necessary, are routed to execute against the full displayed size of any protected bid, in the case of a limit order to sell, or any protected offer, in the case of a limit order to buy, for the options series with a price that is superior to the limit price of the ISO, which such additional orders also marked as ISOs. See proposed BX Options Rules, Chapter XII, Section 1(9). ISOs may have any time-in-force designation except WAIT. See

Only Orders;⁴⁴ with characteristics and functionality identical to what is currently approved for use on NOM.⁴⁵ Orders entered into the System will be designated for display (price and size) on an anonymous basis in the order display service of the System.⁴⁶ Options Participants will be permitted to enter multiple orders at single or multiple price levels.⁴⁷

Amendment No. 1. ISOs with a time-in-force designation of Good Til canceled (“GTC”) are treated as having a time-in-force designation of DAY. See id. ISOs that are marked as Day or GTC lose the ISO designation once posted on the BX Options book. See id. If an entering firm cancel/replaces that resting Day or GTC ISO order, the replacement order cannot be marked as ISO. See id.

⁴² One-cancels-the-other Orders are orders entered by a Market Maker that consists of a buy order and a sell order treated as a unit; the full execution of one of the orders causes the other to be canceled. See proposed BX Options Rules, Chapter VI, Section 1(e)(9).

⁴³ All-or-none Orders are market or limit orders which are to be executed in its entirety or not at all. All-or-none Orders are treated as having a time-in-force designation of Immediate or Cancel. All-or-none Orders received prior to the opening cross or after market close will be rejected. See proposed BX Options Rules, Chapter VI, Section 1(e)(10).

⁴⁴ Post-Only Orders are orders that will not remove liquidity from the System. Post- Only Orders are to be ranked and executed on the Exchange or cancelled, as appropriate, without routing away to another market. Post-Only Orders are evaluated at the time of entry with respect to locking or crossing other orders as follows: (i) if a Post-Only Order would lock or cross an order on the System, the order will be re-priced to \$.01 below the current low offer (for bids) or above the current best bid (for offers) and displayed by the System at one minimum price increment below the current low offer (for bids) or above the current best bid (for offers); and (ii) if a Post-Only Order would not lock or cross an order on the System but would lock or cross the NBBO as reflected in the protected quotation of another market center, the order will be handled pursuant to proposed BX Options, Chapter VI, Section 7(b)(3)(C). Post-Only Orders received prior to the opening cross or after market close will be rejected. Post-Only Orders may not have a time-in-force designation of Good Til Cancelled or Immediate or Cancel. See proposed BX Options Rules, Chapter VI, Section 1(e)(10).

⁴⁵ See proposed BX Options Rules, Chapter VI, Section (1)(e). Options Participants entering orders into the System may designate such orders to remain in force and available for display and/or potential execution for varying periods of time. Unless cancelled earlier, once these time periods expire, the order (or the unexecuted portion thereof) is returned to the entering party. See proposed BX Options Rules, Chapter VI, Section (1)(g).

⁴⁶ See Notice, supra note 4, at 29733.

⁴⁷ See id.

All trading interest on the System will be automatically executable. The System will have a single execution algorithm based on price/time priority. The System and BX Options Rules provide for the ranking, display, and execution of all orders in price/time priority without regard to the status of the entity entering an order. For each order, among equally-priced or better-priced trading interest, the System executes against available contra-side contract amounts in full, in price/time priority.⁴⁸ Any price improvement resulting from an execution in the System will accrue to the party taking liquidity.⁴⁹

Quotes and orders entered by Options Market Makers will not be executed against quotes and orders entered on the opposite side of the market by the same market maker using the same identifier.⁵⁰ In such a case, the System will cancel the oldest of the quotes or orders back to the entering party prior to execution.⁵¹

The Commission believes that BX Options' proposed execution priority rules and order types are consistent with the Act, and in particular, with the requirements in Section 6(b)(5) of the Act, which requires an exchange's rules be, among other things, designed to promote just and equitable principles of trade, 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 are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. The Commission further finds that BX Options' proposed trading rules are consistent with the requirements of the Options Order Protection and Locked/Crossed Market Plan ("Linkage Plan"). Specifically, subject to the exceptions contained in proposed BX Options

⁴⁸ See proposed BX Options Rules, Chapter VI, Section 10.

⁴⁹ See proposed BX Options Rules, Chapter VI, Section 10(3).

⁵⁰ See proposed BX Options Rules, Chapter VI, Section 10(6).

⁵¹ See id.

Rules, Chapter XII, the System will ensure that an order is not executed at a price that trades through another options exchange.⁵² In this regard, the Commission notes that BX is required under Rule 608(c) of Regulation NMS to comply with and enforce compliance by its members with the Linkage Plan, including the requirement to avoid trading through better prices available on other markets.⁵³ Further, any order entered with a price that would lock or cross a protected quotation that is not eligible for routing, will be re-priced to the current national best offer (for bids) or the current national best bid (for offers) and displayed at one minimum price variance above (for offers) or below (for bids) the national best price.⁵⁴

One commenter expressed concern with the timing of the proposal and requested that the Commission grant CBOE and C2 Options Exchange, Incorporated (“C2”) temporary relief from the Linkage Plan.⁵⁵ Specifically, the commenter noted that CBOE and C2 will not be able to complete required systems work by BX Options’ anticipated launch date of June 29, 2012 to allow these exchanges to identify better-priced quotations on BX Options and then cancel or route orders to BX Options in compliance with the Linkage Plan. Consequently, the commenter stated that these exchanges may not be able to comply with the Linkage Plan because their systems will potentially trade through better-priced quotations on BX Options. The commenter requested temporary relief from the Linkage Plan so that CBOE and C2 will be able to continue to operate consistent with the terms of the Linkage Plan until it can implement the necessary systems changes. While BX believes that the notice provided to CBOE and the marketplace in general was sufficient and consistent with customary timeframes respecting systems changes of

⁵² See proposed BX Options Rules, Chapter XII, Section 2.

⁵³ See 17 CFR 242.608(c). See also proposed BX Options Rules, Chapter XII, Section 2(b).

⁵⁴ See proposed BX Options Rules, Chapter VI, Section 7(b)(3)(C).

⁵⁵ See CBOE Letter, supra note 5.

this sort, BX acknowledged the commenter's concerns and stated that temporary relief from the Linkage Plan warrants consideration.⁵⁶

As noted below, BX will be a participant in the Linkage Plan. To meet their regulatory responsibilities under the Linkage Plan, including the requirement to avoid trading through better-priced protected quotations available on other markets, other options exchanges that are Linkage Plan participants must have sufficient notice of new protected quotations, as well as all necessary information (such as final technical specifications). Therefore, the Commission believes that it would be a reasonable policy and procedure under the Linkage Plan for options exchanges to begin treating BX Options' best bid and best offer as a protected quotation within 60 days after the date of this order.

Proposed BX Options Rules, Chapter VII, Section 12, prohibits Options Participants from executing, as principal, orders they represent as agent unless the agency order is first exposed on BX Options for at least one second or the Options Participant has been bidding or offering on BX Options for at least one second prior to receiving an agency order that is executable against such bid or offer.

The Commission believes that in the electronic environment of BX Options, a one second exposure period could facilitate the prompt execution of orders while continuing to provide Options Participants with an opportunity to compete for exposed bids and offers. In addition, the BX Options System is identical to the trading system currently used for NOM today and this order exposure requirement is comparable to that which currently applies on other registered

⁵⁶ See BX Response, supra note 6.

options exchanges.⁵⁷ Accordingly, the Commission believes this proposed rule of BX Options is consistent with the Act.

C. Opening and Halt Cross

The System will support a single price opening or re-opening via an electronic cross.⁵⁸ The auctions at the opening and at the resumption of trading following a halt are identical to those that exist on NOM.

Specifically, BX Options will operate a pre-opening phase that will begin prior to the opening of the market at a time to be determined by the Exchange. Orders may be submitted, modified, and cancelled throughout the pre-opening phase. Prior to opening the market (or resuming trading in the case of a halt), the Exchange will calculate and disseminate certain indicative information: opening price; order imbalance; and the size and direction of any imbalance.⁵⁹ Thereafter, the Exchange will determine, using an algorithm, a single price at which a particular options series will open and will match, using an algorithm, the maximum number of available orders. After the cross concludes, orders will be cancelled, routed, or posted depending on the instructions on the orders and open trading will commence.

The Commission believes that the proposed BX Options Rules regarding the opening of trading on BX Options are reasonably designed to provide for an orderly opening and are consistent with the Act. The Commission further believes that the procedure for re-opening trading in an option following the conclusion of a trading halt in the underlying security is reasonably designed to provide for an orderly re-opening of trading in the option and is consistent with the Act.

⁵⁷ See, e.g., Rules of NOM, Chapter VII, Section 12.

⁵⁸ See proposed BX Options Rules, Chapter VI, Section 8.

⁵⁹ See proposed BX Options Rules, Chapter VI, Section 8.

D. Routing

BX Options Participants may designate orders to be routed to another options exchange when trading interest is not available on BX Options or to execute only on BX Options. The Exchange proposed that its routing functionality will be limited to only routing System securities, which are options listed for trading on BX.⁶⁰ The Exchange has proposed to offer two System routing options: SEEK⁶¹ and SRCH,⁶² which may be combined with all available order types and time-in-force designations, with the exception of order types and time-in-force designations whose terms are inconsistent with the terms of a particular routing option.⁶³ An order that is designated as routable will be routed to other options exchanges to be executed when BX Options is not at the NBBO consistent with the Linkage Plan. Orders routed to other options exchanges do not retain time priority with respect to orders in the System, and the System will continue to execute orders while routed orders are away at another exchange.⁶⁴ If a

⁶⁰ See proposed BX Options Rules, Chapter VI, Section 11(a).

⁶¹ SEEK is a routing option pursuant to which an order will first check the System for available contracts for execution. After checking the System for available contracts, orders are sent to other available market centers for potential execution, per the entering firm's instructions. When checking the book, the System will seek to execute at the price at which it would send the order to a destination market center. If contracts remain un-executed after routing, they are posted on the book. Once on the book, should the order subsequently be locked or crossed by another market center, the System will not route the order to the locking or crossing market center. See proposed BX Options Rules, Chapter VI, Section 11(a)(1)(A).

⁶² SRCH is a routing option pursuant to which an order will first check the System for available contracts for execution. After checking the System for available contracts, orders are sent to other available market centers for potential execution, per the entering firm's instructions. When checking the book, the System will seek to execute at the price at which it would send the order to a destination market center. If contracts remain un-executed after routing, they are posted on the book. Once on the book, should the order subsequently be locked or crossed by another market center, it will re-route. See proposed BX Options Rules, Chapter VI, Section 11(a)(1)(B).

⁶³ See proposed BX Options Rules, Chapter VI, Section 11(a).

⁶⁴ See proposed BX Options Rules, Chapter VI, Section 11(c).

routed order is returned, in whole or in part, that order (or its remainder) will receive a new time stamp reflecting the time of its return to the System.⁶⁵ Options Participants whose orders are routed away will be obligated to honor trades executed on other options exchanges to the same extent they would be obligated to honor a trade executed on BX Options.⁶⁶

The Exchange will route options orders using Nasdaq Options Services LLC (“NOS”), which is a registered broker-dealer and a member of the Exchange.⁶⁷ NOS is owned by NASDAQ OMX, which also owns three registered securities exchanges – the Exchange, NASDAQ, and NASDAQ OMX PHLX LLC (“PHLX”).⁶⁸ Therefore, NOS is an affiliate of these exchanges.⁶⁹

Exchange Rule 2140(a)(1) provides generally that, absent an effective filing under Section 19(b) of the Act, the Exchange may not, directly or indirectly, acquire or maintain an ownership interest in, or engage in a business venture with, an Exchange member or an affiliate of an Exchange member. However, the Exchange proposes that NOS, a member of the Exchange, provide other members of the Exchange options routing services to other markets,

⁶⁵ See id.

⁶⁶ See proposed BX Options Rules, Chapter VI, Section 11(d).

⁶⁷ See Notice, supra note 4, at 29733. The Exchange represented that NOS has developed policies and procedures designed to reject an order or series of orders that violate applicable pre-trade requirements of Rule 15c3-5 under the Act prior to routing such orders, and would seek to cancel any orders that had been routed. See Notice, supra note 4, at 29734.

⁶⁸ See Securities Exchange Act Release No. 58324 (August 7, 2008), 73 FR 46936 (August 12, 2008) (SR-BSE-2008-02; SR-BSE-2008-23; SR-BSE-2008-25; SR-BSECC-2008-01) (order approving NASDAQ OMX’s acquisition of BX); Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (order approving NASDAQ OMX’s acquisition of PHLX).

⁶⁹ See id. See also Notice, supra note 4, at 29734.

including two affiliates of the Exchange---NASDAQ⁷⁰ and PHLX.⁷¹ In addition, the Exchange intends to receive through NOS options orders routed inbound to the Exchange from its affiliated exchanges. Accordingly, the Exchange seeks Commission approval to permit the Exchange to engage in the business venture of outbound routing using NOS as its routing broker, as well as receiving inbound orders from its affiliates, NASDAQ⁷² and PHLX, through NOS.⁷³

Recognizing that the Commission has previously expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange, particularly where a member is routing orders to such affiliated exchange,⁷⁴ the Exchange has proposed limitations and conditions on NOS's affiliation with the Exchange. Specifically, the Exchange proposes that NOS operate as outbound router and inbound router subject to certain limitations and conditions, as described below.

1. NOS as Outbound Router

The Exchange proposes that NOS will operate as a facility (as defined in section 3(a)(2) of the Act) of the Exchange to provide outbound options routing services from the Exchange to other options exchanges. NOS's operation as a facility providing outbound options routing services for the Exchange is subject to the following limitations and conditions:

- NOS will route orders to other market centers as directed by the Exchange. NOS will be programmed to follow the algorithm and order type instructions established in the

⁷⁰ NASDAQ's options trading facility is NOM.

⁷¹ See id.

⁷² See supra note 70

⁷³ See Notice, supra note 4, at 29734.

⁷⁴ See Notice, supra note 4, at 29733-29734.

BX Options Rules and will not have discretion to change the terms of an order or the order routing instructions.⁷⁵

- NOS will not engage in any business other than: (a) as an outbound router for the Exchange; and (b) any other activities it may engage in as approved by the Commission.⁷⁶
- For purposes of Commission Rule 17d-1, the designated examining authority of NOS will be a self-regulatory organization (“SRO”) unaffiliated with the Exchange or any of its affiliates.
- The Exchange will be responsible for filing with the Commission proposed rule changes related to the operation of, and fees for services provided by, NOS and NOS shall be subject to exchange nondiscrimination requirements.
- The books, records, premises, officers, agents, directors and employees of NOS as a facility of the Exchange will be deemed to be the books, records, premises, officers, agents, directors and employees of the Exchange for purposes of, and subject to

⁷⁵ See supra note 67.

⁷⁶ The Exchange also proposed that, immediately prior to the commencement of operations of NOS as an outbound router for the Exchange, the Exchange be approved to use NOS to conduct a test of its routing functionality. See Notice, supra note 4, at 29733-34. The Exchange represented that it will use NOS to perform test trades in an actual security to track the performance of its systems from order entry to clearance and settlement. See id. The Exchange represented that the test will be performed by entering a buy or sell order and then, upon execution of each, entering an offsetting buy and sell order in the same security for the same quantity to close out the test position and minimize financial impact on the Exchange. See id. The Exchange represented that it will deliver the test orders to NOS, as the routing broker, which will route to the designated away market and receive an execution back. See id. The Exchange represented that, to the extent that the offsetting trades require the Exchange to pay out funds, the funds will be provided out of the cash accounts of the Exchange; and, to the extent that the trades result in a profit, the funds will be deposited in the cash accounts of the Exchange. See id.

oversight pursuant to, the Act. The books and records of NOS as a facility of the Exchange will be subject at all times to inspection and copying by the Commission.

- The use of NOS to route options orders to other market centers will be optional. Parties who do not desire to use NOS must enter orders into the System as ineligible for routing.
- NOS will establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange and its facilities (including NOS as its routing facility) and any other entity.

As a facility of the Exchange, NOS will be subject to the Exchange's and the Commission's regulatory oversight; and the Exchange will be responsible for ensuring that NOS's outbound routing function is operated consistent with Section 6 of the Act and the Exchange's rules. In addition, the Exchange will be required to file with the Commission proposed rule changes and fees relating to NOS's outbound routing function. Any such rules and fees relating to NOS's outbound router function will be subject to exchange nondiscrimination requirements. Further, the proposed limitations and conditions for the operation of NOS as an affiliated outbound router on behalf of each Exchange are consistent with conditions the Commission has approved for other exchanges.⁷⁷ The Commission therefore finds the proposed operation of NOS as an affiliated outbound router of the Exchange to be consistent with the Act.

2. NOS as an Inbound Router

The Exchange also proposes to permit BX to accept inbound orders that NOS routes in its

⁷⁷ See, e.g., Securities Exchange Act Release No. 62716 (August 13, 2010), 75 FR 51295 (August 19, 2010) (File No. 10-198) (order granting the exchange registration of BATS-Y Exchange, Inc.).

capacity as a facility of NASDAQ⁷⁸ and PHLX, subject to the following conditions and limitations:

- The Exchange and FINRA will maintain a regulatory contract and an agreement pursuant to Rule 17d-2 under the Act (“17d-2 Agreement”).⁷⁹ Pursuant to the regulatory contract and the 17d-2 Agreement, FINRA will be allocated regulatory responsibilities to review NOS’s compliance with certain Exchange rules. Pursuant to the regulatory contract, however, the Exchange retains ultimate responsibility for enforcing its rules with respect to NOS.⁸⁰
- FINRA will monitor NOS for compliance with the Exchange’s trading rules, and will collect and maintain certain related information. Pursuant to the regulatory contract, both FINRA and the Exchange will collect and maintain all alerts, complaints, investigations and enforcement actions in which NOS (in its capacity as a facility of NASDAQ⁸¹ and PHLX routing orders to the Exchange) is identified as a participant that has potentially violated applicable Commission or the Exchange’s rules. The Exchange and FINRA will retain these records in an easily accessible manner.
- FINRA will provide a report to the Exchange’s chief regulatory officer (“CRO”), on a quarterly basis, that: (i) quantifies all alerts (of which FINRA is aware) that identify NOS as a participant that has potentially violated Commission or the Exchange’s

⁷⁸ See supra note 70.

⁷⁹ 17 CFR 240.17d-2.

⁸⁰ NOS also is subject to independent oversight by FINRA, its designated examining authority, for compliance with financial responsibility requirements. See Notice, supra note 4, at 29734.

⁸¹ See supra note 70.

- rules; and (ii) lists all investigations that identify NOS as a participant that has potentially violated Commission or the Exchange's rules.
- The Exchange has in place BX Rule 2140(c), which requires NASDAQ OMX, as the holding company owning both the Exchange and NOS, to establish and maintain procedures and internal controls reasonably designed to ensure that NOS does not develop or implement changes to its system, based on nonpublic information obtained regarding planned changes to the Exchange's systems as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members, in connection with the provision of inbound order routing to the Exchange.
 - Routing of orders from NOS to the Exchange, in NOS's capacity as a facility of NASDAQ⁸² and PHLX, be authorized for a pilot period of one year.

Although the Commission continues to be concerned about potential unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, for the reasons discussed below, the Commission believes that it is consistent with the Act to permit NOS, in its capacity as a facility of NASDAQ⁸³ and PHLX, to route options orders inbound to the Exchange on a pilot basis, subject to the limitations and conditions described above.

The Exchange has proposed the above limitations and conditions applicable to NOS's inbound options routing activities. The Commission believes that these limitations and conditions mitigate its concerns about potential conflicts of interest and unfair competitive

⁸² See supra note 70.

⁸³ See supra note 70.

advantage. In particular, the Commission believes that a non-affiliated SRO oversight of NOS,⁸⁴ combined with a non-affiliated SRO's monitoring of NOS's compliance with the Exchange's rules and quarterly reporting to the Exchange, will help to protect the independence of the Exchange's regulatory responsibilities with respect to NOS. The Commission also believes that the requirement that the Exchange establish and maintain procedures and internal controls reasonably designed to ensure that NOS does not develop or implement changes to its systems based on non-public information obtained as a result of its affiliation with the Exchange, until such information is available generally to similarly situated members of the Exchange, is reasonably designed to ensure that NOS cannot misuse any information advantage it may have because of its affiliation with the Exchange. Furthermore, the Commission believes that the Exchange's proposal to allow NOS to route options orders inbound to the Exchange from its affiliated exchanges (i.e., NASDAQ⁸⁵ and PHLX), on a pilot basis, will provide the Exchange and the Commission with an opportunity to assess the impact of any conflicts of interest of allowing an affiliated members of an Exchange to route options orders inbound to the Exchange and whether such affiliation provides an unfair competitive advantage.

Further, the Commission notes that the proposed conditions for the operation of NOS as the affiliated inbound router on behalf of the Exchange are consistent with conditions the Commission has approved for other exchanges.⁸⁶ The Commission therefore finds the proposed operation of NOS as an affiliate inbound router of the Exchange is consistent with the Act.

⁸⁴ This oversight will be accomplished through a 17d-2 Agreement and Regulatory Contract.

⁸⁵ See supra note 70.

⁸⁶ See, e.g., Securities Exchange Act Release No. 62877 (September 9, 2011), 75 FR 56633 (September 16, 2011) (SR-PHLX-2010-79).

E. Minimum Quoting and Trading Increments

The Exchange is proposing to apply the following minimum quoting increments: (1) if the option price is less than \$3.00, five (5) cents; and (2) if the option price is \$3.00 or higher, ten (10) cents.⁸⁷ In addition, the Exchange proposes to participate in a pilot program, until June 30, 2012, to allow quoting in certain options in smaller increments (“Pilot Program”).⁸⁸ The Exchange will include in the Pilot Program all classes that are, on that date, included by other options exchanges in substantially similar pilot programs. If an options class is included in the Pilot Program, the Exchange will allow quoting in one (1) cent increments any option priced less than \$3.00 or options on QQQs, IWM, and SPY.⁸⁹ Options priced at \$3.00 or higher that are in the Pilot Program will be quoted in five (5) cent increments.⁹⁰ In addition, the Exchange is proposing that the minimum trading increment for options contracts traded on BX Options would be one (1) cent for all series.⁹¹

The Commission believes that the Exchange’s proposed minimum quoting and trading increments, including its proposal to commence quoting pursuant to the Pilot Program, which are consistent with the rules of the other options exchanges,⁹² are consistent with the Act. As the Commission noted in approving the latest expansion of the Pilot Program, allowing market participants to quote in smaller increments in Pilot options has been shown to reduce spreads,

⁸⁷ See proposed BX Options Rules, Chapter VI, Section 5(a)(1).

⁸⁸ See proposed BX Options Rules, Chapter VI, Section 5(a)(3).

⁸⁹ See id.

⁹⁰ See id.

⁹¹ See proposed BX Options Rules, Chapter VI, Section 5(b).

⁹² See Rules of NOM, Chapter VI, Section 5.

thereby lowering costs to investors.⁹³ In addition, permitting options to be quoted in smaller increments pursuant to the Pilot Program provides the opportunity for reduced spreads for a significant amount of trading volume.⁹⁴ Further, although the Commission anticipates that the Exchange's proposal will contribute to further increases in quotation message traffic, the Commission believes that the Exchange's proposal is sufficiently limited such that it is unlikely on its own to increase quotation message traffic beyond the capacity of market participants' systems.

F. Securities Traded on BX Options

The Exchange proposes to adopt initial and continued listing standards for equity and index options traded on BX Options that are substantially similar to the listing standards adopted by other options exchanges.⁹⁵ The Commission believes that the Exchange's proposed initial and continued listing standards are consistent with the Act, including Section 6(b)(5), in that they are designed to protect investors and the public interest and to promote just and equitable principles of trade.

G. Participation in National Market System Plans

The Exchange represented that it is a participant of various national market system plans for options trading established under Section 11A of the Act.⁹⁶ Specifically, the Exchange represented that it is a participant of the Linkage Plan, the OPRA Plan, the Plan for the Selection and Reservation of Securities Symbols, and the Plan of the Options Regulatory Surveillance

⁹³ See Securities Exchange Act Release No. 60711 (September 23, 2009), 74 FR 49419, 49424 (September 28, 2009) (SR-NYSEArca-2009-44) (partially approving a proposed rule change to expand the Pilot Program).

⁹⁴ See id.

⁹⁵ See, e.g., Rules of NOM, Chapters IV and XIV.

⁹⁶ See Notice, supra note 4, at 29737.

Authority.⁹⁷ BX represented that it will join the Plan for the Purpose of Developing and Implementing Procedures Designed to Facilitate the Listing and Trading of Standardized Options Submitted Pursuant to Section 11A(a)(3)(B) of the Act (“OLPP”).⁹⁸

H. Regulation

According to the Exchange, the Exchange will regulate BX Options using the existing BX regulatory structure. The Exchange’s CRO will have general supervision of the regulatory operations of BX Options, including responsibility for overseeing the surveillance, examination, and enforcement functions and for administering all regulatory services agreements applicable to BX Options.⁹⁹ Similarly, the Exchange’s existing Regulatory Oversight Committee (“ROC”) will be responsible for overseeing the adequacy and effectiveness of the Exchange’s regulatory and SRO responsibilities, including those applicable to BX Options.¹⁰⁰

As members of the Exchange, the Exchange’s existing rules governing members will apply to Options Participants. The Exchange’s By-laws provide that it has disciplinary jurisdiction over its members, including Options Participants, so that it can enforce its members’ compliance with its rules and the federal securities laws.¹⁰¹ The Exchange’s rules also permit it to sanction members, including Options Participants, for violations of its rules and of the federal securities laws by, among other things, expelling or suspending members, limiting members’

⁹⁷ See Amendment No. 2, supra note 7.

⁹⁸ See Amendment No. 2, supra note 7. According to the Exchange, the Exchange’s membership in the OLPP lapsed because the Exchange ceased to operate an options market when the Boston Options Exchange became a national securities exchange. Id.

⁹⁹ See Notice, supra note 4, at 29737.

¹⁰⁰ See Exchange By-laws, Article IV, Section 4.13(c) and Notice, supra note 4, at 29737. Pursuant to a regulatory services agreement, FINRA would perform certain regulatory functions on behalf of the Exchange. See infra note 109 and accompanying text.

¹⁰¹ See, e.g., Exchange By-laws Article XII, Section 12.2.

activities, functions, or operations, fining or censuring members, or suspending or barring a person from being associated with a member.¹⁰² The Exchange’s rules also provide for the imposition of fines for minor rule violations in lieu of commencing disciplinary proceedings.¹⁰³

Moreover, the Exchange will: (1) join the existing options industry agreements pursuant to Section 17(d) of the Act; (2) amend, as necessary, the Exchange’s existing Regulatory Services Agreement (“RSA”) with FINRA to cover many aspects of the regulation and discipline of the Exchange’s Options Participants that participate in options trading on BX Options; (3) perform options listing regulation, as well as authorize Options Participants to trade on BX Options; and (4) perform automated surveillance of trading on BX Options for the purpose of maintaining a fair and orderly market at all times.¹⁰⁴

In addition, BX Regulation will oversee the process for determining and implementing trading halts, identifying and responding to unusual market conditions, and administering the Exchange’s process for identifying and remediating “obvious errors” by and among its Participants.¹⁰⁵ The proposed BX Options rules (Chapter V) regarding halts, unusual market conditions, extraordinary market volatility, obvious errors, and audit trail are identical to the rules of NOM.¹⁰⁶

The Commission finds that the Exchange’s proposed rules and regulatory structure with respect to BX Options are consistent with the requirements of the Act, and in particular with

¹⁰² See, e.g., BX Rule 8310.

¹⁰³ See proposed BX Options Rules, Chapter X, Section 7. See infra notes 121-128 and accompanying text.

¹⁰⁴ See Notice, supra note 4, at 29736. BX Regulation will monitor BX Options to identify unusual trading patterns and determine whether particular trading activity requires further regulatory investigation by FINRA. See id.

¹⁰⁵ See Notice, supra note 4, at 29736.

¹⁰⁶ See Rules of NOM, Chapter V.

Section 6(b)(1) of the Act, which requires an exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to comply, and to enforce compliance by its members and persons associated with its members, with the Act and the rules and regulations thereunder, and the rules of the Exchange,¹⁰⁷ and with Section 6(b)(6) and 6(b)(7) of the Act,¹⁰⁸ which require an Exchange to provide fair procedures for the disciplining of members and persons associated with members.

1. Regulatory Services Agreement

Currently, the Exchange and FINRA are parties to an existing RSA, pursuant to which FINRA personnel operate as agents for the Exchange in performing certain functions. According to the Exchange, FINRA performs certain membership, disciplinary, and enforcement functions for the Exchange.¹⁰⁹ The Exchange represented that the Exchange and FINRA have modified the RSA to capture aspects of regulation specifically applicable to BX Options and the regulation and discipline of Options Participants.¹¹⁰ The Exchange will continue to bear ultimate regulatory responsibility for functions performed on the Exchange's behalf under the RSA. Further, the Exchange retains ultimate legal responsibility for the regulation of its Options Participants and its market.

The Commission believes that it is consistent with the Act to allow the Exchange to contract with FINRA to perform examination, enforcement, and disciplinary functions.¹¹¹ These

¹⁰⁷ 15 U.S.C. 78f(b)(1).

¹⁰⁸ 15 U.S.C. 78f(b)(6) and (b)(7).

¹⁰⁹ See Notice, supra note 4, at 29736.

¹¹⁰ See Amendment No. 2, supra note 7.

¹¹¹ See, e.g., Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998). See also, e.g., Securities Exchange Act Release Nos. 50122 (July 29, 2004), 69 FR 47962 (August 6, 2004) (SR-Amex-2004-32) (approving rule that allowed Amex to

functions are fundamental elements to a regulatory program and constitute core self-regulatory functions. The Commission believes that FINRA has the expertise and experience to perform these functions on behalf of the Exchange.¹¹²

As noted, unless relieved by the Commission of its responsibility,¹¹³ the Exchange bears the responsibility for self-regulatory conduct and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the Exchange's behalf. In performing these functions, however, FINRA may nonetheless bear liability for causing or aiding and abetting the failure of the Exchange to perform its regulatory functions.¹¹⁴ Accordingly, although FINRA will not act on its own behalf under its SRO responsibilities in carrying out these regulatory services for the Exchange relating to the operation of BX Options, FINRA also may have secondary liability if, for example, the Commission finds the contracted functions are being performed so

contract with another SRO for regulatory services) (“Amex Regulatory Services Approval Order”); 57478 (March 12, 2008), 73 FR 14521 (March 18, 2008) (SR-NASDAQ-2007-004) (“NOM Approval Order”); 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (“Nasdaq Exchange Registration Order”); and 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (SR-BATS-2009-031) (“BATS Options Approval Order”).

¹¹² See Amex Regulatory Services Approval Order; NOM Approval Order; Nasdaq Exchange Registration Order, and BATS Options Approval Order, *id.* The Commission notes that the RSA is not before the Commission and, therefore, the Commission is not acting on it.

¹¹³ See Section 17(d)(1) of the Act and Rule 17d-2 thereunder (15 U.S.C. 78q(d)(1) and 17 CFR 240.17d-2).

¹¹⁴ For example, if failings by FINRA have the effect of leaving the Exchange in violation of any aspect of the Exchange's self-regulatory obligations, the Exchange would bear direct liability for the violation, while FINRA may bear liability for causing or aiding and abetting the violation. See Nasdaq Exchange Registration Order, *supra* note 111. See also Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (File No. 10-127) (approving the International Securities Exchange LLC's application for registration as a national securities exchange).

inadequately as to cause a violation of the federal securities laws by the Exchange.¹¹⁵

2. 17d-2 Agreements

Rule 17d-2 under the Act permits SROs to file with the Commission plans under which the SROs allocate among each other the responsibility to receive regulatory reports from, and examine and enforce compliance with specified provisions of the Act and rules thereunder and SRO rules by, firms that are members of more than one SRO (“common members”). If such a plan is declared effective by the Commission, an SRO that is a party to the plan is relieved of regulatory responsibility as to any common member for whom responsibility is allocated under the plan to another SRO.¹¹⁶

Pursuant to Rule 17d-2 under the Act, all of the options exchanges, FINRA, and the New York Stock Exchange LLC (“NYSE”) have entered into the Options Sales Practices Agreement, a Rule 17d-2 Agreement, which allocates to certain SROs (“examining SROs”) regulatory responsibility for common members with respect to certain options-related sales practice matters.¹¹⁷ Under this Agreement, the examining SROs would examine firms that are common members of the Exchange and the particular examining SRO for compliance with certain provisions of the Act, certain of the rules and regulations adopted thereunder, certain examining SRO rules, and certain Exchange Rules. The Exchange’s rules contemplate participation in this

¹¹⁵ See id.

¹¹⁶ Rule 17d-2 provides that any two or more SROs may file with the Commission a plan for allocating among such SROs the responsibility to receive regulatory reports from persons who are members or participants of more than one of such SROs to examine such persons for compliance, or to enforce compliance by such persons, with specified provisions of the Act, the rules and regulations thereunder, and the rules of such SROs, or to carry out other specified regulatory functions with respect to such persons. See 17 CFR 240.17d-2.

¹¹⁷ See Securities Exchange Act Release No. 57987 (June 18, 2008), 73 FR 36156 (June 25, 2008) (File No. S7-966).

Agreement by requiring that any Options Participant also be a member of at least one of the examining SROs.¹¹⁸

Moreover, pursuant to Rule 17d-2 under the Act, all of the options exchanges and FINRA have entered into the Options Related Market Surveillance Agreement, which allocates regulatory responsibility for certain options-related market surveillance matters among the participants.¹¹⁹ Under this agreement, the examining SRO would assume regulatory responsibility with respect to firms that are common members of the Exchange and the particular examining SRO for compliance with applicable common rules for certain accounts.

As a condition to operation, the Exchange must be a party to each of these 17d-2 Agreements, which will cover BX members that are Options Participants. The Exchange represented that it is a party to each of these 17d-2 Agreements.¹²⁰

3. Minor Rule Violation Plan

The Commission approved the Exchange's Minor Rule Violation Plan ("MRVP") in 1989.¹²¹ The Exchange's MRVP specifies those uncontested minor rule violations with sanctions not exceeding \$2,500 that would not be subject to the provisions of Rule 19d-1(c)(1) under the Act¹²² requiring that an SRO promptly file notice with the Commission of any final disciplinary action taken with respect to any person or organization.¹²³ The Exchange's MRVP

¹¹⁸ See proposed BX Options Rules, Chapter II, Section 2(f).

¹¹⁹ See Securities Exchange Act Release No. 58765 (October 9, 2008), 73 FR 62344 (October 20, 2008) (File No. 4-551).

¹²⁰ See Amendment No. 2, *supra* note 7.

¹²¹ See Securities Exchange Act Release No. 26737 (April 17, 1989), 54 FR 16438-I (April 24, 1989) (SR-BSE-88-2) ("BX MRVP Order").

¹²² 17 CFR 240.19d-1(c)(1).

¹²³ The Commission adopted amendments to paragraph (c) of Rule 19d-1 to allow SROs to submit for Commission approval plans for the abbreviated reporting of minor disciplinary

includes the policies and procedures included in BX Rule 9216(b), “Procedures for Violations under Plan Pursuant to SEC Rule 19d-1(c)(2),” and the rule violations included in BX IM-9216, “Violations Appropriate for Disposition Under Plan Pursuant to SEC Rule 19d-1(c)(2).”

The Exchange proposes to amend its MRVP and BX IM-9216 to include references to proposed BX Options Rules, Chapter X, Section 7, “Penalty for Minor Rule Violations for Options Trading.”¹²⁴ The Commission believes that this change is consistent with the Act because it clarifies that the proposed rules listed in Chapter X, Section 7 of the proposed BX Options Rules will be included in BX’s MRVP.

The Commission notes that the rules included in proposed BX Options Rules, Chapter X, Section 7 are similar to rules included in the MRVPs of other options exchanges.¹²⁵ The Commission finds that the BX MRVP, as amended to include the rules listed in proposed BX Options Rules, Chapter X, Section 7, is consistent with Sections 6(b)(1), 6(b)(5), and 6(b)(6) of the Act, which require, in part, that an exchange have the capacity to enforce compliance with, and provide appropriate discipline for, violations of the rules of the Commission and of the exchange.¹²⁶ In addition, because BX Rule 9216(b) will offer procedural rights to a person sanctioned for a violation listed in proposed BX Options Rules, Chapter X, Section 7, the

infractions. See Securities Exchange Act Release No. 21013 (June 1, 1984), 49 FR 23828 (June 8, 1984) (File No. S7-983A). Any disciplinary action taken by an SRO against any person for violation of a rule of the SRO which has been designated as a minor rule violation pursuant to such a plan filed with and declared effective by the Commission would not be considered “final” for purposes of Section 19(d)(1) of the Act if the sanction imposed consists of a fine not exceeding \$ 2,500 and the sanctioned person has not sought an adjudication, including a hearing, or otherwise exhausted his administrative remedies.

¹²⁴ See Notice, supra note 4, at 29736-37.

¹²⁵ See, e.g., Rules of NOM, Chapter X, Section 7.

¹²⁶ 15 U.S.C. 78f(b)(1), 78f(b)(5), and 78f(b)(6).

Commission believes that the Exchange's rules provide a fair procedure for the disciplining of members and associated persons, consistent with Section 6(b)(7) of the Act.¹²⁷

The Commission also finds that the proposal to include the provisions in proposed BX Options Rules, Chapter X, Section 7 in BX's MRVP is consistent with the public interest, the protection of investors, or otherwise in furtherance of the purposes of the Act, as required by Rule 19d-1(c)(2) under the Act,¹²⁸ because it should strengthen the Exchange's ability to carry out its oversight and enforcement responsibilities as an SRO in cases where full disciplinary proceedings are unsuitable in view of the minor nature of the particular violation.

In approving the proposed change to the Exchange's MRVP, the Commission in no way minimizes the importance of compliance with the Exchange's rules and all other rules subject to the imposition of fines under the Exchange's MRVP. The Commission believes that the violation of any SRO rules, as well as Commission rules, is a serious matter. However, the Exchange's MRVP provides a reasonable means of addressing rule violations that do not rise to the level of requiring formal disciplinary proceedings, while providing greater flexibility in handling certain violations. The Commission expects that the Exchange will continue to conduct surveillance with due diligence and make a determination based on its findings, on a case-by-case basis, whether a fine of more or less than the recommended amount is appropriate for a violation under the Exchange's MRVP or whether a violation requires a formal disciplinary action.

¹²⁷ 15 U.S.C. 78f(b)(7).

¹²⁸ 17 CFR 240.19d-1(c)(2).

I. Section 11(a) of the Act

Section 11(a)(1) of the Act¹²⁹ prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, “covered accounts”) unless an exception applies. Rule 11a2-2(T) under the Act,¹³⁰ known as the “effect versus execute” rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute transactions on the exchange. To comply with Rule 11a2-2(T)’s conditions, a member: (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;¹³¹ (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission, the Exchange requests that the Commission concur with the Exchange’s conclusion that Options Participants that enter orders into the System satisfy the requirements of Rule 11a2-2(T).¹³² For the reasons set forth below, the Commission believes that Options Participants entering orders into the System would satisfy the conditions of the Rule.

¹²⁹ 15 U.S.C. 78k(a)(1).

¹³⁰ 17 CFR 240.11a2-2(T).

¹³¹ The member may, however, participate in clearing and settling the transaction.

¹³² See Letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, NASDAQ OMX, to Heather Seidel, Associate Director, Division of Trading and Markets, Commission, dated June 19, 2012 (“BX 11(a) Letter”).

The Rule's first condition is that orders for covered accounts be transmitted from off the exchange floor. The BX Options System will receive orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.¹³³ Because the BX Options System receives orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that the System satisfies the off-floor transmission requirement.

Second, the Rule requires that the member not participate in the execution of its order once it has been transmitted to the member performing the execution. The Exchange represented that at no time following the submission of an order is an Options Participant able to acquire control or influence over the result or timing of an order's execution.¹³⁴ According to the Exchange, the execution of a member's order is determined solely by what other orders, bids, or offers are present in the System at the time the Options Participant submits the order and on the priority of those orders, bids, and offers.¹³⁵ Accordingly, the Commission believes that an Options Participant does not participate in the execution of an order submitted to the System.

¹³³ See, e.g., NOM Approval Order, *supra* note 111; Securities Exchange Act Release Nos. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (approving Nasdaq Stock Market LLC); 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (SR-PCX-00-25) (approving Archipelago Exchange); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (SR-NYSE-90-52 and SR-NYSE-90-53) (approving NYSE's Off-Hours Trading Facility); and 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) ("1979 Release").

¹³⁴ See BX 11(a) Letter, *supra* note 132, at 7.

¹³⁵ See *id.* An Options Participant may cancel or modify the order, or modify the instruction for executing the order, but only from off the floor. The Commission has stated that the non-participation requirement is satisfied under such circumstances, so long as such modifications or cancellations are also transmitted from off the floor. See Securities Exchange Act Release No. 14713 (April 27, 1978), 43 FR 18557 (May 1, 1978) ("1978

Third, Rule 11a2-2(T) requires that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that this requirement is satisfied when automated exchange facilities are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.¹³⁶ BX represented that the design of the System ensures that no Options Participant has any special or unique trading advantage in the handling of its orders after transmitting its orders to the Exchange.¹³⁷ Based on the Exchange's representation, the Commission believes that the BX Options System satisfies this requirement.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and

Release”) (stating that the “non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor”).

¹³⁶ In considering the operation of automated execution systems operated by an exchange, the Commission has noted that while there is not an independent executing exchange member, the execution of an order is automatic once it has been transmitted into the system. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, supra note 133.

¹³⁷ See BX 11(a) Letter, supra note 132, at 8.

Rule 11a2-2(T)(a)(2)(iv).¹³⁸ The Exchange represents that Options Participants trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.¹³⁹

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

The Exchange proposes to incorporate by reference as BX Options Rules certain rules of the CBOE, NYSE, and FINRA.¹⁴⁰ Thus, for certain BX Options rules, Exchange members will comply with a BX Options rule by complying with the CBOE, NYSE, or FINRA rule referenced. In connection with its proposal to incorporate CBOE, NYSE, and FINRA rules by reference, the Exchange requested, pursuant to Rule 240.0-12 under the Act,¹⁴¹ an exemption under Section 36 of the Act from the rule filing requirements of Section 19(b) of the Act for changes to those BX Options rules that are effected solely by virtue of a change to a cross-referenced CBOE, NYSE,

¹³⁸ 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated persons thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, supra note 135 (stating “[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests”).

¹³⁹ See BX 11(a) Letter, supra note 132, at 8.

¹⁴⁰ Specifically, the Exchange proposes to incorporate by reference: (1) CBOE rules governing position and exercise limits for equity and index options, which are cross-referenced in Chapter III, Sections 7 and 9 of the proposed BX Options Rules and Chapter XIV, Sections 5 and 7 of the proposed BX Options Rules, respectively; (2) the margin rules of the CBOE or the NYSE, which are referenced in Chapter XIII, Section 3 of the proposed BX Options Rules; and (3) FINRA's rules governing communications with the public, which are referenced in Chapter XI, Section 22 of the proposed BX Options Rules.

¹⁴¹ 17 CFR 240.0-12.

or FINRA rule.¹⁴² The Exchange proposes to incorporate by reference categories of rules (rather than individual rules within a category) that are not trading rules. The Exchange agrees to provide written notice to Options Participants prior to the launch of BX Options of the specific CBOE, NYSE, and FINRA rules that it will incorporate by reference.¹⁴³ In addition, the Exchange will notify Options Participants whenever CBOE, NYSE, or FINRA proposes a change to a cross-referenced CBOE, NYSE, or FINRA rule.¹⁴⁴

Using its authority under Section 36 of the Act, the Commission previously exempted certain SROs from the requirement to file proposed rule changes under Section 19(b) of the Act.¹⁴⁵ Each such exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify its rules. In addition, each SRO incorporated by reference only regulatory rules (e.g., margin, suitability, arbitration), not trading rules, and incorporated by reference whole categories of rules (i.e., did not “cherry-pick” certain individual rules within a category). Each exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is

¹⁴² See Letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, NASDAQ OMX, to Elizabeth M. Murphy, Secretary, Commission, dated June 21, 2012.

¹⁴³ See id.

¹⁴⁴ The Exchange will provide such notice through a posting on the same website location where the Exchange will post its own rule filings pursuant to Rule 19b-4(l) under Act, within the time frame required by that Rule. The website posting will include a link to the location on the CBOE, NYSE, or FINRA website where those SROs’ proposed rule changes are posted. See id.

¹⁴⁵ See Securities Exchange Act Release No. 49260 (February 17, 2004), 69 FR 8500 (February 24, 2004). See also Securities Exchange Act Release Nos. 57478 (March 12, 2008), 73 FR 14521, 14539-40 (March 18, 2008) (order approving SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080) and 53128 (January 13, 2006), 71 FR 3550, 3565-66 (January 23, 2006) (File No. 10-131) (approving The NASDAQ Stock Market LLC’s exchange application).

proposed to the incorporated rules of another SRO in order to provide its members with notice of a proposed rule change that affects their interests, so that they would have an opportunity to comment on it.

The Commission is granting the Exchange's request for exemption, pursuant to Section 36 of the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that the Exchange proposes to incorporate by reference into BX Options Rules. The Commission believes that this exemption is appropriate in the public interest and consistent with the protection of investors because it will promote more efficient use of Commission and SRO resources by avoiding duplicative rule filings based on simultaneous changes to identical rule text sought by more than one SRO. Consequently, the Commission grants the Exchange's exemption request for BX Options. This exemption is conditioned upon the Exchange providing written notice to Options Participants whenever the CBOE, NYSE, or FINRA proposes to change a rule that BX Options has incorporated by reference.¹⁴⁶

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁴⁷ that the proposed rule change (SR-BX-2012-030), as modified by Amendment Nos. 1 and 2 thereto, be, and hereby is, approved.

Although the Commission's approval of the proposed rule change is final, and the proposed rules are therefore effective, it is further ordered that the operation of BX Options is conditioned on the satisfaction of the requirements below:

¹⁴⁶ As discussed above, the Exchange has represented that it will notify Options Participants whenever the CBOE, NYSE, or FINRA proposes a change to a cross-referenced CBOE, NYSE, or FINRA rule. See supra note 144 and accompanying text.

¹⁴⁷ 15 U.S.C. 78s(b)(2).

A. Participation in National Market System Plans Relating to Options Trading. BX must join: (1) the OPRA Plan; (2) the OLPP; (3) the Linkage Plan; and (4) the Plan of the Options Regulatory Surveillance Authority.

B. RSA and Rule 17d-2 Agreements. BX must ensure that all necessary changes are made to its Regulatory Services Agreement with FINRA and must be a party to the multi-party Rule 17d-2 agreements concerning options sales practice regulation and market surveillance.¹⁴⁸

C. Participation in the Options Clearing Corporation. BX must join the Options Clearing Corporation.

D. Participation in the Intermarket Surveillance Group. BX must be a member of the Intermarket Surveillance Group.

E. Effective Regulation. BX must have, and represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations that it has, adequate procedures and programs in place to effectively regulate BX Options.

F. Trade Processing and Exchange Systems. The Exchange must have, and represent in a letter to the staff in the Commission's Division of Trading and Markets that it has, adequate procedures and programs in place, as detailed in Commission Automation Policy Review guidelines, to effectively process trades and maintain the confidentiality, integrity, and availability of the Exchange's systems.¹⁴⁹

¹⁴⁸ See supra notes 117 and 119 and accompanying text. See also 17 CFR 240.17d-2.

¹⁴⁹ On November 16, 1989, the Commission published its first Automation Review Policy ("ARP I"), in which the Commission created a voluntary framework for SROs to establish comprehensive planning and assessment programs to determine systems capacity and vulnerability. On May 9, 1991, the Commission published its second Automation Review Policy ("ARP II") to clarify the types of review and reports expected from SROs. See Securities Exchange Act Release No. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989) and 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

It is further ordered, pursuant to Section 36 of the Act,¹⁵⁰ that BX shall be exempted from the rule filing requirements of Section 19(b) of the Act with respect to the CBOE, FINRA, and NYSE rules that BX proposes to incorporate by reference, subject to the conditions specified in this Order.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁵¹

Kevin M. O'Neill
Deputy Secretary

[FR Doc. 2012-16079 Filed 06/29/2012 at 8:45 am; Publication Date: 07/02/2012]

¹⁵⁰ 15 U.S.C. 78mm.

¹⁵¹ 17 CFR 200.30(a)(12).