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SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-67281; File No. SR-NASDAQ-2012-057)

June 27, 2012

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Approving a Proposed Rule Change With Respect to the Authority of NASDAQ or NASDAQ Execution Services To Cancel Orders When a Technical or Systems Issue Occurs and To Describe the Operation of an Error Account

I. Introduction

On April 30, 2012, The NASDAQ Stock Market LLC (“Exchange” or “NASDAQ”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend NASDAQ Equity Rule 4758 by adding a new paragraph (d) that addresses the authority of NASDAQ or NASDAQ Execution Services (“NES”) to cancel orders when a technical or systems issue occurs and to describe the operation of an error account for NES. The proposed rule change was published for comment in the Federal Register on May 16, 2012.<sup>3</sup> The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposal

NES, a broker-dealer that is a facility and an affiliate of NASDAQ, provides outbound routing services from NASDAQ to other market centers pursuant to NASDAQ rules.<sup>4</sup> In its

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

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

<sup>3</sup> Securities Exchange Act Release No. 66964 (May 10, 2012), 77 FR 28905 (May 16, 2012) (SR-NASDAQ-2012-057) (“Notice”).

<sup>4</sup> See Notice, 77 FR at 28906, n.3 and accompanying text, and text accompanying n.4. See also NASDAQ Equity Rule 4758.

proposal, NASDAQ states that a technical or systems issue may occur at NASDAQ, NES, or a routing destination that causes NASDAQ or NES to cancel orders, if NASDAQ or NES determines that such action is necessary to maintain a fair and orderly market.<sup>5</sup> NASDAQ also states that a technical or systems issue that occurs at NASDAQ, NES, a routing destination, or a non-affiliate third-party Routing Broker<sup>6</sup> may result in NES acquiring an error position that it must resolve.<sup>7</sup>

New paragraph (d) to NASDAQ Equity Rule 4758 provides NASDAQ or NES with general authority to cancel orders to maintain fair and orderly markets when a technical or systems issue occurs at NASDAQ, NES, or a routing destination. It also provides authority for NES to maintain an error account for the purpose of addressing, and sets forth the procedures for resolving, error positions. Specifically, paragraph (d)(1) of NASDAQ Equity Rule 4758 authorizes NASDAQ or NES to cancel orders as either deems necessary to maintain fair and orderly markets if a technical or systems issue occurs at NASDAQ, NES, or a routing

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NASDAQ also has authority to receive equities orders routed inbound to NASDAQ by NES from NASDAQ OMX BX and the NASDAQ OMX PSX of NASDAQ OMX PHLX on a pilot basis. See Notice, 77 FR at 28906, n.4. See also Securities Exchange Act Release No. 65554 (October 13, 2011), 76 FR 65311 (October 20, 2011) (SR-NASDAQ-2011-142).

<sup>5</sup> See Notice, 77 FR at 28906. For examples of some of the circumstances in which NASDAQ or NES may decide to cancel orders, see id.

<sup>6</sup> NASDAQ states that, from time to time, it also uses non-affiliate third-party broker-dealers to provide outbound routing services. In its proposal, the Exchange refers to these broker-dealers as “third party Routing Brokers.” See Notice, 77 FR at 28906, n.3.

<sup>7</sup> See Notice, 77 FR at 28906. Specifically, NASDAQ Equity Rule 4758(d)(2) defines “error positions” as “positions that result from a technical or systems issue at Nasdaq Execution Services, Nasdaq, a routing destination, or a non-affiliate third-party Routing Broker that affects one or more orders.”

For examples of some of the circumstances that may lead to error positions, see Notice, 77 FR at 28906–07.

destination. NASDAQ or NES will be required to provide notice of the cancellation to all affected members as soon as practicable.<sup>8</sup>

Paragraph (d)(2) of NASDAQ Equity Rule 4758 will allow NES to maintain an error account for the purpose of addressing error positions that result from a technical or systems issue at NASDAQ, NES, a routing destination, or a non-affiliate third-party Routing Broker.

For purposes of NASDAQ Equity Rule 4758(d), an error position will not include any position that results from an order submitted by a member to NASDAQ that is executed on NASDAQ and automatically processed for clearance and settlement on a locked-in basis.<sup>9</sup> NES will not be permitted to (i) accept any positions in its error account from a member's account or (ii) permit any member to transfer any positions from the member's account to NES's error account.<sup>10</sup> In other words, NES may not accept from a member positions that are delivered to the member through the clearance and settlement process, even if those positions may have been related to a technical or systems issue at NASDAQ, NES, a routing destination, or a non-affiliate third-party Routing Broker.<sup>11</sup> If a member receives locked-in positions in connection with a

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<sup>8</sup> See NASDAQ Equity Rule 4758(d)(1).

<sup>9</sup> See NASDAQ Equity Rule 4758(d)(2)(A).

<sup>10</sup> See NASDAQ Equity Rule 4758(d)(2)(B).

<sup>11</sup> See Notice, 77 FR at 28907, n.11. This provision would not apply if NES incurred a short position to settle a member's purchase, as the member would not have had a position in its account as a result of the purchase at the time of NES's action. Similarly, if a systems issue occurs that causes one member to receive an execution for which there is not an available counterparty, action by NES would be required for the positions to settle into that member's account. See *id.*

If error positions result in connection with NASDAQ's use of a third-party Routing Broker for outbound routing and those positions are delivered to NES through the clearance and settlement process, NES would be permitted to resolve those positions. If, however, such positions were not delivered to NES through the clearance and settlement process, then the third-party Routing Broker would resolve the error positions itself, and NES would not be permitted to accept the positions. See Notice, 77 FR at 28906, n.3.

technical or systems issue and experiences a loss in unwinding those positions, that member may seek to rely on NASDAQ Equity Rule 4626, which provides members with the ability to file claims against NASDAQ “for losses directly resulting from the [NASDAQ] systems’ actual failure to correctly process an order, Quote/Order, message, or other data, provided the Nasdaq Market Center has acknowledged receipt of the order, Quote/Order, message, or data.”<sup>12</sup> If, however, a technical or systems issue results in NASDAQ not having valid clearing instructions for a member to a trade, NES may assume that member’s side of the trade so that the trade can be automatically processed for clearance and settlement on a locked-in basis.<sup>13</sup>

Paragraph (d)(3) of NASDAQ Equity Rule 4758 permits NASDAQ or NES, in connection with a particular technical or systems issue, to either (i) assign all resulting error positions to members or (ii) have all resulting error positions liquidated. Any determination to assign or liquidate error positions, as well as any resulting assignments, will be made in a nondiscriminatory fashion.<sup>14</sup>

NASDAQ and NES will be required to assign all error positions resulting from a particular technical or systems issue to the members affected by that technical or systems issue if NASDAQ or NES:

- (i) Determines that it has accurate and sufficient information (including valid clearing information) to assign the positions to all of the members affected by that technical or systems issue;

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<sup>12</sup> See Notice, 77 FR at 28907, n.11.

<sup>13</sup> See NASDAQ Equity Rule 4758(d)(2)(C).

<sup>14</sup> See NASDAQ Equity Rule 4758(d)(3).

- (ii) Determines that it has sufficient time pursuant to normal clearance and settlement deadlines to evaluate the information necessary to assign the positions to all of the members affected by that technical or systems issue; and
- (iii) Has not determined to cancel all orders affected by that technical or systems issue in accordance with NASDAQ Equity Rule 4758(d)(1).<sup>15</sup>

If NASDAQ or NES is unable to assign all error positions resulting from a particular technical or systems issue to all of the affected members, or if NASDAQ or NES determines to cancel all orders affected by the technical or systems issue, then NES will be required to liquidate the error positions as soon as practicable.<sup>16</sup> NES will be required to provide complete time and price discretion for the trading to liquidate the error positions to a third-party broker-dealer, and would be prohibited from attempting to exercise any influence or control over the timing or methods of such trading.<sup>17</sup> Further, NES will be required to establish and enforce policies and procedures that are reasonably designed to restrict the flow of confidential and proprietary information between the third-party broker-dealer, on one hand, and NASDAQ and NES, on the other, associated with the liquidation of the error positions.<sup>18</sup>

Finally, paragraph (d)(4) of NASDAQ Equity Rule 4758 requires NASDAQ and NES to make and keep records to document all determinations to treat positions as error positions; all determinations to assign error positions to members or to liquidate error positions; and the liquidation of error positions through the third-party broker-dealer.

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<sup>15</sup> See NASDAQ Equity Rule 4758(d)(3)(A)(i)–(iii).

<sup>16</sup> See NASDAQ Equity Rule 4758(d)(3)(B).

<sup>17</sup> See NASDAQ Equity Rule 4758(d)(3)(B)(i).

<sup>18</sup> See NASDAQ Equity Rule 4758(d)(3)(B)(ii).

### III. Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b) of the Act<sup>19</sup> and the rules and regulations thereunder applicable to a national securities exchange.<sup>20</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>21</sup> which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. In addition, the Commission believes the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act<sup>22</sup> in that it seeks to assure economically efficient execution of securities transactions.

The Commission recognizes that technical or systems issues may occur, and believes that NASDAQ Equity Rule 4758, in allowing NASDAQ or NES to cancel orders affected by technical or systems issues, should provide a reasonably efficient means for NASDAQ to handle

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<sup>19</sup> 15 U.S.C. 78f(b).

<sup>20</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>21</sup> 15 U.S.C. 78f(b)(5).

<sup>22</sup> 15 U.S.C. 78k-1(a)(1)(C).

such orders, and appears reasonably designed to permit NASDAQ to maintain fair and orderly markets.<sup>23</sup>

The Commission also believes that allowing the Exchange to resolve error positions through the use of an error account maintained by NES pursuant to the procedures set forth in the rule, and as described above, is consistent with the Act. The Commission notes that the rule establishes criteria for determining which positions are error positions,<sup>24</sup> and that NASDAQ or NES, in connection with a particular technical or systems issue, will be required to either (i) assign all resulting error positions to members or (ii) have all resulting error positions liquidated.<sup>25</sup> Also, NASDAQ or NES will assign error positions that result from a particular technical or systems issue to members only if all such error positions can be assigned to all of the members affected by that technical or systems issue.<sup>26</sup> If NASDAQ or NES cannot assign all error positions to all members, NES will liquidate all of those error positions.<sup>27</sup> In this regard, the Commission believes that the new rule appears reasonably designed to further just and equitable principles of trade and the protection of investors and the public interest, and to help prevent unfair discrimination, in that it should help assure the handling of error positions will be

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<sup>23</sup> The Commission notes that NASDAQ states that the proposed amendments to NASDAQ Equity Rule 4758 are designed to maintain fair and orderly markets, ensure full trade certainty for market participants, and avoid disrupting the clearance and settlement process. See Notice, 77 FR at 28908. The Commission also notes that NASDAQ states that a decision to cancel orders due to a technical or systems issue is not equivalent to the Exchange declaring self-help against a routing destination pursuant to Rule 611 of Regulation NMS. See 17 CFR 242.611(b). See also Notice, 77 FR at 28907, n.10.

<sup>24</sup> See NASDAQ Equity Rule 4758(d)(2).

<sup>25</sup> See NASDAQ Equity Rule 4758(d)(3).

<sup>26</sup> See NASDAQ Equity Rule 4758(d)(3)(A).

<sup>27</sup> See NASDAQ Equity Rule 4758(d)(3)(B).

based on clear and objective criteria, and that the resolution of those positions will occur promptly through a transparent process.

Additionally, the Commission notes that it has previously expressed concern about the potential for 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.<sup>28</sup> The Commission is also concerned about the potential for misuse of confidential and proprietary information. The Commission believes that the requirement that NES provide complete time and price discretion for the liquidation of error positions to a third-party broker-dealer, including that NES not attempt to exercise any influence or control over the timing or methods of such trading, combined with the requirement that NASDAQ establish and enforce policies and procedures that are reasonably designed to restrict the flow of confidential and proprietary information to the third-party broker-dealer liquidating such positions, should help mitigate the Commission's concerns. In particular, the Commission believes that these requirements should help assure that none of NASDAQ, NES, or the third-party broker-dealer is able to misuse confidential or proprietary information obtained in connection with the liquidation of error positions for its own benefit. The Commission also notes that NASDAQ and NES would be required to make and keep records to document all determinations to treat positions as error positions; all determinations to assign error positions to members or liquidate error positions; and the liquidation of error positions through the third-party broker-dealer.<sup>29</sup>

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<sup>28</sup> See, e.g., Securities Exchange Act Release No. 65455 (September 30, 2011), 76 FR 62119 (October 6, 2011) (SR-NYSEArca-2011-61) at 62120, n.16 and accompanying text.

<sup>29</sup> See NASDAQ Equity Rule 4758(d)(4).

Finally, the Commission notes that the proposed procedures for canceling orders and the handling of error positions are consistent with procedures the Commission has approved for other exchanges.<sup>30</sup>

#### IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>31</sup> that the proposed rule change (SR-NASDAQ-2012-057) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>32</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>30</sup> See, e.g., Securities Exchange Act Release Nos. 66963 (May 10, 2012), 77 FR 28919 (May 16, 2012) (SR-NYSEArca-2012-22); 67010 (May 17, 2012), 77 FR 30564 (May 23, 2012) (SR-EDGX-2012-08); and 67011 (May 17, 2012), 77 FR 30562 (May 23, 2012) (SR-EDGA-2012-09).

<sup>31</sup> 15 U.S.C. 78s(b)(2).

<sup>32</sup> 17 CFR 200.30-3(a)(12).