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SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-70756; File No. SR-BX-2013-016]

Self-Regulatory Organizations; NASDAQ OMX BX Inc.; Order Disapproving Proposed Rule Change to Adopt a Directed Order Process
October 25, 2013.

I. Introduction

On February 21, 2013, NASDAQ OMX BX Inc. ("Exchange" or "BX") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] a proposed rule change to establish a directed order process for the trading of listed options. The proposed rule change was published for comment in the Federal Register on March 11, 2013.[3] The Commission received a comment letter on the proposal,[4] BX's response to the comment letter,[5] and a follow up comment letter from the same commenter.[6] On April 17, 2013, BX filed Amendment No. 1

1 15 U.S.C. 78a.

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 69040 (March 5, 2013), 78 FR 15385 ("Notice").

4 See Letter, dated April 2, 2013, to Elizabeth M. Murphy, Secretary, Commission, from Janet McGuiness, Executive Vice President, Secretary and General Counsel, NYSE Euronext ("NYSE Euronext Letter 1"). For a summary of this letter, see Securities Exchange Act Release No. 69684 (June 3, 2013), 78 FR 34683 (June 10, 2013) ("Order Instituting Proceedings").

5 See Letter, dated April 17, 2013, to Elizabeth M. Murphy, Secretary, Commission, from Edith Hallahan, Principal Associate General Counsel, BX ("BX Letter 1"). For a summary of this letter, see Order Instituting Proceedings, supra note 4, 78 FR at 34685.

6 See Letter, dated May 10, 2013, to Elizabeth M. Murphy, Secretary, Commission, from Janet McGuiness, Executive Vice President, Secretary and General Counsel, NYSE Euronext ("NYSE Euronext Letter 2"). For a summary of this letter, see Order Instituting Proceedings, supra note 4, 78 FR at 34685.

to the proposed rule change.[7] On April 22, 2013, BX extended to June 6, 2013 the time period within which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change. On June 3, 2013, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule change.[8] The Commission received a letter from BX responding to the Order Instituting Proceedings,[9] another comment letter from the same commenter – NYSE Euronext – who had commented previously on the proposed rule change,[10] and a follow up letter from BX in response to NYSE Euronext's comment letter.[11] This order disapproves the proposed rule change.

II. Description of the Proposal

BX proposes to establish a directed order process that would permit members of BX ("BX Participants") to direct orders in listed options ("Directed Orders") to a particular market maker on BX ("Directed Market Maker").[12] As detailed below, a Directed Market Maker would be eligible

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7 Amendment No. 1, which the Commission believes is technical in nature and not subject to notice and comment, clarifies that, when a Directed Order (as defined below) is submitted in an options class that is subject to the price/time priority on BX, the Directed Market Maker's Directed Allocation (as defined below) would be capped at 40%, unless the Directed Market Maker's size at the first position in time priority at that price exceeds 40%, in which case the Directed Market Maker would have priority for that size.

8 See Order Instituting Proceedings, supra note 4.

9 See Letter, dated July 1, 2013, to Elizabeth M. Murphy, Secretary, Commission, from Edith Hallahan, Principal Associate General Counsel, BX ("BX Letter 2").

10 See Letter, dated July 15, 2013, to Elizabeth M. Murphy, Secretary, Commission, from Janet McGuiness, Executive Vice President, Secretary and General Counsel, NYSE Euronext ("NYSE Euronext Letter 3").

11 See Letter, dated August 28, 2013, to Elizabeth M. Murphy, Secretary, Commission, from Edith Hallahan, Principal Associate General Counsel, BX ("BX Letter 3").

12 Specifically, BX proposes to add BX Chapter VI, Section 1(e)(1) to Chapter VI to define a Directed Order as "an order to buy or sell which has been directed (pursuant to BX's

to receive an allocated percentage of the Directed Order (40%) at all price levels at which the Directed Market Maker has a quote or order (a "Directed Allocation").[13] To receive a Directed Allocation, the Directed Market Maker would be required to have quotes or orders at the National Best Bid or National Best Offer ("NBBO") at the time of the execution of the Directed Order; the Directed Market Maker would not be required to be quoting at the NBBO at the time the Directed Order is received.[14] If a Directed Order is not executed upon receipt, it would be placed on the BX book and would retain its status as a Directed Order.[15]

The calculation of a Directed Market Maker's Directed Allocation would depend on whether the Directed Order is submitted in an options class that is subject to price/time priority or in an options class that is subject to the size pro-rata execution algorithm on BX. Specifically, if an option is subject to price/time priority, a Directed Market Maker who has time priority at a particular price would receive the amount of the Directed Order equal to the Directed Market

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instructions on how to direct an order) to a particular Market Maker ("Directed Market Maker") after the opening." BX also proposes to amend BX Chapter VI, Section 6(a)(2) to include Directed Order to the list of orders handled within the BX System.

13 Proposed BX Chapter VI, Section 10(3)(iv)(C).

14 For example, as shown in Example 4 in the Notice, if BX was not at the National Best Offer ("NBO") and the Directed Market Maker was quoting one tick away from the NBO at the time a Directed Order was received, once the NBO was exhausted and BX became the new NBO, the Directed Order could be executed at this new NBO and the Directed Market Maker would receive its Directed Allocation, even though the Directed Market Maker was not at the NBO at when the order was received.

15 Proposed BX Chapter VI, Section 10(3)(iv)(C). For example, if a marketable non-routable Directed Order to buy is received on BX and BX is not quoting at the NBO, the order could not be executed on BX and could not route. See BX Chapter VI, Section 7(b)(3)(C) (providing that "[a]n order will not be executed at a price that trades through another market . . . ."). Thus, under BX's rules, the order would be posted on the BX book at the current NBB but displayed one minimum price increment below the NBO. See BX Chapter VI, Section 7(b)(3)(C). If the market moves such that the BX best offer is now the NBO, the Directed Order would be executed against the BX best offer, which is now the NBO, and the Directed Market Maker would receive a Directed Allocation of 40% of the Directed Order. See Notice, supra note 3, at 15390.

Maker's quotes/orders with time priority at that price. However, if the Directed Market Maker does not have time priority for a size equal to or greater than 40% of the Directed Allocation, the Directed Market Maker would receive a Directed Allocation of 40% of the Directed Order at a particular price.[16]

If a Directed Order is submitted in an options class that is subject to the size pro-rata execution algorithm, any public customer limit orders resting on the limit order book at the execution price would first be executed against the Directed Order.[17] Once all public customer limit orders are executed, the Directed Market Maker would receive the greater of: (1) the pro-rata allocation to which such Directed Market Maker would be entitled or (2) 40% of the original size of the Directed Order at that particular price. Once the Directed Allocation is determined, BX proposes to allocate all remaining contracts of the Directed Order on a size pro-rata basis among all remaining participants (except for the Directed Market Maker).

If the calculation of the 40% Directed Allocation results in a fractional remainder, BX proposes to round up the Directed Market Maker's Directed Allocation to the next whole number whether the Directed Order is submitted in an options class subject to price/time priority or in an options class that is subject to the size pro-rata execution algorithm.[18] In addition, the Directed Market Maker would not be entitled to receive a number of contracts that is greater than the size associated with its quote or order at a particular price.[19]

BX also proposes to reduce the quoting obligations applicable to its Market Makers that are not Directed Market Makers. Currently, BX Market Makers are required to quote during regular

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16 Proposed BX Chapter VI, Section 10(3)(i)(A). See also Amendment No. 1, supra note 7.

17 Proposed BX Chapter VI, Section 10(3)(i)(B).

18 Proposed BX Chapter VI, Section 10(3)(iv)(B).

19 Proposed BX Chapter VI, Section 10(3)(iv)(A).

market hours on a continuous basis (i.e., 90% of the trading day) in at least 60% of the series in options in which the Market Maker is registered. The proposed rule would reduce this requirement such that Market Makers would be required to quote 60% of the trading day (as a percentage of the total number of minutes in such trading day) or such higher percentage as BX may announce in advance, in all options in which the Market Maker is registered.

The quoting obligations applicable to Directed Market Makers would be higher than those applicable to Market Makers that are not Directed Market Makers. Specifically, Directed Market Makers would be required to quote such options 90% of the trading day (as a percentage of the total number of minutes in such trading day) or such higher percentage as BX announces in advance, applied collectively to all series in all of the option classes in which the Directed Market Maker receives Directed Orders (rather than on an option-by-option basis). Once a Directed Market Maker receives a Directed Order, the heightened quoting obligation is triggered and applies to the options in which the Directed Market Maker receives the Directed Order. The Directed Market Maker would be required to comply with the heightened quoting requirements only upon receiving a Directed Order in a class, and the heightened quoting requirements would be applicable until the end of the calendar month.

III. Discussion

Under Section 19(b)(2)(C) of the Act, the Commission shall approve a proposed rule change of a self-regulatory organization if the Commission finds that such proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable to such organization.[20] The Commission shall disapprove a proposed rule change if it

[20] 15 U.S.C. 78s(b)(2)(C)(i).

does make such a finding.[21] The Commission's Rules of Practice, under Rule 700(b)(3), state that the "burden to demonstrate that a proposed rule change is consistent with the [Act] . . . is on the self-regulatory organization that proposed the rule change" and that a "mere assertion that the proposed rule change is consistent with those requirements . . . is not sufficient."[22]

After careful consideration, the Commission does not find that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[23] In particular, the Commission does not find that the proposed rule change is consistent with Section 6(b)(5) of the Act,[24] which requires that the rules of a national securities exchange be designed, among other things, to prevent fraudulent and manipulative acts and practices, 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 to protect investors and the public interest.

In the Order Instituting Proceedings, the Commission summarized the comments received and BX's response, and noted several concerns that raise questions as to whether the BX proposal is consistent with the requirements of Section 6(b)(5) of the Act, including whether

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21 15 U.S.C. 78s(b)(2)(C)(i); see also 17 CFR 201.700(b)(3) and note 25 infra, and accompanying text.

22 17 CFR 201.700(b)(3). The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding. See id. Any failure of a self-regulatory organization to provide the information solicited by Form 19b-4 may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Act and the rules and regulations issued thereunder that are applicable to the self-regulatory organization. Id.

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

24 15 U.S.C. 78f(b)(5).

the proposed process for handling Directed Orders would promote just and equitable principles of trade, perfect the mechanism of a free and open market and the national market system, or protect investors and the public interest.[25] Specifically, the Commission stated that the proposal raises the following issues: (1) Whether BX's proposal would protect investors in that the proposal would provide Directed Market Makers with priority for Directed Allocations ahead of public customer limit orders that arrived first in time; and (2) how the proposed rules would impact quote competition on BX, and how any impact on quote competition on BX in turn would impact execution quality on BX.[26] The Commission invited interested persons to submit written views with respect to these concerns. The Commission received three letters in response to the Order Instituting Proceedings, two of which were from BX.[27]

The Commission recognizes that it has previously approved rules of other national securities exchanges that provide for directed order programs.[28] BX's proposed Directed Order rules, however, deviate from the directed order rules of other exchanges previously approved by the Commission, as described in more detail below. First, BX proposes to provide a Directed Market Maker time priority over pre-existing customer orders in certain instances. In addition, unlike other exchanges with directed order programs, BX would not require its Directed Market

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25 See Order Instituting Proceedings, supra note 4, at 34686.

26 Id.

27 See BX Letter 2, supra note 9 and NYSE Euronext Letter 3, supra note 10; see also BX Letter 3, supra note 11.

28 See Securities Exchange Act Release No. 51759 (May 27, 2005), 70 FR 32860 at 32861 (June 6, 2005) (SR-Phlx-2004-91) ("Phlx Order"); see also e.g., Securities Exchange Act Release Nos. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (SR-CBOE-00-55) ("CBOE Order"); 52331 (August 24, 2005), 70 FR 51856 (August 31, 2005) (SR-ISE-2004-16) ("ISE Order"); 59472 (February 27, 2009) 74 FR 9843 (March 6, 2009) (SR-NYSEALTR-2008-14) ("NYSEALTR Order"); 60469 (August 10, 2009), 74 FR 41478 (August 17, 2009)(SR-NYSEArca-2009-73) ("NYSE Arca Notice"); and 68070 (October 18, 2012), 77 FR 65037 (October 18, 2012) (SR-C2-2012-24) ("C2 Order").

Makers to quote at the NBBO at the time a Directed Order is received to be eligible to receive an execution guarantee; rather, BX would only require its Directed Market Makers to be at the NBBO at the time the Directed Order is executed. BX also deviates from other exchanges in its proposal to apply heightened quoting requirements only after a Directed Market Maker receives a Directed Order in a given month.

A. No Public Customer Priority

As outlined above, BX's proposed Directed Order rule would provide, in options classes utilizing the price/time allocation methodology, the Directed Market Maker with priority for the 40% allocation ahead of public customer orders. Specifically, the Directed Market Maker's allocation would go ahead of public customer orders that otherwise had time priority over the Directed Market Maker's quote.

NYSE Euronext commented on this aspect of BX's proposal, noting that, under BX's proposal, a Directed Market Maker that submits a quote after a public customer who has aggressively improved the NBBO would receive a Directed Allocation that the earlier-arriving public customer could potentially have completely filled. According to NYSE Euronext, public customers would not be fully rewarded for providing an aggressive quote and thus the incentives to improve the NBBO would decrease, resulting in fewer displayed public customer orders and fewer public customers willing to improve the NBBO.[29]

In response to NYSE Euronext's comment letter, BX argues that customer priority is not mandated by the Act or the rules and regulations thereunder.[30] BX also argues that it is reasonable and consistent with applicable statutory standards for a Directed Market Maker's

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29 See NYSE Euronext Letter 2, supra note 6, at 3-4.

30 See BX Letter 2, supra note 9, at 3.

quote to execute against a Directed Order before a priority customer order that goes ahead of the Directed Market Maker quote in time priority, stating that public customer orders are not precluded from participating in the trade, but rather continue to stand in time priority once the Directed Order's execution guarantee is satisfied.[31] BX contends that public customers may not have otherwise received an execution on BX because the Directed Market Maker may have attracted the Directed Order to BX as a result of the Directed Market Maker's relationship with the order flow provider.[32]

NYSE Euronext also notes the longstanding history of distinguishing public customers from professionals and allowing advantages to public customer orders.[33] NYSE Euronext states its belief that BX is attempting to "turn this distinction [between a public customer and a professional] on its head" by providing preferential treatment to sophisticated professionals rather than public customers.[34] NYSE Euronext argues further that it would be inconsistent with the protection of investors if other exchanges followed the approach of treating directed orders in the same manner as BX, resulting in public customers losing priority and receiving fewer fills.[35]

In response, BX states its view that the distinction between public customers and professionals was rooted in floor-based trading models where customers were not charged fees and in pro rata priority models where there were opportunities for professionals to "size out"

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31 See Notice, supra note 3, at 15388. See also BX Letter 2, supra note 9, at 3-4.

32 Id.

33 See NYSE Euronext Letter 2, supra note 6, at 3-4.

34 See NYSE Euronext Letter 3, supra note 10, at 4. See also NYSE Euronext Letter 2, supra note 6, at 2-3.

35 See NYSE Euronext Letter 3, supra note 10, at 5. (citing Securities Exchange Act Release No. 42808 (May 22, 2000), 65 FR 34515, 34517 (May 30, 2000) (SR-ISE-00-01)).

public customers, therefore there was a particular need for public customer priority.[36] BX argues that currently other trading models are used by the options exchanges, and that under a price/time model public customers do not need the same protection as under a pro rata model. BX also argues that its proposal rewards a specific category of market participants who have general market making obligations that are critical to the functioning of the market in addition to enhanced obligations, which qualify them for a Directed Allocation.[37] In response to NYSE Euronext's argument that it would be inconsistent with the protection of investors if other exchanges followed the approach of treating directed orders in the same manner as BX, BX notes that NYSE Euronext can choose not to adopt a similar approach on its markets, and if BX's proposed approach is not successful based on its treatment of customer orders, NYSE Euronext might benefit.[38] BX also reiterates its argument that Directed Orders attract liquidity to the Exchange, and that a customer order on BX could remain unfilled if a Directed Order is not routed to BX, in favor of another option exchange that would allow the order to be directed to a particular market maker.[39]

The directed order rules of other exchanges all provide for public customer priority over directed order market makers at a particular price level, whether the exchange has a pro-rata allocation methodology or a price/time allocation methodology.[40] The rules of the one options

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36 See BX Letter 2, supra note 9, at 3.

37 See BX Letter 3, supra note 11, at 2.

38 Id.

39 Id.; see also BX Letter 2, supra note 9, at 3-4.

40 See, e.g., C2 Rules 6.12 and 8.17; CBOE Rule 8.13; NYSE Rule 964NY; and ISE Rule 713 (pro-rata allocation methodology) and NYSE Arca Rule 6.76A (time priority allocation methodology. See, e.g., Securities Exchange Act Release 42808 (May 22, 2000), 65 FR 34515, 34517 (May 30, 2000) (SR-ISE-00-01) ("Although the Commission recognizes that intramarket competition, as well as protection of public customers, could

exchange that has a directed order program in a price/time allocation market do not allow the directed market maker participation entitlement to step ahead of customer orders that have time priority over the directed market maker's quote or order.[41] Similar to the other exchanges, under BX's proposal, if the option is subject to the pro-rata execution algorithm, public customer limit orders resting on the limit order book at the execution price will execute against the Directed Order first, before the 40% allocation to the Directed Market Maker.[42] To the contrary, however, BX's proposal would not protect any public customer orders under a price/time allocation methodology. Instead, it would allow the Directed Market Maker's quote or order to go ahead of earlier-arriving public customer orders based solely on the relationship of the Directed Market Maker with the order flow provider that sent the Directed Order.

The Commission believes that BX's failure to accord protection to public customer orders would result in an execution allocation that is inconsistent with Section 6(b)(5) of the Act, which requires that the rules of an exchange must designed, among other things, to protect investors.[43] Specifically, rather than giving priority to public customer orders or placing public

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be compromised if such a participation right constituted an absolute guarantee or if it consumed too great a percentage of order flow, the Commission believes that the ISE's proposal sets forth reasonable safeguards against such potential harms. The ISE's proposal prioritizes public customer limit orders on the book. Indeed, if sufficient existing customer interest exists a PMM might not receive any allocation of a given incoming order . . . . The Commission believes that these limits on a PMM's participation right should assure reasonable protection for public customers and prevent impediments to a free and open market that might otherwise result from an absolute specialist guarantee.") (order approving rules related to market maker participation rights).

41 See NYSE Arca Rule 6.76A, which provides that the participation entitlement has priority over other orders except customer orders that were ranked ahead of the directed market maker's quote or order in time priority. See NYSE Arca Notice, supra note 28, at 41479.

42 Proposed BX Chapter VI, Section 10(3)(i)(B).

43 15 U.S.C. 78f(b)(5).

customers and Directed Market Makers on an equal footing, BX's proposal would, by allowing Directed Market Maker quotes or orders to "jump" the price/time queue over previously received public customers limit orders, disadvantage public customer orders in order to give a trading benefit to Directed Market Makers in contravention of Section 6(b)(5) of the Exchange Act.[44]

B. NBBO Quoting Requirement

Unlike other exchanges with directed order programs, BX would not require its Directed Market Makers to be quoting at the NBBO at the time a Directed Order is received to be eligible to receive an execution guarantee.[45] Rather, BX would only require its Directed Market Makers to be quoting at the NBBO at the time the Directed Order is executed.[46] In its filing, BX supports this aspect of its proposal by stating its belief that because executions occur across multiple prices with simultaneous routing, the availability of the participation entitlement should

44 15 U.S.C. 78f(b)(5).

45 See, e.g., Securities Exchange Act Release 51818 (June 10, 2005), 70 FR 35146, 35149-50 (June 16, 2005) (SR-ISE-2005-18) ("The Commission has previously approved rules that guarantee a Primary Market Maker a portion of each order when the Primary Market Maker's quote is equal to the NBBO . . . . [A] Preferred Market Maker will have to be quoting at the NBBO at the time the Preferenced Order is received to capitalize on the participation guarantee. The Commission believes it is critical that the Preferred Market Maker cannot step up and match the NBBO after it receives an order, but must be publicly quoting at that price when the order is received.") (order approving rules relating to preferencing of market maker orders).

46 Under BX's proposal, if the Directed Market Maker is not at the NBBO at the time a Directed Order is received, the order would first execute against available interest at the NBBO. If the orders at the NBBO on BX and on away markets are executed so that the Directed Market Maker is at the NBBO, and there is remaining size available from the Directed Order, the Directed Market Maker would receive its execution guarantee (40% of the remaining shares) at each price level at which the Directed Market Maker has quotes/orders.

not be limited by the requirement that Directed Market Makers be quoting at the NBBO at the time the Directed Order is received.[47]

NYSE Euronext expressed concern with BX's proposed rule to allow a Market Maker to receive a Directed Allocation when the Market Maker does not have a quote at the NBBO at the time the Directed Order is received by BX. NYSE Euronext stated that in approving rule proposals that guarantee an allocation to a market maker, the Commission has consistently focused on two distinct aspects of the proposals, one of which is that the market maker's quote is equal to the NBBO at the time of receipt of the order.[48] NYSE Euronext states that the Commission has granted the increased reward of a preferential directed order allocation only to market makers who are taking the commensurate risk of quoting at the NBBO, and appropriately so: posting firm quotes acceptable by all participants at the NBBO is a benefit to all participants in that it fosters price discovery and transparency.[49]

NYSE Euronext states that BX's proposed rule would be unprecedented and would be detrimental to transparency and price discovery by destroying incentives for market makers to quote aggressively at the NBBO.[50] Specifically, NYSE Euronext argues that by rewarding market makers whose quotes are not the most aggressive, the BX proposal will encourage market makers to quote away from the inside market, and that the Exchange's proposal would deteriorate market makers' incentives to compete for incoming orders based on price.[51] According to NYSE Euronext, a market maker could "lay in wait" outside the NBBO, allowing

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47 See Notice, supra note 3, at 15389.

48 See NYSE Euronext Letter 2, supra note 6, at 2.

49 See NYSE Euronext Letter 1, supra note 4, at 5.

50 Id.

51 See NYSE Euronext Letter 2, supra note 6, at 1.

other participants to participate in the order at less attractive prices, while the market maker receives a 40% participation entitlement for that portion of the Directed Order that trades at the more attractive price.[52] NYSE Euronext also believes that Directed Market Makers will have no incentive to match or improve the NBBO of a thinly traded option due to the low risk that a Directed Order will be fully executed against a better-priced order.[53]

NYSE Euronext further argues that, although BX believes its proposed rule will increase depth of market, BX fails to acknowledge that such an increase would be the result of fewer Directed Market Makers quoting at the NBBO.[54] Rather than create additional liquidity, NYSE Euronext believes that BX's proposal would shift liquidity from the top-of-book to depth-of-book.[55]

In response to these concerns, BX acknowledges that its proposal does break new ground, but stresses that to receive an execution of a Directed Order, a Directed Market Maker must be quoting at the NBBO at the time of execution, and that there would never be an allocation to a quote outside the NBBO.[56] BX maintains that its proposed program will help make market makers quote more competitively, not less.[57] Specifically, BX notes that, in order for a Directed Market Maker to execute an order at a particular price, all orders at more aggressive prices will

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52 See NYSE Euronext Letter 1, supra note 4, at 5.

53 See NYSE Euronext Letter 2, supra note 6, at 4.

54 See NYSE Euronext Letter 3, supra note 10, at 2.

55 Id. at 4.

56 See BX Letter 1, supra note 5, at 2.

57 See BX Letter 3, supra note 11, at 2.

first have to be executed.[58] As a result, BX believes that Directed Market Makers will be incentivized to provide their best quote and add depth to the market.[59]

BX also argues that a market maker who chooses to quote at a price other than the inside is providing value and depth at that price when orders trade at multiple price levels and when that price becomes the NBBO, thus benefitting investors.[60] In particular, BX argues that its proposal addresses the reality of multiple prices and creates an ability to efficiently execute a larger volume of an order, particularly when the NBBO is for a small size. Thus, according to BX, its proposal "recognizes the new NBBO and preserves the requirement that the Directed Market Maker be at the NBBO" (emphasis in original).[61]

BX disagrees with NYSE Euronext's contention that liquidity would be shifted from the top-of-book to depth-of-book. BX instead contends that market participants and market makers in particular have independent and varied motivations for their pricing decisions and pricing points and that a directed order program would not affect those motivations.[62] BX argues that a market maker who chooses to quote at a price other than the inside is providing value and depth at that price when orders trade at multiple price levels as well as when that price level becomes the NBBO.[63]

The Commission has considered the arguments raised by both BX and NYSE Euronext. On the one hand, the existing requirement to be quoting at the NBBO in order to receive a

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58 See BX Letter 1, supra note 5, at 3.

59 Id.

60 See BX Letter 1, supra note 5, at 3. See also BX Letter 2, supra note 9, at 2.

61 See BX Letter 1, supra note 5, at 2. See also BX Letter 2, supra note 9, at 2, 4.

62 See BX Letter 3, supra note 11, at 2.

63 Id.

directed order may incentivize market makers to quote tighter spreads, and therefore contribute to more efficient markets. On the other hand, BX's proposal to allow Directed Market Makers to receive Directed Orders when they are not quoting at the NBBO at the time of receipt of the Directed Order may, as BX argues, contribute to greater depth in the market, which also could contribute to market efficiency. However, BX has not provided sufficient information in its proposal to overcome the Commission's fundamental concerns about the impact the proposal could have on participants' incentives to quote competitively and the potential impact on overall prices in the market. For example, a directed market maker's incentive to quote in the depth-of-book is likely related to the frequency with which marketable orders execute against not just the NBBO but also the depth-of-book. BX, however, has not provided any analysis regarding the frequency or nature of such marketable orders or any data showing the interaction of such orders with the market makers' orders or quotes. Accordingly, the Commission does not believe that BX has met its burden in demonstrating that this aspect of the proposed rule change is consistent with the Act.[64]

C. Application of Heightened Quoting Requirement

The rules approved by the Commission governing the directed order programs of other options exchanges require that directed market makers on those exchanges satisfy quoting requirements that are higher than those imposed on market makers not receiving directed orders.[65] BX also would impose a heightened quoting requirement on its Directed Market Makers that receive Directed Orders. However, unlike the directed order rules in place at other options exchanges, BX proposes that the heightened quoting requirements for its Directed

[64] 17 CFR 201.700(b)(3).

[65] See C2 Rule 8.17; CBOE Rule 8.13; ISE Rule 811; NYSE Rule 964NY; NYSEArca Rule 6.88; and Phlx Rule 1014.

Market Makers apply only after the Directed Market Maker receives its first Directed Order in a given month. BX argues that this provision is appropriate because a Directed Market Maker does not know if and when it will receive a Directed Order, and therefore should not be required to quote at a heightened level unless and until it receives a Directed Order. [66] BX also argues that if the Directed Market Maker is not quoting, the Directed Order will not execute against such Directed Market Maker and thus the Directed Market Maker has an incentive to quote competitively in as many series as possible to attract Directed Orders. BX then asserts its view that this provision properly balances the benefit of receiving enhanced allocations with the obligations of heightened quoting.[67]

The Commission does not believe that BX has sufficiently demonstrated why requiring Directed Market Makers to be quoting at a heightened level only after receiving a Directed Order would not inappropriately upset the balance between a Directed Market Maker's obligations (including quoting obligations) and the benefits it receives (i.e., its participation entitlement). Accordingly, the Commission does not believe that BX has met its burden in demonstrating that this aspect of the proposed rule change is consistent with the Act.[68]

IV. Conclusion

For the reasons set forth above, the Commission does not believe that BX has met its burden to demonstrate that the proposed rule change is consistent with the requirements of the

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66 See BX Letter 2, supra note 9, at 4. The proposal would allow a Market Maker to accept Directed Orders at the end of each month and then only quote at a heightened level for the remainder of that month.

67 Id.

68 17 CFR 201.700(b)(3).

Act and the rules and regulations thereunder applicable to a national securities exchange, and in particular, Section 6(b)(5) of the Act.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-BX-2013-016) be, and hereby is, disapproved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[69]

Kevin M. O'Neill,
Deputy Secretary.

[FR Doc. 2013-25829 Filed 10/30/2013 at 8:45 am; Publication Date: 10/31/2013]

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[69] 17 CFR 200.30-3(a)(12).