



SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-72883; File No. SR-BX-2014-035]

Self-Regulatory Organizations; NASDAQ OMX BX, Inc.; Order Approving Proposed Rule Change Relating to Market Maker Quoting Obligations and the Introduction of a Lead Market Maker

August 20, 2014

I. Introduction

On June 19, 2014, NASDAQ OMX BX, Inc. (“BX” or the “Exchange”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² filed with the Securities and Exchange Commission (the “Commission”) a proposed rule change relating to market maker quoting obligations and the introduction of a lead market maker. The proposed rule change was published for public comment in the Federal Register on July 8, 2014.³ The Commission received no comment letters on the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposal

The Exchange proposes to amend the current BX Market Maker quoting obligations and adopt rules to permit BX Market Makers to act as Lead Market Makers (“LMMs”), provided the LMM meets certain obligations and quoting requirements. In addition, the Exchange proposes to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 72502 (Jul. 1, 2014), 79 FR 38620 (“Notice”).

provide assigned LMMs with certain participation entitlements. Finally, the Exchange proposes to provide Public Customers with priority when the Price/Time execution algorithm is in effect.

A. BX Market Maker Quoting Obligations

Currently, Chapter VII, Section 6(d)(i) of the BX Options Rules provides that on a daily basis, a Market Maker must during regular market hours make markets consistent with the applicable quoting requirements specified in the BX Options Rules, on a continuous basis in at least sixty percent (60%) of the series in options in which the Market Maker is registered.

Chapter VII, Section 6(d)(i)(1) of the BX Options Rules provides that, to satisfy this requirement with respect to quoting a series, a Market Maker must quote such series 90% of the trading day (as a percentage of the total number of minutes in such trading day).

BX proposes to reduce the quoting requirement for BX Options Market Makers so a Market Maker must quote the options in which it is registered 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 addition, this quoting obligation would apply to all of a Market Maker's registered options collectively on a daily basis. This quoting obligation would be reviewed on a monthly basis, and would allow the Exchange to review the Market Maker's daily compliance in the aggregate and determine the appropriate disciplinary action for single or multiple failures to comply with the continuous quoting requirement during the month period. However, determining compliance with the continuous quoting requirement on a monthly basis would not relieve a Market Maker of the obligation to provide continuous two-sided quotes on a daily basis, nor would it prohibit the Exchange from taking disciplinary action against a Market Maker for failing to meet the continuous quoting obligation each trading day.

B. Lead Market Maker Allocation

Currently, there are two types of Options Participants on BX: Options Order Entry Firms and Options Market Makers. The Exchange proposes to add a third type of Options Participant: an LMM. An approved BX Options Market Maker⁴ may become an LMM in one or more listed options. Under the proposal, initial application(s) to become an LMM would be in a form and/or format prescribed by the Exchange and would include: (1) background information on the LMM, including experience in trading options; (2) the LMM's clearing arrangements; (3) adequacy of capital; and (4) adherence to Exchange rules and ability to meet the obligations of an LMM.⁵ Subsequent applications would be in a form and/or format prescribed by the Exchange and would include the information requested therein, including, but not limited to, an account of the abilities and background of the applicant as well as any other special requirements that the Exchange may require.⁶ Once an applicant is approved by the Exchange as an LMM, any material change in capital would be reported in writing to the Exchange within two business days after the change.⁷ BX would not place any limit on the number of entities that may become LMMs, but there would only be one LMM per class.

When an options class is to be allocated or reallocated by the Exchange, the Exchange would solicit applications from all eligible LMMs. If the Exchange determines that special qualifications should be sought in the successful applicant, it would indicate such desired qualifications in the notice.⁸

⁴ See Chapter VII, Section 2.

⁵ See proposed BX Options Rules at Chapter VII, Section 13(A)(b).

⁶ See proposed BX Options Rules at Chapter VII, Section 13(A)(c).

⁷ See proposed BX Options Rules at Chapter VII, Section 13(A)(d).

⁸ See proposed BX Options Rules at Chapter VII, Section 13(B)(a).

Under the proposal, allocation applications would be submitted in writing to the Exchange's designated staff and would include, at a minimum, the name and background of the LMM, the LMM's experience and capitalization demonstrating an ability to trade the particular options class sought, and any other reasons why the LMM believes it should be assigned or allocated the security. In addition, the Exchange may also require that applications include other information such as system acceptance/execution levels and guarantees. The Exchange would be permitted to re-solicit applications for any reason, including if it determines that its initial solicitation resulted in an insufficient number of applicants.⁹

Allocation decisions and automatic allocations would be communicated in writing to Exchange members. Once the LMM is allocated an issue, such LMM would immediately notify the Exchange in writing of any change to the respective system acceptance/execution levels or any other material change in the application for any assigned issue. If an LMM seeks to withdraw from allocation in a security, it would be required to notify the Exchange at least one business day prior to the desired effective date of such withdrawal.¹⁰ Options on Related Securities would be automatically allocated to the LMM that is already the LMM in Currently Allocated Options (as defined hereafter).¹¹ Only one LMM would be permitted to be allocated to an options class.¹²

⁹ See proposed BX Options Rules at Chapter VII, Section 13(B)(b).

¹⁰ See proposed BX Options Rules at Chapter VII, Section 13(B)(c)(d) and (e).

¹¹ See proposed BX Options Rules at Chapter VII, Section 13(B)(g).

¹² The Exchange is defining the term "Related Securities" for purpose of Chapter VII, Section 13 as follows: "Related Securities means, but is not limited to: securities of a partially or wholly owned subsidiary; securities that are convertible into the securities of the issuer; warrants on securities of the issuer; securities issued in connection with a name change; securities issued in a reverse stock split; contingent value rights; "tracking" securities designed to track the performance of the underlying security or corporate affiliate thereof; securities created in connection with the merger or acquisition of one or

The Exchange would allocate new options classes, or reallocate existing options classes to applicants based on the results of such factors as the Exchange deems appropriate. Among the factors that the Exchange may consider in making such decisions are: the number and type of securities in which applicants are currently registered; the capital and other resources of the applicant; recent allocation decisions within the past eighteen months; the desirability of encouraging the entry of new LMMs into the Exchange's market; order flow commitments; any prior transfers of LMM privileges by the applicant and the reasons therefor and such policies as the Board instructs the Exchange to follow in allocating or reallocating securities. The Exchange would also be permitted to consider: quality of markets data; observance of ethical standards and administrative responsibilities. Solely with respect to options class allocations or reallocations, past or contemplated voluntary delisting of options by LMMs, done in the best interest of the Exchange, would not be viewed negatively by the Exchange in making allocation and reallocation decisions. The Exchange would be permitted to allocate option classes for a limited period of time or subject to such other terms and conditions as it deems appropriate.¹³

Requests to allocate or transfer allocation, or transfer of an options class request would be made in writing to the Exchange and such transfer may only be made to an approved LMM. The LMM would be assigned to an options class for a period defined by the Exchange. The Exchange

more companies; securities created in connection with a "spin-off" transaction; convertible on non-convertible senior securities; and securities into which a listed security is convertible, where such Related Securities emanate from or are related to securities underlying options that are currently allocated to an LMM on the Exchange ("Currently Allocated Options"). The term Related Securities would not include Exchange Traded Funds. See proposed BX Options Rules at Chapter VII, Section 13(B)(f).

¹³ See proposed BX Options Rules at Chapter VII, Section 13(C).

would communicate such period in solicitation applications. The Exchange may re-allocate an options class after the defined period has expired.¹⁴

¹⁴ See proposed BX Options Rules at Chapter VII, Section 13(D).

C. LMM Obligations and Quotations

Under the Proposal, the Exchange would require that LMM transactions constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market, and no LMM should enter into transactions or make bids or offers that are inconsistent with such a course of dealings.¹⁵ Further, with respect to each class of options in his or her appointment, an LMM would be expected to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between option contracts of the same class. Without limiting the foregoing, an LMM would be expected to perform certain additional activities in the course of maintaining a fair and orderly market pursuant to proposed Chapter VII, Section 14(b).¹⁶

With respect to unusual conditions, if the interest of maintaining a fair and orderly market so requires, BX Regulation may declare that unusual market conditions exist in a particular issue and allow LMMs in that issue to make auction bids and offers with spread differentials of up to two times, or in exceptional circumstances, typically up to three times, the legal limits permitted under BX Options Rules. In making such determinations to allow wider markets, BX Regulation would consider certain enumerated factors.¹⁷ In the event that BX Regulation determines that unusual market conditions exist in any option, it would be the responsibility of BX Regulation to

¹⁵ See proposed BX Options Rules at Chapter VII, Section 14(a).

¹⁶ See proposed BX Options Rules at Chapter VII, Section 14(b).

¹⁷ See proposed BX Options Rules at Chapter VII, Section 14(c).

file a report with BX operations setting forth the relief granted for the unusual market conditions, the time and duration of such relief and the reasons therefor.¹⁸

In classes of options other than those to which the LMM is appointed, LMMs would not be permitted to engage in transactions for an account in which they have an interest that are disproportionate in relation to, or in derogation of, the performance of their obligations as specified in BX Options Rules with respect to the classes in their appointment. Furthermore, LMMs would not be permitted to: (1) Individually or as a group, intentionally or unintentionally, dominate the market in option contracts of a particular class; and (2) effect purchases or sales on the Exchange except in a reasonable and orderly manner.¹⁹

LMMs would be prohibited from (1) any practice or procedure whereby LMMs trading any particular option issue determine by agreement the spreads or option prices at which they will trade that issue; and (2) any practice or procedure whereby LMMs trading any particular option issue determine by agreement the allocation of orders that may be executed in that issue.²⁰

An LMM would be permitted to enter quotations only in the issues included in its appointment. An LMM would be required to provide continuous two-sided quotations throughout the trading day in its appointed issues for 90% of the time the Exchange is open for trading in each issue. Such quotations would be required to meet the legal quote width requirements of the BX Options Rules. These obligations would apply to all of the LMM's appointed issues collectively, rather than on an option-by-option basis. Compliance with this obligation would be determined on a monthly basis. BX Regulation may consider exceptions to the requirement to quote 90% (or higher) of the trading day based on demonstrated legal or

¹⁸ See proposed BX Options Rules at Chapter VII, Section 14(c)(i).

¹⁹ See proposed BX Options Rules at Chapter VII, Section 14(d).

²⁰ See proposed BX Options Rules at Chapter VII, Section 14(e).

regulatory requirements or other mitigating circumstances. However, determining compliance with the continuous quoting requirement on a monthly basis would not relieve an LMM of the obligation to provide continuous two-sided quotes on a daily basis, nor would it prohibit the Exchange from taking disciplinary action against an LMM for failing to meet the continuous quoting obligation each trading day.²¹

If a technical failure or limitation of a system of the Exchange prevents an LMM from maintaining, or prevents an LMM from communicating to the Exchange, timely and accurate electronic quotes in an issue, the duration of such failure would not be considered in determining whether the LMM has satisfied the 90% quoting standard with respect to that option issue. The Exchange would be permitted to consider other exceptions to this continuous electronic quote obligation based on demonstrated legal or regulatory requirements or other mitigating circumstances.²² An LMM may be called upon by BX Regulation to submit a single quote or maintain continuous quotes in one or more series of an option issue within its appointment whenever, in the judgment of BX Regulation, it is necessary to do so in the interest of maintaining fair and orderly markets.²³

An LMM would be compelled to buy/sell a specified quantity of option contracts at the disseminated bid/offer pursuant to his obligations with respect to firm quotes. All quotes and orders entered into the System by Options Participants are firm under BX Options Rules Chapter VII, Section 14(f) and Rule 602 of Regulation NMS under the Exchange Act (“SEC Rule 602”) for the number of contracts specified and according to the size requirements set forth under BX Options Rules. Market Maker bids and offers are not firm under BX Options Rules Chapter VII,

²¹ See proposed BX Options Rules at Chapter VII, Section 14(f)(1).

²² See proposed BX Options Rules at Chapter VII, Section 14(f)(1)(i).

²³ See proposed BX Options Rules at Chapter VII, Section 14(f)(2).

Section 14(f) and SEC Rule 602: (1) for the period prior to the Opening Cross; or (2) if any of the circumstances provided in paragraphs (b)(3) or (c)(4) of SEC Rule 602 exist.²⁴ The obligations of BX Options Rules Chapter VII, Section 14(f) would not apply to LMMs with respect to adjusted option series, quarterly options series, or any series with a time to expiration of nine months or greater. For purposes of BX Options Rules Chapter VII, Section 14(f), an adjusted option series would be an option series wherein, as a result of a corporate action by the issuer of the underlying security, one option contract in the series represents the delivery of other than 100 shares of underlying security.²⁵

D. Lead Market Maker Priority

The Exchange proposes to provide LMM participation entitlements in Chapter VI (Trading Systems) at Section 10. Specifically, with respect to Size Pro-Rata executions, the Exchange would afford an LMM a participation entitlement if the LMM's bid/offer is at the Exchange's disseminated price and all Public Customer²⁶ orders have been fully executed.²⁷ The LMM would not be entitled to receive a number of contracts that is greater than the displayed size associated with such LMM. LMM participation entitlements would be considered after the opening process. A BX Options LMM would receive the greater of: the LMM's Size Pro-Rata share; 50% of remaining interest if there is one or no other Market Maker at that price; 40% of remaining interest if there are two other Market Makers at that price; or 30% of remaining interest if there are more than two other Market Makers at that price; or if rounding would result

²⁴ See proposed BX Options Rules at Chapter VII, Section 14(f)(3).

²⁵ See proposed BX Options Rules at Chapter VII, Section 14(f)(4).

²⁶ See Chapter I, Section 1(50). The term "Public Customer" means a person that is not a broker or dealer in securities.

²⁷ Price Improving Orders will retain price priority before an LMM participation entitlement is provided at the Exchange's disseminated price. See Chapter VI, Sections 1(a)(6) and 7(b)(3)(B).

in an allocation of less than one contract, a BX Options LMM would receive one contract.

Rounding would be up or down to the nearest integer.

Orders for 5 contracts or fewer would be allocated to the LMM. The Exchange would review this provision quarterly and would maintain the small order size at a level that would not allow orders of 5 contracts or fewer executed by the LMM to account for more than 40% of the volume executed on the Exchange. After all Public Customer orders have been fully executed and LMM participation entitlements applied, if applicable, BX Options Market Makers would have priority over all other Participant orders at the same price.²⁸

With respect to Price/Time executions, the Exchange proposes to provide that the highest bid and lowest offer would have priority except that Public Customer orders would have priority over non-Public Customer orders at the same price. Currently, Public Customer orders do not have priority over non-Public Customer orders at the same price. If there are two or more Public Customer orders for the same options series at the same price, priority would be afforded to such Public Customer orders in the sequence in which they are received by the System. For purposes of BX Options Rules Chapter VI, Section 10(1)(C)(1)(a), a Public Customer order would not include a Professional Order. Public Customer Priority would always be in effect when the Price/Time execution algorithm is in effect.²⁹ This would be a substantive change which would provide Public Customer orders with priority over non-Public Customer orders at the same price for executions under the Price/Time execution algorithm. Similar language would also be added to BX Options Rules Chapter VI, Section 10(1)(C)(2)(i) to conform the Size Pro-Rata language for clarity. Public Customer priority has been in effect when the Size Pro-Rata execution

²⁸ See Notice, supra note 3 for examples illustrating the manner in which an LMM would be allocated contracts pursuant to the Size Pro-Rata model under the proposed rule change.

²⁹ See proposed Chapter VI, Section 10(1)(C)(1)(a).

algorithm has been in effect. This amendment to the Size Pro-Rata language would seek to clarify Public Customer priority with respect to that algorithm. The Public Customer priority overlay recognizes the unique status of customers in the marketplace and the role their orders play in price competition and adding depth to the marketplace.

The Exchange proposes that LMM participant entitlements may be in effect when the Public Customer Priority Overlay is also in effect. After all Public Customer orders have been fully executed, upon receipt of an order, provided the LMM's bid/offer is at the Exchange's disseminated price, the LMM would be afforded a participation entitlement.³⁰ The LMM would not be entitled to receive a number of contracts that is greater than the displayed size associated with such LMM. A BX Options LMM would receive the greater of: (a) contracts the LMM would receive if the allocation was based on time priority with Public Customer priority; (b) 50% of remaining interest if there is one or no other Market Maker at that price; (c) 40% of remaining interest if there are two other Market Makers at that price; or (d) 30% of remaining interest if there are more than two other Market Makers at that price or if rounding would result in an allocation of less than one contract, a BX Options LMM would receive one contract. Rounding would be up or down to the nearest integer.

Orders for 5 contracts or fewer would be allocated to the LMM. The Exchange would review this provision quarterly and would maintain the small order size at a level that would not allow orders of 5 contracts or fewer executed by the LMM to account for more than 40% of the volume executed on the Exchange.³¹

³⁰ Price Improving Orders will retain price priority before an LMM participation entitlement is provided at the Exchange's disseminated price. See Chapter VI, Sections 1(a)(6) and 7(b)(3)(B).

³¹ See Notice, supra note 3 for examples illustrating the manner in which an LMM would be allocated contracts pursuant to the Price/Time model under the proposed rule change.

The Exchange proposes to implement this proposed rule change by rolling out the rule amendments on an option-by-option basis over a period of time. The Exchange would issue Options Trader Alerts in advance to inform market participants of the timing of implementation of this proposed rule change for various symbols.

III. Commission Findings

After careful consideration, the Commission finds 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.³² The Commission believes that the proposal is consistent with Section 6(b)(5)³³ in particular in that it is 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 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.

A. BX Market Maker Quoting Obligations

BX proposes to reduce the quoting requirement for BX Options Market Makers so a Market Maker must quote the options in which it is registered 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 addition, this quoting obligation would apply to all of a Market Maker's registered options collectively on a daily basis. This quoting obligation would be reviewed on a monthly basis, and would allow the Exchange to review the Market Maker's daily compliance in the aggregate and determine the appropriate disciplinary action for single or

³² In approving this rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³³ 15 U.S.C. 78f(b)(5).

multiple failures to comply with the continuous quoting requirement during the month period.

The Commission notes that determining compliance with the continuous quoting requirement on a monthly basis would not relieve a Market Maker of the obligation to provide continuous two-sided quotes on a daily basis, nor would it prohibit the Exchange from taking disciplinary action against a Market Maker for failing to meet the continuous quoting obligation each trading day.

The Commission believes that the proposed changes to the quoting obligations of Market Makers are consistent with the Act. The Commission notes that the proposed changes to the quoting obligations of Market Makers are consistent with market maker obligations in place on other markets.³⁴

B. Lead Market Makers

The Exchange proposes to add a third type of Options Participant: an LMM. Each market maker who desires to be an LMM would be required to submit an application to the Exchange. In allocating an option series, the Exchange would consider a number of factors including but not limited to, the number and type of securities in which applicants are currently registered; the capital and other resources of the applicant; recent allocation decisions within the past eighteen months; the desirability of encouraging the entry of new LMMs into the Exchange's market; order flow commitments; any prior transfers of LMM privileges by the applicant and the reasons therefore; quality of markets data; and observance of ethical standards and administrative responsibilities and such policies as the Board instructs the Exchange to follow in allocating or reallocating securities.

With respect to an LMM's obligations, the Exchange would require LMMs to be subject to heightened standards as compared to other market makers. An LMM would be required to

³⁴ See NYSE Arca Rule 6.37B(c) and NYSE MKT Rule 925.1NY(c).

provide continuous two-sided quotations throughout the trading day in its appointed issues for 90% of the time the Exchange is open for trading in each issue. Such quotations would be required to meet legal quote width requirements. These obligations would apply to all of the LMM's appointed issues collectively, rather than on an option-by-option basis. Compliance with this obligation would be determined on a monthly basis.³⁵

In addition, an LMM's transactions would be required to constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market. An LMM would be required to engage in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between option contracts of the same class. An LMM would be required to: (1) to compete with other LMMs to improve the market in all series of options classes to which the LMM is appointed; (2) to make markets that will be honored for the number of contracts entered into the Trading System in all series of options classes within the LMM's appointment; (3) to update market quotations in response to changed market conditions in all series of options classes within the LMM's appointment; and (4) to quote with a difference not to exceed \$5 (or such other quote width difference established by BX Regulation) between the bid and offer regardless of the price of the bid.

³⁵ The Commission notes that, as is the case with market makers, determining compliance with the continuous quoting requirement on a monthly basis would not relieve an LMM of the obligation to provide continuous two-sided quotes on a daily basis, nor would it prohibit the Exchange from taking disciplinary action against an LMM for failing to meet the continuous quoting obligation each trading day.

Under the proposal, an LMM would be entitled to a participation guarantee, as described more fully in Section II.D above, if the LMM's bid/offer is at the Exchange's disseminated price and all Public Customer orders have been fully executed.

The Commission believes that the proposed rules regarding LMMs are consistent with the Act and raise no novel issues. The Commission notes that the proposed rules regarding LMMs are substantially similar to the rules of other exchanges.³⁶ The Commission also believes that the Exchange's proposed priority and allocation rules are consistent with the Act. The Commission has previously approved participation guarantees for LMMs, provided such LMM meets specified, higher quoting obligations.³⁷ The Commission believes that these guarantees strike a reasonable balance between rewarding certain participants for making markets and providing other market participants an incentive to quote aggressively.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the

³⁶ See e.g., NASDAQ OMX PHLX Rules 501, 505, 506 and 511 and NYSE Arca Rules 6.37A and 6.37B.

³⁷ See e.g., Rule 8.87 of the Chicago Board Options Exchange, Incorporated.

proposed rule change (SR-BX-2014-035), is hereby approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁸

Kevin M. O'Neill,
Deputy Secretary.

BILLING CODE 8011-01p

[FR Doc. 2014-20209 Filed 08/25/2014 at 8:45 am; Publication Date: 08/26/2014]

³⁸ 17 CFR 200.30-3(a)(12).