



**JONATHAN F. CAYNE**  
ASSOCIATE GENERAL COUNSEL  
805 KING FARM BLVD  
ROCKVILLE, MD 20850  
**P:** +1 301 978 8493  
**F:** +1 301 978 8472  
**E:** jonathan.cayne@nasdaqomx.com

April 24, 2013

**VIA E-MAIL AND FEDERAL EXPRESS**

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Re: Securities Exchange Act Release No. 34-69039; File No. SR-NASDAQ-2013-031

Dear Ms. Murphy:

NASDAQ OMX LLC (“NASDAQ” or “Exchange”) submits this letter in response to the comment letter dated March 11, 2013, submitted by the Securities Industry and Financial Markets Association (“SIFMA”) on the above-referenced proposed rule change filed by the Exchange (the “SIFMA Comment Letter”).<sup>1</sup> The Exchange is in substantial agreement with the recent comment response letter submitted by NYSE Euronext on behalf of NYSE and NYSE Market to the SIFMA Comment Letter.<sup>2</sup> As a result, NASDAQ’s comment response letter in large part reiterates these comment responses.

The proposed changes to NASDAQ Rule 4780, which established the Retail Price Improvement Program (the “Program”) as a pilot, would amend the attestation requirement of this rule to allow a Retail Member Organization (“RMO”) to attest that “substantially all” orders submitted to the Program will qualify as “Retail Orders.” The rule currently requires RMOs to attest that “any order” will so qualify, effectively preventing certain significant retail brokers from participating in the Program due to operational constraints.

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<sup>1</sup> Letter to the Commission from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA, dated March 11, 2013 (“SIFMA Comment Letter”). The SIFMA comment letter also addressed similar rule change proposals submitted by the New York Stock Exchange LLC (“NYSE”) and NYSE MKT, LLC (“NYSE MKT”) and the BATS-Y-Exchange, Inc. to their respective versions of the Program.

<sup>2</sup> See Letter to the Commission from Janet McGinness, Senior Vice President-Legal & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated April 2, 2013.

For the reasons set forth in this letter, NASDAQ does not believe that the arguments advanced in the SIFMA Comment Letter provide a basis for the Securities and Exchange Commission (“Commission”) to disapprove the proposed amendments to the Program.

**I. The Proposed Amendments are Intended to Remove a Significant Unintended Obstacle to Greater Participation by Retail Orders in the Program**

Several significant retail brokers, who are also SIFMA members, have informed the Exchange that limitations in order management systems and routing networks used by these firms may make it infeasible for them to be certain that 100% of the agency or riskless principal orders that they would direct to the Program qualify as “Retail Orders.” Because of the categorical nature of the current attestation requirement and the burdens associated with the systems changes required to satisfy this requirement, these firms have informed the Exchange that they have been unwilling to participate in the Program. The unwillingness of these firms to participate in the Program deprives all of their retail customers of the opportunity to benefit from the Program. These firms have also informed the Exchange that they believe the systems they use are sufficiently robust to enable them to attest, with a reasonable degree of confidence, that substantially all of the orders they would direct to the Program would qualify as “Retail Orders.” Therefore, adoption of a “substantially all” attestation requirement should enable significantly broader participation in an Exchange-sponsored program where retail investors’ orders are exposed for price improvement in a more competitive environment with greater transparency vis-à-vis broker-sponsored internalization venues.

In its comment letter, SIFMA states that the inability of some retail brokers to satisfy the current attestation requirement “is undermined by examples of situations in which broker dealers must strictly comply with definitions of ‘customers.’”<sup>3</sup> Although the Exchange does not have direct insight into the technology capabilities of a firm, as noted above, several retail brokers have informed the Exchange that the firms’ order flow is routed in aggregate for retail execution purposes and a *de minimis* amount of that order flow may have been generated electronically. Consequently, regardless of whether or not the order may have been initiated by a natural person, these firms are unable to attest that 100% of orders meet the strict definition of Retail Order without developing, testing and deploying new technology.

Furthermore, SIFMA’s reference to the definition of “customer” obscures rather than clarifies the question at issue here, which is the distinction between orders that originate with natural persons and those that do not. The point of limiting the Program to natural persons (and excluding orders generated by trading algorithms) is to allow retail

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<sup>3</sup> SIFMA Comment Letter at 5.

customers to benefit from the value that liquidity providers put on interacting with order flow that may be less correlated with short-term price movements. The distinction between public and professional customers in the options markets, by contrast, operates entirely differently. It is a volume-based threshold roughly designed to identify market participants with technological and informational sophistication. A Retail Order, however, is a higher hurdle to meet with regard to segmenting order flow than identifying between public and professional customers in the options industry.

More broadly, it is worth noting that internalization of customer options order flow away from exchanges is not permitted. Indeed, the Commission has uniformly required that the options internalization that occurs on an exchange occurs in an environment where multiple liquidity providers can compete to price improve the order. The Exchange would welcome any opportunity to discuss subjecting current off-exchange equity internalization processes to price competition mechanisms similar to those used to validate internalized transactions in the options markets. The Program, in an important sense, is just such a validation mechanism for exchange-sponsored competitive price improvement. In addition to confusing the issue at hand, therefore, SIFMA's reference to the options markets cuts precisely against their effort to restrict the Program.

## **II. The Proposed Changes do not Represent a Significant Change in the Scope of the Program**

SIFMA asserts that the Exchange's proposal would broaden the definition of "Retail Orders" to a degree "well beyond the scope that justified the original approval of the Program . . . ."<sup>4</sup> This is simply not the case. As stated in the rule proposal, if the amendment is approved, the Exchange intends to issue an Equity Trader Alert that will make clear that the "substantially all" language is meant to permit isolated and de minimis quantities of agency or riskless principal orders that do not qualify as Retail Orders but that cannot be segregated from Retail Orders due to systems limitations. Moreover, the Exchange notes that the "substantially all" language will not allow a significant number of orders that do not qualify as "Retail Orders" to participate in the Program. The proposed amendment is designed to accommodate system limitations at RMOs to segregate Retail Orders from de minimis quantities of other agency or riskless principal orders. An RMO's compliance with this requirement will be monitored as RMOs will need to retain, in their books and records, adequate substantiation that this requirement has been satisfied and the Financial Industry Regulatory Authority, Inc. ("FINRA") will, on behalf of the Exchange, review a member organization's compliance with these requirements.<sup>5</sup>

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<sup>4</sup> SIFMA Comment Letter at 4.

<sup>5</sup> See, e.g., Exchange Act Release No. 68747, 78 FR 7824, 7825 (February 4, 2013).

The Exchange also does not understand SIFMA's contention that moving to a "substantially all" standard will make it more difficult for the Exchange to effectively monitor compliance with the Program's Retail Order requirements.<sup>6</sup> It is simply counter-intuitive to suggest that a "substantially all" standard, which by its nature allows for a *de minimis* number of exceptions, is more difficult to monitor or enforce than an absolute standard, which permits no exceptions.

### **III. Competitive Forces will Act as an Additional Check on Non-Retail Participation in the Program**

The Commission has on several occasions noted that retail orders are generally considered to be more desirable by liquidity providers than those submitted by professional traders, whose orders are presumed on average to be more informed about short-term price movements.<sup>7</sup> To the extent that, notwithstanding the requirements and restrictions described above, a significant number of non-Retail Orders could be entered into the Program, Retail Liquidity Providers would become less willing to participate, thereby undermining the effectiveness of the Program in attracting a larger share of Retail Order flow.<sup>8</sup> Therefore, the Exchange, which operates in a highly competitive environment, will

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<sup>6</sup> See SIFMA Comment Letter at 6.

<sup>7</sup> See Exchange Act Release No. 67347 (July 3, 2012), 77 FR 40673 (July 10, 2012); see also Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594, 3606 n. 67 (January 21, 2010) (Concept Release on Equity Market Structure).

<sup>8</sup> In particular, the Exchange understands that liquidity providers utilize the average realized spread measurement to gauge the information content of orders they execute under the Program. In basic terms, average realized spread compares prices paid by a liquidity provider to the mid-point of the NBBO five minutes after the execution. In doing so, it serves as an indicator of the information content of the order with respect to short-term price movements. See Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75423-24 (December 1, 2000) ("The term 'average realized spread' . . . is calculated by comparing the execution price of an order with the midpoint of the consolidated BBO as it stands five minutes after the time of order execution . . . . [A]verage realized spread can measure the extent to which 'informed' and 'uninformed' orders are routed to different market centers . . . ."). To the extent that more than isolated and *de minimis* amounts of electronically generated orders somehow were included in the Program despite the protections and monitoring described above, the average realized spread measurement would likely reflect that inclusion and act as a disincentive for liquidity providers to participate in the Program. The Exchange's interest, in other words, are aligned directly with its stated intention to monitor

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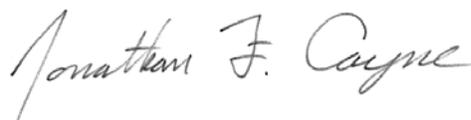
have powerful incentives to minimize the ability of non-Retail orders to participate in the Program in order to maximize the likelihood that the Program can achieve its stated objective of attracting additional retail order flow to the Exchange.

Further, the Program is designed to attract retail order flow to the Exchange by replicating and enhancing the current practices of broker-dealers that internalize much of the market's retail order flow. The execution of retail orders today occurs in a largely segmented environment.<sup>9</sup> Broker-dealers do not compete for these orders by offering aggressive prices, but rather through bilateral internalization arrangements. The Program offers a competitive alternative to segmentation and internalization, and the "substantially all" standard, together with the policies and procedures of the Program, offer an exchange-sponsored and more transparent alternative than what is available in broker-sponsored internalization venues. It is worth noting that this very discussion of the details of the Program is itself a direct reflection of the heightened obligation of exchanges to be commercially and operationally transparent with their members. No such debate would be occurring if an ATS or broker-dealer/internalizer was implementing a similar change.

#### **IV. Conclusion**

For the reasons set forth above, the Exchange does not believe that the SIFMA Comment Letter has identified any concerns that would support disapproving the proposed amendments. The Exchange therefore respectfully requests that the Commission approve the proposed amendments.

Sincerely,



Jonathan F. Cayne  
Associate General Counsel

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compliance with the "substantially all" requirement.

<sup>9</sup> See Letter to the Commission from Janet McGinness, Senior Vice President-Legal & Corporate Secretary, Legal & Government Affairs, NYSE Euronext, dated April 10, 2012.