

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-69233; File No. SR-NASDAQ-2013-028)

March 25, 2013

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Approving a Proposed Rule Change for the Permanent Approval of a Pilot Program to Permit NASDAQ to Accept Inbound Orders Routed by NASDAQ Execution Services LLC from the BX Equities Market and PSX

I. Introduction

On February 6, 2013, 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 requesting permanent approval of the Exchange’s pilot program that permits the Exchange to accept inbound orders routed by NASDAQ Execution Services LLC (“NES”) from the NASDAQ OMX BX Equities Market of NASDAQ OMX BX, Inc. (“BX”) and the NASDAQ OMX PSX facility (“PSX”) of NASDAQ OMX PHLX LLC (“PHLX”). The proposed rule change was published for comment in the Federal Register on February 14, 2013.<sup>3</sup> The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Background

NASDAQ Rule 2160(a) prohibits the Exchange or any entity with which it is affiliated from, directly or indirectly, acquiring or maintaining an ownership interest in, or engaging in a business venture with, an Exchange member or an affiliate of an Exchange member in the

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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> See Securities Exchange Act Release No. 68891 (February 8, 2013), 78 FR 10670 (“Notice”).

absence of an effective filing under Section 19(b) of the Act.<sup>4</sup> NES is a registered broker-dealer that is a member of the Exchange, and currently provides to members of the Exchange optional routing services to other markets.<sup>5</sup> NES is owned by NASDAQ OMX Group, Inc. (“NASDAQ OMX”), which also owns three registered securities exchanges – the Exchange, BX, and PHLX.<sup>6</sup> Thus, NES is an affiliate of these exchanges.<sup>7</sup> Absent an effective filing, NASDAQ Rule 2160(a) would prohibit NES from being a member of the Exchange.

On October 6, 2011, the Exchange filed a proposed rule change for NASDAQ to accept inbound orders routed from the NASDAQ OMX BX Equities Market of BX and PSX on a pilot basis subject to certain limitations and conditions.<sup>8</sup> On February 6, 2013, the Exchange filed the instant proposal to allow the Exchange to accept such orders routed inbound by NES from BX

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<sup>4</sup> 15 U.S.C. 78s(b). NASDAQ Rule 2160 also prohibits a NASDAQ member from being or becoming an affiliate of NASDAQ, or an affiliate of an entity affiliated with NASDAQ, in the absence of an effective filing under Section 19(b). See NASDAQ Rule 2160(a)(2).

<sup>5</sup> See NASDAQ Rule 4758. See also Notice, supra note 3, 10670.

<sup>6</sup> See Securities Exchange Act Release No. 58324 (August 7, 2008), 73 FR 46936 (August 12, 2008) (SR-BSE-2008-02; SR-BSE-2008-23; SR-BSE-2008-25; SR-BSECC-2008-01) (order approving NASDAQ OMX’s acquisition of BX) (“BX Acquisition Order”); Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (SR-Phlx-2008-31) (order approving NASDAQ OMX’s acquisition of PHLX) (“PHLX Acquisition Order”).

<sup>7</sup> See id. See also Notice, supra note 3, at 10670; and Securities Exchange Act No. 59153 (December 23, 2008), 73 FR 80485 (December 31, 2008) (SR-NASDAQ-2008-098). On September 7, 2007, NASDAQ filed a proposed rule change codifying the function of NES. See Securities Exchange Release No. 56708 (October 26, 2007), 72 FR 61925 (November 1, 2011) (SR-NASDAQ-2007-078).

<sup>8</sup> See Securities Exchange Act Release No. 65554 (October 13, 2011), 76 FR 65311 (October 20, 2011) (SR-NASDAQ-2011-142) (notice of proposed rule change to allow NASDAQ to accept inbound orders from the NASDAQ OMX BX Equities Market of BX and PSX on a one-year pilot basis). See also, Securities Exchange Act Release No. 67997 (October 5, 2012), 77 FR 62293 (October 12, 2012) (extending one-year pilot for an additional six-month period).

and PSX on a permanent basis subject to certain limitations and conditions.<sup>9</sup>

### III. Discussion and Commission Findings

After careful review, 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.<sup>10</sup> Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(1) of the Act,<sup>11</sup> which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulation thereunder, and the rules of the Exchange. Further, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>12</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, and processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

Recognizing that the Commission has previously expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange

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<sup>9</sup> See Notice, supra note 3.

<sup>10</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78f(b)(1).

<sup>12</sup> 15 U.S.C. 78f(b)(5).

of which it is a member, the Exchange previously proposed, and the Commission approved, limitations and conditions on NES's affiliation with the Exchange.<sup>13</sup> Also recognizing that the Commission has expressed concern regarding the potential for conflicts of interest in instances where a member firm is affiliated with an exchange to which it is routing orders, the Exchange previously implemented limitations and conditions to NES's affiliation with the Exchange to permit the Exchange to accept inbound orders that NES routes in its capacity as a facility of BX and PHLX on a pilot basis.<sup>14</sup> The Exchange has proposed to permit NASDAQ to accept inbound orders that NES routes in its capacity as a facility of BX and PHLX on a permanent basis, subject to the same limitations and conditions of this pilot:

- First, the Exchange and the Financial Industry Regulatory Authority ("FINRA") will maintain a Regulatory Contract, as well as an agreement pursuant to Rule 17d-2 under the Act ("17d-2 Agreement").<sup>15</sup> Pursuant to the Regulatory Contract and the 17d-2 Agreement, FINRA will be allocated regulatory responsibilities to review NES's compliance with certain NASDAQ rules.<sup>16</sup> Pursuant to the Regulatory Contract, however, the Exchange retains ultimate responsibility for enforcing its rules with respect to NES.
- Second, FINRA will monitor NES for compliance with NASDAQ's trading rules, and will collect and maintain certain related information.<sup>17</sup>

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<sup>13</sup> See supra, note 7, 73 FR at 80486. See also Notice, supra note 3, at 10670 n.8 and accompanying text.

<sup>14</sup> See Notice, supra note 3, at 10670.

<sup>15</sup> 17 CFR 240.17d-2.

<sup>18</sup> NES is also subject to independent oversight by FINRA, its designated examining authority, for compliance with financial responsibility requirements.

<sup>19</sup> Pursuant to the Regulatory Contract, both FINRA and the Exchange will collect and maintain all alerts, complaints, investigations and enforcement actions in which NES (in

- Third, FINRA will provide a report to the Exchange’s chief regulatory officer (“CRO”), on a quarterly basis, that: (i) quantifies all alerts (of which the Exchange or FINRA is aware) that identify NES as a participant that has potentially violated Commission or Exchange rules, and (ii) lists all investigations that identify NES as a participant that has potentially violated Commission or NASDAQ rules.
- Fourth, the Exchange has in place NASDAQ Rule 2160(c), which requires NASDAQ OMX, as the holding company owning both the Exchange and NES, to establish and maintain procedures and internal controls reasonably designed to ensure that NES does not develop or implement changes to its system, based on non-public information obtained regarding planned changes to the Exchange’s systems as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members, in connection with the provision of inbound order routing to the Exchange.

The Exchange stated that it has met all the above-listed conditions. By meeting such conditions, the Exchange believes that it has set up mechanisms that protect the independence of the Exchange’s regulatory responsibility with respect to NES, and has demonstrated that NES cannot use any information advantage it may have because of its affiliation with the Exchange.<sup>18</sup> In the past, the Commission has expressed concern that the affiliation of an exchange with one of its members raises potential conflicts of interest, and the potential for unfair competitive

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its capacity as a facility of BX and PHLX routing orders to the Exchange) is identified as a participant that has potentially violated applicable Commission or Exchange rules. The Exchange and FINRA will retain these records in an easily accessible manner in order to facilitate any potential review conducted by the Commission’s Office of Compliance Inspections and Examinations. See Notice, supra note 3, at 10670 n.11.

<sup>18</sup> See Notice, supra note 3, at 10671.

advantage.<sup>19</sup> Although the Commission continues to be concerned about potential unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interest when the exchange is affiliated with one of its members, for the reasons discussed below, the Commission believes that it is consistent with the Act to permit NES, in its capacity as a facility of BX and PHLX, to route orders inbound to the Exchange on a permanent basis instead of a pilot basis, subject to the limitations and conditions described above.<sup>20</sup>

The Exchange has proposed four ongoing conditions applicable to NES's routing activities, which are enumerated above. The Commission believes that these conditions will mitigate its concerns about potential conflicts of interest and unfair competitive advantage. In

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<sup>19</sup> See, e.g., Securities Exchange Act Release Nos. 54170 (July 18, 2006), 71 FR 42149 (July 25, 2006) (SR-NASDAQ-2006-006) (order approving NASDAQ's proposal to adopt NASDAQ Rule 2140, restricting affiliations between NASDAQ and its members); 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (order approving the combination of the New York Stock Exchange, Inc. and Archipelago Holdings, Inc.); 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008) (SR-Amex-2008-62 and SR-NYSE-2008-60) (order approving the combination of NYSE Euronext and the American Stock Exchange LLC); 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) (SR-ISE-2009-85) (order approving the purchase by ISE Holdings of an ownership interest in Direct Edge Holdings LLC); 59281 (January 22, 2009), 74 FR 5014 (January 28, 2009) (SR-NYSE-2008-120) (order approving a joint venture between NYSE and BIDS Holdings L.P.); 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (File No. 10-182) (order granting the exchange registration of BATS Exchange, Inc.); 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (File Nos. 10-194 and 10-196) (order granting the exchange registration of EDGX Exchange, Inc. and EDGA Exchange, Inc.); and 62716 (August 13, 2010), 75 FR 51295 (August 19, 2010) (File No. 10-198) (order granting the exchange registration of BATS-Y Exchange, Inc.).

<sup>20</sup> The Commission notes that these limitations and conditions are consistent with those previously approved by the Commission for other exchanges. See, e.g., Securities Exchange Act Release Nos. 67256 (June 26, 2012) 77 FR 39277 (July 2, 2012) (SR-BX-2012-030); and 64090 (March 17, 2011), 76 FR 16462 (March 23, 2011) (SR-BX-2011-007).

particular, the Commission believes that FINRA's oversight of NES,<sup>21</sup> combined with FINRA's monitoring of NES's compliance with the Exchange's rules and quarterly reporting to the Exchange, will help to protect the independence of the Exchange's regulatory responsibilities with respect to NES. The Commission also believes that the Exchange's Rule 2160 is designed to ensure that NES cannot use any information advantage it may have because of its affiliation with the Exchange.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>22</sup> that the proposed rule change (SR-NASDAQ-2013-028) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>23</sup>

Elizabeth M. Murphy  
Secretary

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<sup>21</sup> This oversight will be accomplished through the 17d-2 Agreement between FINRA and the Exchange and the Regulatory Contract. See Notice, supra note 3, at 10670 n.10 and accompanying text.

<sup>22</sup> 15 U.S.C. 78s(b)(2).

<sup>23</sup> 17 CFR 200.30-3(a)(12).