

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-76718; File No. SR-NASDAQ-2015-112)

December 21, 2105

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Approving a Proposed Rule Change to Amend Rule 4758

I. Introduction

On September 21, 2015, The NASDAQ Stock Market LLC (“NASDAQ” or “Exchange”) 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 adopt a new routing option, the Retail Order Process (“RTFY”). The proposed rule change was published for comment in the Federal Register on October 1, 2015.³ The Commission received two comment letters on the proposed rule change⁴ and a response letter from NASDAQ.⁵ On November 3, 2015, the Commission extended the time period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change, to December 30, 2015.⁶ NASDAQ subsequently submitted a second response letter.⁷ This order approves the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 75987 (September 25, 2015), 80 FR 59210 (“Notice”).

⁴ See letter from Joseph Saluzzi, Themis Trading LLC to the Commission, dated September 29, 2015 (“Themis Letter”); and letter from Suzanne Shatto to the Commission, dated October 6, 2015 (“Shatto Letter”).

⁵ See letter from Jonathan F. Cayne, Senior Associate General Counsel, NASDAQ to Brent J. Fields, Secretary, Commission, dated October 22, 2015 (“NASDAQ Response”).

⁶ See Securities Exchange Act Release No. 76335, 80 FR 69256 (November 9, 2015).

⁷ See letter from Jonathan F. Cayne, Senior Associate General Counsel, NASDAQ to Brent J. Fields, Secretary, Commission, dated December 11, 2015 (“NASDAQ Supplemental Response”).

proposed rule change.

II. Description of the Proposal

NASDAQ is proposing to amend Rule 4758 to add a new order routing option – RTFY – for Designated Retail Orders (“DROs”).⁸ NASDAQ states that retail order firms⁹ often send non-marketable order flow to post and display on exchanges. However, some orders that have been deemed to be non-marketable by the entering firm become marketable by the time the exchange receives them.¹⁰ NASDAQ notes that these orders ultimately remove liquidity from the NASDAQ order book even though the firm entering the order did not intend them to remove liquidity.¹¹

Under the proposal, a DRO that is marketable upon receipt by NASDAQ and that elects to follow the RTFY routing option will be routed to destinations in the System routing table instead of immediately removing liquidity from the Exchange order book – unless explicitly

⁸ A Designated Retail Order is an agency or riskless principal order that meets the criteria of FINRA Rule 5320.03 and that originates from a natural person and is submitted to NASDAQ by a member that designates it pursuant to Rule 7018, provided that no change is made to the terms of the order with respect to price or side of market and the order does not originate from a trading algorithm or any other computerized methodology. An order from a “natural person” can include orders on behalf of accounts that are held in a corporate legal form – such as an Individual Retirement Account, Corporation, or a Limited Liability Company – that has been established for the benefit of an individual or group of related family members, provided that the order is submitted by an individual. Members must submit a signed written attestation, in a form prescribed by NASDAQ, that they have implemented policies and procedures that are reasonably designed to ensure that substantially all orders designated by the member as DROs comply with these requirements. Orders may be designated on an order-by-order basis, or by designating all orders on a particular order entry port as DROs. See NASDAQ Rule 7018.

⁹ The term “retail order firms” refers to NASDAQ member firms that provide orders that qualify as Designated Retail Orders under NASDAQ Rule 7018.

¹⁰ See Notice, 80 FR at 59210.

¹¹ See id.

instructed by the entering party to check the Exchange order book first.¹² RTFY orders may remove liquidity from the Exchange book after routing to other destinations.¹³ All non-marketable RTFY orders will post on the Exchange book.¹⁴

According to NASDAQ, the destinations in the System routing table for RTFY will include OTC market makers,¹⁵ which may also be registered NASDAQ market makers.¹⁶ NASDAQ believes these market makers will likely provide the greatest opportunity for price improvement for the DROs, and the RTFY routing option will benefit DROs by providing additional price improvement opportunities for retail investors.¹⁷ NASDAQ anticipates that the RTFY routing option will route to trading centers in the System routing table that have experience executing and providing price improvement to DROs.¹⁸

¹² See id. The term “System routing table” refers to the proprietary process for determining the specific trading venues to which the System routes orders and the order in which it routes them. NASDAQ reserves the right to maintain a different System routing table for different routing options and to modify the System routing table at any time without notice. See NASDAQ Rule 4758(a)(1)(A).

¹³ See Notice, 80 FR at 59210.

¹⁴ If a RTFY order is posted on the Exchange, either because it was non-marketable when it was received or it has exhausted all available liquidity within its limit price – including on the Exchange, Regulation NMS protected quotations and other destinations in the System routing table – and the order is subsequently locked or crossed by another market center, the System will not route to the locking or crossing market center. See id.

¹⁵ An “OTC market maker” in a stock is defined in Rule 600(b)(52) of Regulation NMS as, in general, a dealer that holds itself out as willing to buy and sell the stock, otherwise than on a national securities exchange, in amounts of less than block size (less than 10,000 shares).

¹⁶ See Notice, 80 FR at 59210.

¹⁷ See id. NASDAQ believes that, because retail orders are generally smaller on average, they are often able to receive better prices than the prevailing national best bid and offer. See id. at 59211. NASDAQ believes that this is achieved by retail order firms sending their orders to OTC market makers that provide some level of price improvement. See id.

¹⁸ See id. NASDAQ believes that approximately 96% of the DROs that will use the RTFY routing option will not be marketable and will add liquidity on the Exchange, while the

As proposed, an order using the RTFY routing option will be sent to the primary listing exchange for opening, reopening, and closing auctions.¹⁹ Orders received in non-NASDAQ listed securities prior to market open that are not eligible for the pre-market session will be submitted to the primary listing market for inclusion in that market's opening process.²⁰ Orders received in NASDAQ-listed securities prior to market open that are not eligible for the pre-market session will follow normal pre-market processing.²¹ Orders received prior to the market open that are eligible for the pre-market session will be posted – and routed if marketable – for potential execution.²² Approximately two minutes prior to market open, active pre-market session orders in the Exchange's possession will be routed to the primary listing exchange.²³ When a security that is listed on an exchange other than NASDAQ is halted, RTFY orders – including RTFY orders received during the halt – will be sent to the primary listing exchange for inclusion in that exchange's reopening process.²⁴ All RTFY orders will be sent to the primary listing exchange approximately two minutes prior to that exchange's closing process.²⁵

In its proposal, NASDAQ notes that the RTFY routing option is similar to the existing TFTY routing option.²⁶ NASDAQ specifically notes that orders using the TFTY routing option

remainder will be routed to destinations on the System routing table for potential price improvement, including to OTC market makers. See id.

¹⁹ See id.

²⁰ See id.

²¹ See id. and NASDAQ Rule 4752.

²² See Notice, 80 FR at 59211.

²³ See id.

²⁴ See id.

²⁵ See id.

²⁶ See NASDAQ Rule 4758(a)(1)(A)(v). NASDAQ further notes that RFTY is also similar to BATS' TRIM routing option, under which an order checks the BATS system for

do not check the NASDAQ book – unless so instructed by the entering firm – for available shares, and instead route to the TFTY destinations on the System routing table with the goal of executing with lower transaction fees.²⁷ NASDAQ states that the RTFY routing option differs from TFTY in three ways: (i) RTFY is only available to DROs; (ii) RTFY uses a separate and distinct routing table; and (iii) RTFY orders will be sent to the primary listing exchange for opening, reopening, and closing auctions.²⁸

NASDAQ notes that there are several alternatives to using an Exchange routing strategy.²⁹ NASDAQ also notes that it offers multiple routing options, that each routing option has its own set of strengths and trade-offs, and that these varying routing strategies are designed to meet varying market participants’ needs.³⁰ NASDAQ believes the RTFY routing option will meet the needs of the retail order firms that opt to use it based on their routing technology, business model, or level of retail order flow.³¹

NASDAQ states that the RTFY routing table will be monitored and approved by a best execution committee (“Committee”).³² NASDAQ states that the Committee determines how to organize the System routing table and which trading destinations are included in the routing table

available shares only if so instructed by the entering firm and then is sent to destinations on the system routing table. See Notice, 80 FR at 59211.

²⁷ See Notice, 80 FR at 59210.

²⁸ See id. at 59211.

²⁹ See id. For example, the Exchange notes that broker-dealers and vendors provide customized routing strategies and order execution algorithms, order flow firms may choose to make their own routing decisions based on proprietary routing processes, and retail order firms may use other firms to enhance their routing capabilities. See id.

³⁰ See id.

³¹ See id.

³² See id. at 59212. The Exchange states that the Committee consists of several internal NASDAQ participants representing product management, internal audit, economic research, broker-dealer compliance, and market operations. See id.

by reviewing various parameters, such as price improvement, fill rate, latency, interaction rate, experience of the execution venue operator, and the volume the execution venue handles on a daily basis.³³ NASDAQ notes that the parameters considered by the Committee evolve over time; often resulting in new parameters being considered.³⁴

NASDAQ states that neither the Exchange, nor any of its affiliates, will accept payment for order flow from any OTC market maker to which an RTFY order is sent.³⁵ If the trading venue pays a standard rebate for DROs to all of its subscribers or another exchange pays a rebate to remove liquidity, NASDAQ will accept and retain those rebates.³⁶ However, NASDAQ expects that most, if not all, orders routed using the RTFY routing option will be sent to and executed by an OTC market maker that may also be a registered NASDAQ market maker.³⁷

III. Comment Summary 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.³⁸ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,³⁹ 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 remove impediments to and perfect

³³ See id.

³⁴ See id.

³⁵ See id.

³⁶ See id.

³⁷ See id.

³⁸ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³⁹ 15 U.S.C. 78f(b)(5).

the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission received two comment letters opposing the proposal, as well as a response and a supplemental response from NASDAQ.⁴⁰

The commenters express concern that RFTY is designed to allow leakage of order flow information.⁴¹ The Commission notes that, in response, NASDAQ states that this claim is factually incorrect and is speculation.⁴² NASDAQ reiterates that RFTY is designed to enhance execution quality and benefit retail investors by providing price improvement opportunities to retail order flow.⁴³ According to NASDAQ, it will use the Committee to review and determine the structure and destinations of the System routing table, and if the Committee observes that a particular destination is not providing sufficient price improvement, the destination will have to improve or be dropped from the System routing table.⁴⁴ NASDAQ also notes that RFTY is a voluntary routing type, and retail orders firms can elect not to use RFTY if it fails to benefit their clients.⁴⁵ Moreover, NASDAQ notes that retail investors have a choice when routing their orders and it is up to them to determine whether they will use a broker-provided router or send their orders directly to a particular destination.⁴⁶

The commenters also express concerns related to best execution. Specifically, one commenter questions whether retail investors will forgo their marketable orders interacting with

⁴⁰ See supra notes 4, 5, and 7.

⁴¹ See Themis Letter and Shatto Letter, supra note 4.

⁴² See NASDAQ Response, supra note 5, at 2.

⁴³ See id.

⁴⁴ See id.

⁴⁵ See id.

⁴⁶ See id. at 4.

the NBBO at NASDAQ for “meaningless” price improvement at OTC market makers.⁴⁷ This commenter expresses concern that RTFY could result in a failure to obtain best execution, specifically in situations where NASDAQ was at the NBBO when a marketable retail order that has elected the RTFY routing option was received, NASDAQ routes the marketable retail order away but the order does not execute on the away destinations, and by the time the order comes back to NASDAQ, the NBBO has moved so that the retail order is no longer marketable and posts to the book instead of executing.⁴⁸ In addition, both commenters express concerns regarding the transparency of the RTFY routing table and the effectiveness of the Committee.⁴⁹

In response, NASDAQ states its belief that providing additional price improvement opportunities for retail investors is a “critical component of its best execution obligations.”⁵⁰ In its supplemental response letter, NASDAQ states that, in all routing of orders, when one routing destination is chosen over another, there is always a possibility that an execution will be missed.⁵¹ The Commission notes, however, that NASDAQ believes that any chance of an RTFY order missing a better price at the Exchange is “miniscule.”⁵² The Commission notes that, according to NASDAQ, some routing destinations agree to a guaranteed minimum price improvement per share for RTFY orders, some focus more on the average price improvement, and others are unsure of what the level of price improvement will be, but provide assurances that

⁴⁷ See Themis Letter, supra note 4.

⁴⁸ See id.

⁴⁹ See Themis Letter and Shatto Letter, supra note 4.

⁵⁰ See NASDAQ Response, supra note 5, at 4. Moreover, NASDAQ reiterates that it will not accept any negotiated payment for order flow. See NASDAQ Supplemental Response, supra note 7, at 1-2.

⁵¹ See NASDAQ Supplemental Response, supra note 7, at 2.

⁵² See id. at 3.

they will compete vigorously with their execution quality.⁵³ Consequently, NASDAQ believes that the competition for RTFY orders, and thus the resulting execution quality, will be better than what is experienced today.⁵⁴

The Commission notes that, with respect to commenters' concerns regarding the RTFY routing table and the Committee, NASDAQ states that – as with all other routing options, other than Directed Orders – the RTFY routing table will be monitored and approved by the Committee.⁵⁵ According to NASDAQ, the use of a best execution committee is not novel, and such committees are widely-used at many broker-dealers.⁵⁶ In addition, the Committee is subject to FINRA oversight, as well as oversight by NASDAQ Inc.'s internal audit group, which reports to the audit committee of the Board of Directors of NASDAQ Inc.⁵⁷ According to NASDAQ, the Committee reviews the performance of routing destinations on a regular basis for all routing and the same will be true for RTFY.⁵⁸ If the Committee determines that a particular routing destination is underperforming based on the various parameters, such as price improvement, fill rate, and latency, the Committee may either remove that destination altogether or lower its priority within the routing table.⁵⁹ According to NASDAQ, this process ensures that these

⁵³ See id. at 2.

⁵⁴ See id.

⁵⁵ See NASDAQ Response, supra note 5, at 3. NASDAQ notes that many factors are weighed when making best execution determinations, and that price improvement opportunities for retail investors are an “integral component of such decisions by both the Committee and by retail order firms.” See id.

⁵⁶ See id.

⁵⁷ See id. at 3-4.

⁵⁸ See NASDAQ Supplemental Response, supra note 7, at 2.

⁵⁹ See id. NASDAQ notes that missed executions often may be due to latency in away destinations systems. See id. at 3. According to NASDAQ, because latency is one of the parameters that the Committee considers in its regular reviews of routing destinations, destinations causing undue latency that may lead to missed executions or inferior

destinations will compete aggressively with each other in order to receive RTFY orders.⁶⁰

Based on the foregoing, the Commission believes that the proposed rule change is consistent with the Act.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁶¹ that the proposed rule change (SR-NASDAQ-2015-112) be and hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁶²

Brent J. Fields
Secretary

execution prices would lose their priority within the routing table or be removed altogether. See id. NASDAQ also notes that, if the Committee determines that a particular routing destination is not providing sufficient price improvement opportunities, then that destination will likely be removed from the RTFY routing table. See NASDAQ Response, supra note 5, at 4.

⁶⁰ See NASDAQ Supplemental Response, supra note 7, at 2. NASDAQ states that, in the past, the Committee has moved venues down within the routing table due, in part, to unsatisfactory fill rate, unsatisfactory price improvement, and/or unsatisfactory latency profile. See id.

⁶¹ 15 U.S.C. 78s(b)(2).

⁶² 17 CFR 200.30-3(a)(12).